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# States in the Global Economy

Bringing domestic institutions  
back in

*Edited by*

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# Contents

<i>List of figures</i>	page ix
<i>List of tables</i>	x
<i>List of contributors</i>	xi
<i>Preface</i>	xiii
1 Introduction: bringing domestic institutions back in <i>Linda Weiss</i>	  1
 <b>Part I: The resilience of welfare states</b>	
2 Disappearing taxes or the 'race to the middle'? Fiscal policy in the OECD <i>John M. Hobson</i>	 37
3 Withering welfare? Globalisation, political economic institutions, and contemporary welfare states <i>Duane Swank</i>	 58
4 Globalisation and social security expansion in East Asia <i>M. Ramesh</i>	 83
 <b>Part II: New economic challenges, changing state capacities</b>	
5 France: a new 'capitalism of voice'? <i>Michael Loriaux</i>	 101
6 The challenges of economic upgrading in liberalising Thailand <i>Richard F. Doner and Ansil Ramsay</i>	 121

7	Building institutional capacity for China's new economic opening <i>Tianbiao Zhu</i>	142
8	New regimes, new capacities: the politics of telecommunications nationalisation and liberalisation <i>David Levi-Faur</i>	161
9	Ideas, institutions, and interests in the shaping of telecommunications reform: Japan and the US <i>Mark Tilton</i>	180
10	Diverse paths towards 'the right institutions': law, the state, and economic reform in East Asia <i>Meredith Woo-Cumings</i>	200
 <b>Part III: Governing globalisation</b>		
11	Managing openness in India: the social construction of a globalist narrative <i>Jalal Alamgir</i>	225
12	Guiding globalisation in East Asia: new roles for old developmental states <i>Linda Weiss</i>	245
13	Governing global finance: financial derivatives, liberal states, and transformative capacity <i>William D. Coleman</i>	271
14	Is the state being 'transformed' by globalisation? <i>Linda Weiss</i>	293
	 <i>List of references</i>	 318
	<i>Index</i>	346

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# Figures

1.1	The logics of globalisation, domestic institutions, and state responses	<i>page 6</i>
2.1	Aggregate tax and expenditure burdens (OECD average), 1965–99	40
2.2	Direct and indirect tax burdens, 1965–97	42
2.3	Capital and labour tax burdens, 1965–97	45
2.4	Corporate income tax, 1965–97	46
2.5	National differentials in tax regimes, 1965–97	49
7.1	Government revenue, expenditure, and investment, 1978–89	148
7.2	Economic growth and inflation, 1992–99	152
7.3	Central government's share of total revenue and expenditure	153
7.4	Profit rates of SOEs, LMEs, and COEs	157
8.1	The diffusion of nationalisation	165
8.2	The diffusion of liberalisation	170

---

# Tables

2.1	Aggregate tax and expenditure burdens	<i>page</i> 40
2.2	Direct and indirect tax burdens	42
2.3	The tax burdens of capital and labour	44
2.4	Corporate income tax burdens	46
2.5	National differentials in tax regimes	48
2.6	Corporate income tax burdens in countries with very high dependence on FDI inflows	50
3.1	Welfare state, political, and economic institutions: annual country averages, 1980–95	62
3.2	Principal components analysis for national political economic institutions, 1973–94	64
3.3	Change and continuity in developed welfare states, 1980–95	70
3.4	The social welfare effects of international capital mobility across nationally coordinated, sector coordinated, and uncoordinated market economic institutions, 1973–95	77
4.1	Government expenditure on health and income maintenance as per cent of GDP	87

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# 1 Introduction: bringing domestic institutions back in

*Linda Weiss*

An issue of central importance in the globalisation debate today concerns the impact of increasing economic openness upon the state's capacity to govern the national economy. As participants in that debate, we seek answers to the big questions, such as whether, in a world of highly mobile capital, states – as territorially centred authorities – are still vital to the social and economic well-being of their citizens. We want to know what, if anything, states can do to promote wealth creation and social protection in an era of economic interdependence. And we want to know whether countries which travel the path of international economic openness must necessarily abandon their distinctive institutions (and embrace the norms, arrangements, and policies of competitive liberalism).

These are not idle questions. The reason we are asking such questions so insistently at the turn of the century has much to do with the widespread changes going on both inside and outside the nation-state – ranging from welfare reforms, through financial liberalisation, to the proliferation of intergovernmental agreements.

These organisational and regulatory reforms appear to be coinciding with other changes taking place in the structure of the international political economy – in particular, the multinationalisation of production and the growth of so-called 'footloose' business corporations, as well as the astonishing increase and speed of cross-border capital flows. So the assumption frequently made is that these two sets of changes must be intimately related, that the state's actions (or inactions) – from fiscal conservatism and deregulation to welfare restructuring – can be explained readily as a response of besieged or hapless governments to global flows and similar pressures of openness and interdependence.

This is why much of the discussion being conducted today about globalisation's alleged impact on the state evokes that well-told tale about a drunken fellow who loses his keys in a dark place and then goes over by the light in order to search for them. 'What are you doing?' asks a passing stranger. 'Well', replies the inebriate, 'I won't get very far searching for my keys in the dark place, so I'm looking over here where the light is brighter.'

Domestic institutions are a bit like the 'dark place' in the globalisation debate. Challenges coming from the global arena are well illuminated. But there is correspondingly little sense of how national authorities are managing the challenges of openness. Indeed, a good many of the participants in the globalisation-national governance debate, somewhat like the drunken figure, have been reeling from the many changes to the domestic and international environments and, like that figure, they have been searching over by the light of globalisation for clues as to what it all means.

The result is a story that is being told largely in terms of one-way traffic. That is to say that most thinking about the changes going on at the domestic level has been oriented towards the global arena because that is where most light is directed, with global actors and markets always seen to be 'constraining' national governance, and states either responding ineffectually, or else retreating more and more from economic management.

In the standard tale, then, globalisation is very much a 'top-down' affair, understood as a series of constraints that economic openness places on the viability and effectiveness of particular national policies – macroeconomic, fiscal, social, and industrial. Globalisation is seen to be intrinsically constraining because openness involves the fall of national barriers to trade, investment, and financial flows, exposure to increasing capital mobility (via the multinationalisation of production and growth of global financial markets), and also conformity with intergovernmental agreements requiring, for example, that governments open their markets to foreign trade and financial institutions as well as eliminating certain subsidies to industry.

Openness is therefore seen to constrain and limit severely what governments can do across a range of policy areas. Globalisation analysts propose that economic openness not only drastically reduces scope for expansionary fiscal and social protection strategies, but that it also renders unviable a host of trade, financial, and industrial policies supporting national wealth creation, since these would conflict with

international agreements. Such are the conclusions of the more 'moderate' globalists<sup>1</sup> who differentiate themselves from those who posit the end of the nation-state (Ohmae 1990; Horsman and Marshall 1994), the so-called 'hyper-globalists'. Since few scholars of the international political economy seriously hold to the minority view of the hyper-globalisers, we waste little time in that direction, turning our attention instead to the claims of the more moderate majority (hereafter, the 'constraints school').

In the language deployed by the constraints school, the state is changing and the changes are not generally reinforcing or strengthening its capacities, its autonomy, or control. On the contrary, according to this influential view, state powers are being severely 'constrained', and ultimately 'transformed'. To 'constrain', according to the dictionary, means 'to compel'; 'to force or produce in an unnatural or strained manner'; 'to confine'; 'to hold back by force'. This constraints view of globalisation has many adherents, and although they disagree about many things, they are united in the view that changes in the international political economy have radically restricted policy choice and forced policy shifts that play to the preferences of global investors and mobile corporations, rather than to the needs of the domestic political economy and its citizenry.<sup>2</sup>

Proponents of the constrained state thesis thus advance strong claims about how much political autonomy states have lost (compared with some usually unspecified previous era); about how restricted are their policy choices; and ultimately about how little states can do to provide decent social protection and promote wealth creation. From this perspective, managing the national economy to promote growth, industrial upgrading, and employment – whether by maintaining or raising taxation and spending levels, coordinating an investment strategy, encouraging industrial upgrading, or supporting technological innovation, and so on – are nowadays seen to be increasingly beyond the capacities of territorially centred states.

Moreover, this view of the 'constrained state' is often accompanied by another claim about the 'erosion of national capitalisms'. This is the contention that – from East Asia to continental Europe – we are witnessing the end of an era of 'coordinated market economies' (read also 'organised' and 'managed capitalism') and moving towards a world more consistently 'liberal market' in orientation. In such a world, government's role is restricted to providing rule of law, basic regulation, and minimum social safety nets.

There is clearly something to these claims. It is not hard to recognise that national governments are at times constrained by various pressures beyond their borders and that some of these pressures can be ascribed to international interdependence and economic openness. After all, who could fail to be impressed by the 'electronic herd' which – as Thomas Friedman (1999) and many others endlessly point out – can readily move vast amounts of capital in and out of countries in accordance with the herd's perceptions of their political and economic merit?

In short, the idea of 'globalisation' can certainly help to shed *some light* on national governance issues. But the general point should be clear: before we abandon the *darker place* and go heading off in the general direction of the light, we need to strain our eyes and look more carefully at what is going on *inside* nation-states – particularly as national authorities set about responding to the global economy.

That is the starting point for this volume. The issue to be explored in this book is the extent to which the global economy has the potential not only to *constrain* but also to *enable* governments to pursue their policy objectives. It asks: 'To what extent does the outcome depend on the character of the domestic institutional context (including its normative and organisational aspects)?' It is the central contention of this volume that if we wish to account for impacts of globalisation in any particular national setting, we must start with the domestic institutions of governance, which mediate the challenges of openness. Such institutions embody regnant ideas and normative orientations (especially ideas about the state's economic role and public purpose) as well as organisational structures (in particular, arrangements which produce cohesive or disunified elites, structure policy networks linking state and society, and more generally aggregate and represent interests in the political and policy process). This book proposes that rather than national states being generally constrained, hollowed out, and transformed by global markets, domestic institutions – especially, *but not only*, political ones – are key to understanding the effects of openness and where interdependence may be heading. In general, one cannot deduce the impacts of global markets – whether constraining or enabling – because these are mediated by domestic institutions, which in turn shape the ways in which national authorities choose to deal with the challenges of openness.<sup>3</sup>

In this introductory chapter I analyse in the first section the key claims of the constraints hypothesis at the core of the standard account along with its strengths and weaknesses; the main critical response – the

so-called ‘measurement critique’ of globalisation – and its limitations are detailed in the second section. Subsequent sections (three and four) then outline the approach developed in this book, which is represented in Figure 1.1 below. Section three sets out the case for studying globalisation as a process with *enabling* – not just constraining – effects on policy. Section four explains why institutions are important and how they matter to an analysis of globalisation’s impacts, and summarises aspects of existing research on domestic institutions of relevance to this volume. I conclude with an outline of the main propositions of the present study.

## **Globalisation as constraint: the standard view**

The standard view of globalisation conceives the process as a constraining force that limits what governments can do and ultimately transforms the state into a weaker, meaner, or leaner version of its former self. The globalisation thesis is a two-pronged claim which combines both descriptive and causal statements. It asserts:

- (a) that the world is becoming more interconnected through increasing economic openness and the growth of transborder networks that accompany that process, and
- (b) that this interconnectedness is increasing the power of global (economic and political) networks of interaction *at the expense of* national (economic and political) networks.

The first is a descriptive claim, the second a claim as to impact or causation. Both are frequently bundled together in various definitions of globalisation. Thus many conceptualisations elide the nature of globalisation (*what it is*) with its effects (*how it impacts*) in the domestic arena. From this confusion stem two features which have framed much of the debate to date. One is the tendency towards ‘circularity of argument’, whereby globalisation’s effects become true by definition.<sup>4</sup> This explains in part the importance attached to measuring interconnectedness through foreign direct investment (FDI), trade, and other such indicators – often seen implicitly at least as a proxy for gauging consequences or impacts, a point taken up in the next section.

The other feature is the embodiment of a ‘win–lose logic’ in discussions of the global–national relationship. This logic has been expressed in more or less nuanced ways: from the more extreme views positing the extinction of the nation-state or its demise as a sovereign power (Ohmae 1995; Camilleri and Falk 1992), to those of the more ‘moderate’

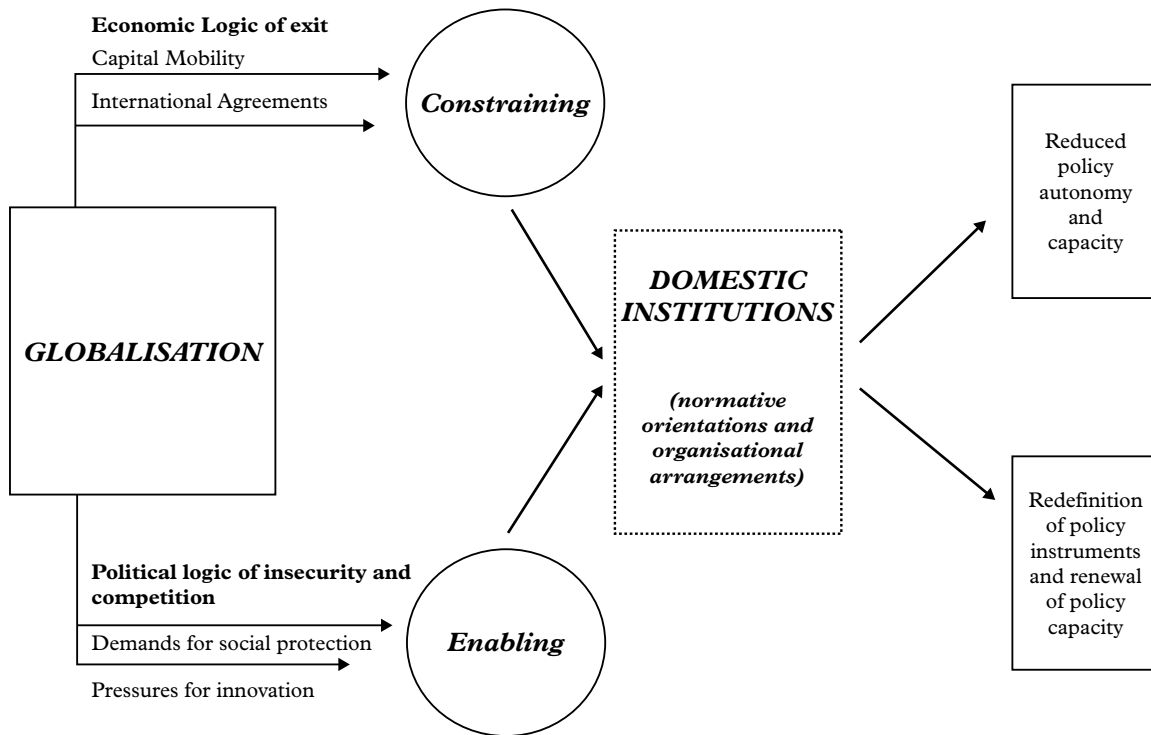


Figure 1.1 The logics of globalisation, domestic institutions, and state responses

majority anticipating erosion of the state's policymaking capacities and virtual retreat from national economic management (e.g., Reich 1991; Cerny 1996; Schmidt 1995; Strange 1996; Held and McGrew 2000; Cox 1997) to the recent transmogrification of this idea into that of the state's 'transformation' or 'reconstitution' (e.g., Scholte 1997; Held *et al.*, 1999; Rosenau 2000).

### *The 'globalisation-as-constraint' school*

While sometimes referring to themselves as 'transformationalists' (globalisation is real but it has 'changed', not 'displaced' the state) in order to distinguish their position from the so-called 'sceptics' (those who question the very existence of a strong globalisation tendency itself), it is none the less reasonable to refer to this moderate globalist majority as the 'constraints' school. This is necessary in order to distinguish the latter from other analysts of globalisation who have also posited or analysed state power changes – as do a number of chapters in this book (Coleman; Levi-Faur; Loriaux; Weiss; Woo-Cumings; Zhu) – but who find unconvincing the negative-sum conclusions more typical of the constraints school. These so-called sceptics (or more appropriately, 'institutional adaptationists'), while often acknowledging important *changes* in the structure of the international political economy, none the less question the *impact* claims proffered by the 'constraints transformationalists'. Among the more prominent sceptics regarding the 'constrained state' and convergence claims of the constraints school are the scholars of comparative politics and comparative political economy whose analyses are informed by a domestic institutions perspective.<sup>5</sup>

In short, while many constraints theorists – like domestic institutionalists – posit state 'transformation' as a major impact of economic openness, the nature of the changes they identify, while not always clearly drawn, are generally taken to imply the emergence of a different kind of beast whose powers, if not eroded, are substantially pared back. In this respect, as we shall see, 'constraints transformationalists' differ markedly from 'institutional adaptationists'.

### *The propositions*

The impact of the international political economy on the state, as espoused by the constraints school, can be encapsulated in two principal propositions. Both focus on the state's policymaking capacities and the ability to pursue its desired goals. The first claims that these capacities are shrinking (or have already eroded) very significantly under

globalisation; that in most cases states are being forced into donning the straitjacket of fiscal conservatism, cutting budgets, taxes, and spending. Capital mobility is seen as the key to this outcome, wreaking constraining effects on fiscal, welfare, and industrial-technology policies. While these effects may sometimes occur through direct political pressure as corporate employers, investors, and even foreign governments may seek to influence the policies of a particular state, such 'strategic' pressures are generally held to be less important than 'structural' ones.<sup>6</sup> For the latter are presumed to hold sway, with or without the existence of strategic pressure.

The structural pressures of openness are supposed to work their effects on policy in the following way: economic openness creates a new capitalism of 'entry' and 'exit'. As barriers to trade, investment, and finance fall, governments increasingly compete to attract and retain mobile capital; they must therefore pursue policies that complement the preferences of multinational corporations (MNCs) and financial markets lest these highly mobile investors exercise the exit option and take flight to lower-tax and welfare-conservative environments. As a result, financial openness and corporate mobility are expected to exert downward pressure on fiscal and social policy, forcing welfare retrenchment, corporate tax cuts, and shifts in the tax burden from capital to labour. This is the effect popularly known as a 'race to the bottom'.

The second proposition about globalisation's impact holds that the rise of intergovernmental agreements and international organisations like the World Trade Organisation (WTO) have substantially stripped states of their autonomy and control over the domestic economy, removing the scope for pursuing trade, industry, and financial policies to strengthen the economy.

So policy choices are deemed to be 'straitjacketed' by the pressures of trade competition, the preferences of MNCs and financial markets, and the rules of multilateralism. As a result of these and other developments, states virtually everywhere have been 'reduced to the role of adjusting national economies to the dynamics of an unregulated global economy' (Cox 1996: 528).

From this perspective, then, the overarching conclusion is that it is not just the state's policymaking capacities but the state itself as an institution which is being transformed, downsizing its powers and capacities, and distributing authority to other political and economic actors at local, national, and international levels (Strange 1996: 4; Hirst and Thompson 1996: 183–94; Scholte 2000: 238–9; Held *et al.* 1999: 50).

Although constraints theorists often contend that globalisation has impacted on the sovereignty and autonomy (read also 'capacity') of the state in a radical way,<sup>7</sup> they seek to differentiate their position from the 'hardliner' radical globalists who posit demise or retreat of the nation-state. Yet even as 'moderate' globalists, these analysts none the less maintain that the changes they are at pains to identify lead inevitably to a reduced policymaking capacity. In particular, a number of constraints theorists contend that financial globalisation has had a 'radical impact' on the ability of states to decide and pursue their own policy preferences (Held *et al.* 1999: 442–3). More generally, they assert that globalisation is impacting on the power, functions, and authority of the nation-state in a negative-sum way, producing a marked shift towards a 'divided authority system' in which states share the tasks of governance with a multiplicity of public and private institutions at local, regional, transnational, and global levels (Held and McGrew 1998: 221; Rosenau 2000: 186).

It is significant that for these observers authority is not deemed to be 'delegated' but 'divided'. And when you divide something and redistribute the portions to others, you end up with a smaller share for yourself. This is why constraints theorists conclude that national governments are 'no longer... the locus of effective political power' (Held and McGrew 1998: 242); that their 'capacities for governance... [are] lessening' (Rosenau 2000: 186); and that the state has now lost its centrality, becoming instead just one among many contending rule-making powers, with quite restricted policymaking capacities (Held *et al.* 1999: 50, 442–4), if sometimes heightened rule-making functions in more narrowly defined areas.<sup>8</sup>

Constraints theorists make a number of uncontentious claims about the state's changing context. But the conclusion of most interest to the studies in this volume boils down to the contentious claim that states are losing their independence or autonomy for social goal-setting and that their rule-making authority, decisionmaking powers, and ability to control domestic outcomes – in short, their room to manoeuvre and capacity to govern – are becoming increasingly restricted and specialised over a far narrower terrain than ever before.

However plausible such conclusions seem in the light of so many readily observable changes in the international and domestic political economies, they need to be grounded in systematic empirical research. At the very least, before rushing to easy conclusions, we need to untangle theoretical assumptions: Why, for example, should new forms of

cooperation between states and other power actors – whether public or private, domestic or international – be, in principle, more restricting or less enabling than before; and how, in practice, are we to measure ‘more’ and ‘less’ capacity to govern?

We can only make progress on these issues when we stop conceptualising states and their powers in static and negative-sum ways. As discussed in later sections, far from curtailing the state’s capacity for independent goal-setting, a number of recent studies have found that the new power-sharing arrangements – public and private, intergovernmental, multilateral, and so on – may well extend the state’s infrastructural reach and implementation effectiveness, especially where domestic structures are so oriented.

If this observation conflicts with the conclusions of the governance literature (the source of much ‘transformationalist-cum-constraints’ thinking), this is because the latter operates with a strictly negative-sum conception of power – if *A* has power, then *B* does not. But this distributive view of state power (as ‘power over’) seems in many respects more suited to the pre-industrial state; it has more limited value as a *standard* from which to appraise *changes* in state powers in modern times. The biggest state transformation came with the leap into industrialism as states gained in penetrative reach and extractive capacity what they forfeited in despotic power over their subjects. These newly acquired ‘infrastructural powers’ of industrial (read ‘modern’) states implied, increasingly, ‘power through’ collaboration or negotiation with other power actors in society (Mann 1984). It is fruitful to view the power-sharing changes both inside and outside the nation-state currently being discussed in the governance and globalisation literatures as more recent extensions of this ‘collective’ notion of power, a point we return to later in this chapter.<sup>9</sup>

## Critical responses (I): delimiting the constraints

In spite of these conceptual weaknesses, there is unquestionably some basis to the constraints hypothesis. The hypothesis is at its most compelling in the financial realm, appearing most accurate on monetary policy and least accurate on social, trade, and industry and innovation policies. In particular, the loss of monetary policy autonomy – for example, under the standard trilemma<sup>10</sup> or as a result of European Monetary Union (EMU) – is probably the area of economic policy where conventional ‘globalisation’ (qua ‘interdependence’) theory is most on the ball.

But even here there is no need to overstate. The loss of monetary policy control under conditions of capital mobility and floating exchange rates is neither complete nor generalised. It is far from *complete* in that it applies most clearly to loss of control over the price of money (in particular, the exchange rate). However, with regard to levels and types of private debt, governments are still able to regulate domestic credit expansion, if they so choose (Shaberg 1999: 209–10). While this ability is to some degree offset by the access of domestic players to international credit, even here regulatory authorities can, in principle, and sometimes in practice do set rules to define the nature and limits of access (for example, so as to favour long- or short-term debt, or to limit consumer credit). So the loss of control over monetary policy is by no means complete.

Loss of monetary policy control is also far from *generalised*, in that it tends to apply rather more to the small, highly open economies and rather less to the larger ones like the United States, Japan, or Germany. (Although even with regard to smaller states, the evidence on causal sequencing in the relationship between state size, policy choice, and currency stability remains ambiguous).<sup>11</sup> While the nation-states of EMU are also clearly constrained in their monetary policy autonomy, the primary dynamic at work here is one of *regional* interdependence and political choice, not the more abstract, structural pressure of global markets.

With regard to fiscal (and, by implication, social) policy, the major financial constraint has typically been specified in the following way: globalisation limits a government's ability to run fiscal deficits and pursue inflationary monetary policy because financial markets react severely to policies which would lead them to anticipate inflationary outcomes. While this claim is not in contention, the implication that such a policy constraint would disappear in the absence of global financial markets is unsustainable. Macroeconomic policy has *always* been vulnerable to private sector reaction, irrespective of capital market integration. Whether or not capital markets are integrated, high deficit spending in the presence of high government debt is expected to trigger inflationary outcomes and thus a rise in long-term interest rates, partly to insure the bond holders against inflation risk, and partly to hedge against the possibility that governments will inflate in the future to reduce the real costs of the debt (Glyn 1998a: 397; Garrett 1998a: 804).

A corollary of this point is that business is concerned much less with the *level* of government spending than with *how* it is financed. Recent findings based on interviews with fund managers and other financial market players offer strong support for this conclusion (Mosley 2000:

747–50). They confirm that such investors remain largely indifferent to the level or composition of government spending and that their most important concern is inflation. Financial market actors, however, do worry about the total amount of spending if this is financed by borrowing, for reasons noted above. So market players concede that it is the size of the deficit that matters rather than simply *how* the government finances its spending. Thus, as Layna Mosley puts it, ‘If domestic constituents prefer and are willing to fund larger public sectors, financial markets do not punish governments for acceding to this demand’ (Mosley 2000: 749).

So capital flight is a more likely outcome when governments opt to pay for higher spending by borrowing rather than by raising new taxes. But this too requires qualification, since the evidence indicates that government debt must be very high before a negative impact on policy is felt (see Swank 2000: 23). This would indicate significant room for expansionary fiscal policy before constraints set in, a conclusion that meshes well with the actual taxation and spending patterns reported in Chapters 2 (Hobson) and 3 (Swank).<sup>12</sup>

All in all then, macroeconomic constraints exist, but not to the point of constituting a ‘straitjacket’. Most important, where governments do appear to concede to financial market pressures, this applies to a limited number of well-defined areas – chiefly, big deficit spending funded by big borrowing – and with greater consequence for smaller, highly open economies. By the same token, governments retain autonomy in many other significant areas. Indeed, in view of the evidence on investor preferences (real rather than imputed), one might conclude with Mosley that in the developed democracies, at least, the influence of global financial markets on governments is ‘somewhat strong, but somewhat narrow’ (2000: 766). Constraints theory therefore requires significant modification to tailor its claims to more modest (empirically justifiable) proportions.

## **Critical responses (II): measuring interdependence**

Although the constraints on government policy have been often overstated, there is no disputing that economic interdependence has grown very significantly over the past four decades. The facts concerning globalisation are familiar. Reflecting a reduction in the transaction costs of international economic exchange, trade in goods and services and especially capital flows have increased notably in the last thirty years.<sup>13</sup>

For the average developed democracy, trade in goods and services as a share of Gross Domestic Product (GDP) has expanded from approximately 45 per cent to 65 per cent between the mid-1960s and mid-1990s (United Nations 1996). In 2000, the value of world merchandise trade reached \$6,180 billion, and experienced its fastest annual growth rate in over a decade of 12.5 per cent (WTO 2001). Inward and outward flows of foreign direct investment, portfolio investment, and bank lending have increased from a 1960s national average of roughly 5 per cent of GDP to approximately 50 per cent in the mid-1990s. In 1999 alone, global FDI inflows totalled \$865 billion and constituted 14 per cent of capital formation around the world, compared with 2 per cent twenty years ago (UNCTAD 2000). In the OECD, cross-border trade in bonds and equities increased from an average of 10 per cent of GDP in 1980 to between 150 per cent and 250 per cent of GDP in 1995 (Petit and Soete 1998). The averages for Germany, Japan, and the United States grew from 6.9, 2.8, and 5.9 per cent of GDP respectively between 1975–79, to a total of 334.5, 85.1, and 178.9 per cent in 1999 (BIS 2000). Total borrowing on international capital markets rose to more than \$830 billion in 1995, from less than \$360 billion just five years before (OECD 1996). Declines in covered interest rate differentials and liberalisation of controls on movements of goods, services, and finance have proceeded apace. While observers have noted distinct limits to globalisation (e.g., Berger and Dore 1996; Keohane and Milner 1996; Weiss 1998), there is little question that internationalisation has significantly expanded during the post-Bretton Woods era.

While these figures show that national economies are far more interdependent today than in the recent past (though not necessarily more than a century ago), the implied conclusion that they support the existence of a strong globalisation tendency which in turn constrains state capacity has been widely challenged. Indeed, the main critical response to the idea of globalisation as constraint has been a quantitative one, which consists in showing that globalisation is far less advanced than its proponents have claimed.<sup>14</sup> Many scholars sceptical of such a tendency have sought to counter the idea of an all-powerful, border-erasing force at work by setting these quantitative changes within a larger perspective, assessing their overall weight as a proportion of national economic activity. Through rigorous measurement, *inter alia*, of trade, capital, and investment flows, sceptics have shown that economies are still primarily national in scope: around 90 per cent of production is still carried out for the domestic market and about 90 per cent of consumption is locally

produced. Moreover, domestic investment by domestic capital is financed mostly by domestic savings and far exceeds the size of FDI flows in all major markets, while companies generally continue to concentrate most of their production, assets, and strategic decisionmaking in their home country (and trade in their 'home' region). Finance on the other hand is a different story – one in which genuinely global markets (especially in foreign exchange, bonds, and derivatives) are central characters. Even so, on most other dimensions, globalisation sceptics leave little doubt that economic enmeshment through trade, investment, and finance has not displaced the preponderance of 'national' networks. If anything, it has simply produced a more complex system in which both international and transnational networks have developed in parallel with, and complementary to, national systems of production and finance.

Sceptics therefore conclude that the reach of globalisation is limited (Wade 1996; Hirst and Thompson 1996; Boyer and Drache 1996), that it has important historical parallels which belie notions of state power depletion (Bairoch 1996), and that borders and national states still matter very much (Helliwell 1998).

### *Beyond measurement*

Accounts focusing on how far globalisation has advanced are valuable for infusing quantitative analysis with a historical perspective that ably clarifies the real extent of globalisation. But, as a critical response, the measurement approach remains limited and inconclusive. For one thing, it has produced a stalemate: if globalists are not impressed with these findings, it is because they can always counter with the claim that even if globalisation has not yet gone far, it is surely only a matter of time.

Moreover, a focus on the extent of globalisation may set us on a false trail. For it assumes that the fate of national governance rests on the outcome and thereby implicitly endorses the win-lose premise that 'more globalisation must equal less scope for state capacity'. The presumption is that if one can show that economic integration has advanced very far, then it must follow that a major power shift is under way – one that restricts the scope for national institutions, actors, and policies, while elevating the interests and preferences of non-national actors in a negative-sum form of logic (Weiss 1999a: 64).

However, the extent of globalisation may tell us little about national responses to, or capacities for managing, the challenges of openness. For, as the next section argues and as the studies in this volume demonstrate,

the pressures of interdependence set up both enabling and constraining dynamics, which are approached and 'resolved' in ways that depend to a significant degree on the existing institutional environment.

## **The enabling face of globalisation**

In addition to the structural pressures implied by the growth of capital mobility and international agreements, there is another aspect to interdependence, which has been largely overlooked by the constraints school. I refer to this as the 'enabling' face of globalisation. Unlike the constraining aspect with its economic logic of exit, the enabling dimension of globalisation reveals a political logic of competition and insecurity, which generates incentives for governments to take initiatives that will strengthen the national system of innovation and social protection.

The case for an enabling view of globalisation was first made in a rigorous way by Dennis Quinn (1997) in a correlational analysis of the impact of financial openness on fiscal, social protection, and a range of other policies. Quinn found that financial openness is correlated with *increases* in taxation and spending and that capital mobility had only one negative impact of any significance – increasing income inequality. His conclusion that financial integration is generally enabling runs counter to the conventional wisdom and thus cries out for explanation, a task which correlational analysis, however, cannot meet.

The larger message is the need for a new research agenda, which focuses on the enabling face of globalisation. This book is a contribution to that endeavour. It adds to a small but substantial literature covering a variety of topics – from financial liberalisation to industrial relations – which presents compelling arguments for an enabling view of globalisation. I extract from this literature two theoretical arguments, adding a third of my own, as to why globalisation does not produce a 'race to the bottom' in government taxation and spending policies, and why it does not *in principle* prevent governments from pursuing desired economic and social objectives.

The first argument can be summarised in the following way. Strong exposure to world markets (qua globalisation) has a tendency to heighten insecurity among broad segments of the population, which in turn generates demand for social protection. So rather than implementing generalised cuts, governments will often have strong political incentives either to sustain or to increase domestic compensation. This

is the widely overlooked 'political logic' of voice that acts as a counter-tendency to the 'economic logic' of exit, as argued by Geoffrey Garrett (1998a: 791). This view of interdependence – as a process that encourages governments to balance openness with social protection – has a distinguished pedigree, linking back to Peter Katzenstein's (1985) pioneering work on the small states of northern Europe where he found trade openness strongly associated with well-developed measures aimed at providing 'domestic compensation' for labour and industry.<sup>15</sup> In the small states context, Katzenstein found that the strength of economic openness correlates with a heightened perception of vulnerability, giving rise to an ideology of social partnership and complementary (corporatist) institutional arrangements. Thus 'small states' in the Katzensteinian sense can be seen as the forerunners of globalisation's 'enabling' dynamic in the developed democracies.

From this body of work one may generate the following hypothesis: the greater the level of (trade) interdependence, the stronger the elite perception of vulnerability, and the greater the likelihood of compensatory and inclusionary domestic structures which blunt rather than exacerbate the pressures of openness.

The main point, then, is that against the expectation that mobile capital in the form of multinational corporations and financial market investors will generally depress social spending and drive down corporate taxes via threat of exit, one must set the less noted (politically) *enabling impact of openness*. By heightening perceptions of vulnerability among different social groups, the latter has the potential to encourage compensatory responses from government.

The stress on 'potential' is important because the responses vary with institutional setting. As Duane Swank shows in Chapter 3, the 'political logic' of enablement impacts differently according to the prevailing normative and organisational conditions – hence explaining, for example, the more fiscally restrained patterns of welfare reform in liberal-market economies like Britain, compared with the more fiscally accommodating or moderately expansive patterns respectively in sectorally or centrally coordinated-market systems like Germany and Sweden, all nowadays highly interdependent economies. In a parallel manner for East Asia, Ramesh argues in Chapter 4 that the more competitive the political system (as a result of democratisation), the more governments have become responsive to welfare constituencies in a period of growing economic openness, even in the absence of any real political commitment to a welfare system.

The second theoretical argument about enablement concerns the conditions of global competition, which serve to valorise business access to national innovation structures, to a constant supply of skilled labour, and to various other infrastructural resources that firms depend on. However potentially mobile the modern corporation may be, increased exposure to world markets heightens the firm's need for continuous innovation, industrial upgrading, and competent workers. So instead of generalised slashing of corporate taxes and shifting the tax burden from capital to labour, governments will often have strong incentives to provide services to capital in exchange for maintaining tax revenue. As a number of scholars have observed, for all the neoclassical strictures about the harm wrought by state intervention, internationally oriented firms are still prone to welcome the benefits offered by a host of government programmes (Boix 1998; Garrett 1998a).<sup>16</sup>

At the very least, this offers a plausible way of explaining why, in many national settings, internationally mobile firms may be willing to sustain relatively high tax (and spending) levels, contrary to the standard expectations of capital exit. For this is where the overall evidence points, as John Hobson demonstrates in Chapter 2, subjecting 'race-to-the-bottom' claims to the test in a compelling analysis of the state's fiscal profile in the current golden period of globalisation. Overturning conventional expectations, Hobson's findings leave little room for doubting the general trend: notwithstanding limited oscillations and country particularities over time, it is clear that the tax burden on corporations in the OECD has generally *increased* rather than declined in the period of rising economic interdependence, that governments have *not* shifted the tax burden from capital to labour and, moreover, that they have generally *increased* taxes.

To these two arguments, we can add a third as to why globalisation has enabling rather than simply constraining effects on national governance. This concerns the way in which intensified competitive pressures may threaten to destabilise key sectors of the economy – from agriculture to telecommunications and finance. The effect of such competitive challenges is to urge governments to devise new policy responses, new regulatory regimes, and similar restructuring reforms. Most critically, responding to these new challenges creates incentives for governments to develop new or strengthen existing policy networks. For some purposes, this entails the expansion of *intergovernmental* cooperation in more or less permanent fora (e.g., the EU, WTO, BIS, G8). For others, it involves the extension of links *between government and business* in order

to increase or improve policy input from the private sector. In both domestic and international settings, the capacity for economic governance may be enhanced by more effective information sharing and policy implementation. In each case, neither government nor business autonomy is thereby negated. Rather, it is 'enmeshed' in a network of interdependencies, the rules for which are established by government – hence 'governed interdependence'. Its recent flourishing in unexpected places is discussed in the chapters by Weiss and Coleman. The overall effect of such changes is a transformation in the state's *relational* enmeshment with other power actors.

Staying with the domestic setting, the more general point to emphasise is that openness can create strong pressures for maintaining or extending cooperative ties between government and industry, as well as for information sharing, for coordinated responses to collective action problems, and more generally for the state to act as provider of collective goods. Of course the transformation of public-private sector relations is not the only possible outcome of globalisation's enabling dynamic. In some cases – the Chinese response to WTO-induced reforms being the exemplary one, analysed by Tianbiao Zhu in Chapter 7 – preparing for increased competitive pressures has led to the restructuring of central-local government relations rather than of public-private sector ones. As a result of new power-sharing arrangements between the different units of government, the capacity of the Chinese state has been transformed from one based on the closed-economy model of central planning to one based on selective intervention at both national and local levels.

But outside the somewhat special case of China, in the developed democracies the more general principle applies, whereby increasing policy input from encompassing economic groups in the private sector tends to strengthen the state's transformative capacity. This principle is nicely illustrated in a number of existing studies, in particular, William Coleman's study of agricultural reform in France (2000), Mark Lehrer's analysis of the growth of high-technology entrepreneurship in Germany (2000), as well as my own account of industrial upgrading in European and East Asian countries (1998: especially ch. 3). In a pioneering study of the highly globalised derivatives markets in Chapter 13, Coleman offers further evidence of a similar dynamic at work in this most unexpected quarter. Also running contrary to expectations about the demise of transformative capacity in East Asia is the Korean state's

recent partnering with organised industry groups to create, *inter alia*, a domestic software industry, highlighted by Weiss in Chapter 12.

Such examples add flesh to a larger theoretical point advanced in this study: namely, that globalisation does indeed impact on national governance and its domestic structures, but the impact is not *only*, or even *generally*, constraining. For globalisation also contributes to the expansion of governing capacities through both the transformation of public–private sector relations and the growth of policy networks. In Chapter 14 (Weiss) to this volume we consider the implications of this finding for the constraints–transformationalist thesis.

So much then for the third aspect of enablement. The important point to reiterate is that the extent to which these enabling conditions (of international competition) and the political incentives for intervention that they generate are likely to be actualised and to inform policymaking will depend heavily on institutional features of the domestic environment. As Richard Doner and Ansil Ramsay show in Chapter 6, although the economic incentives for particular kinds of intervention may be extremely strong and the national political rewards high – as would certainly be the case for a national strategy to upgrade Thailand’s low-technology industries, an issue of critical importance since the Asian crisis – the political and economic institutional capacities may none the less be lacking or inadequate to the new developmental tasks. In this context, globalisation’s enabling qualities turn into constraints.

There is then a plausible case for studying globalisation as a process with enabling effects. This case is established in a systematic way in the opening chapters on taxation by Hobson and welfare spending by Swank. But, as indicated in Figure 1.1, just how those enabling conditions will translate into policy responses will depend to an important extent on specific features of the institutional set-up, which mediate those outcomes. The main objective of the discussion thus far has not been to deny the existence of constraints but to offer a more realistic picture of them and to restore analytical balance by turning the spotlight on the enabling face of globalisation.

## **A domestic institutions approach**

As argued in previous sections, the win–lose framework of globalisation analysis offers a limited way of grasping how national authorities are actually managing the challenges of openness. We need to think

outside that framework and, to do that, there is no more appropriate place to turn than to the domestic institutions literature. This is of course a large literature and it would serve little purpose here to engage in an extensive review, especially since that task has been so ably undertaken by others.<sup>17</sup> The task of this section is to present a succinct outline of some aspects of domestic institutions analysis relevant to our concerns. In particular, we ask: What do we mean by institutions? Why are they important (what do they do)? And how are they created and changed? These are also issues central to contemporary institutional analysis.

### *The nature of institutions*

Much ink has been spilled on the definitional side, specifically, over whether institutions should be defined as bundles of rules, norms, or organisational arrangements. Disciplinary background has much to do with these different usages. As an economist, for instance, you would be most likely to give primacy to the rule-bound, law-like notion of institutions (North 1990). Sociologists, on the other hand, have tended to emphasise the normative features of institutions, which extend beyond legal norms to define not only what is socially 'acceptable' but also what is 'appropriate' in particular contexts (e.g., Powell and DiMaggio 1991);<sup>18</sup> while political scientists have been drawn to highlight the importance of organisational arrangements, ranging from the structure of policymaking networks and the financing of industry, to the forms of collective bargaining (e.g., Katzenstein 1978; Johnson 1982, 1984; Zysman 1983; Hall 1986; Pempel 1998; Thelen and Kume 1999).

While this schema necessarily simplifies a complex and often highly nuanced literature, it serves as a reasonable statement of tendency. It also makes sense when one recognises that the different usages are typically driven by quite different analytical concerns. For economists, famous for their methodological individualism – which posits the interests and actions of individuals as cornerstone of the economy and unit of analysis – institutions (as rules) set important *constraints* on individual behaviour.<sup>19</sup> For sociologists, who see 'society' or social structure as prior to the individual, institutions (as norms) are *constitutive* of interests and identity. While there is no shortage of political scientists who lean towards either the sociological (e.g., March and Olsen 1989; Katzenstein 1996a, 1996b; Sikkink 1991) or the rationalist understanding of institutions (e.g., Milner 1997),<sup>20</sup> more generally, emphasis has been given