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GLOBALIZATION, SOCIAL PROTECTION AND PUBLIC FINANCE*

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I. Introduction

The last couple of decades have been characterized by a growing attention to a phenomenon that generally goes under the name of globalization. Many articles and books have been written about it and at times violent demonstrations have been organized to protest its alleged effects or to put an end to it. As is often the case with many words in common use, globalization has many faces and, consequently, it is not easy to define precisely. It means different things to different people. For some it conveys the image of a world that has become a "global village..... in which distance and isolation have been dramatically reduced by electronic media". This definition, provided by Merriam Webster's Collegiate Dictionary, Tenth Edition, points to one aspect of the phenomenon, an aspect that, for sure, is of marginal relevance to a large proportion of the world's population which still may not have witnessed much reduction in distance and isolation.

It can be argued that, in some ways, globalization has been going on for centuries. For example Columbus' trip to the Americas can be seen as a manifestation of globalization. Among many changes that it brought about, in time this trip would cause a person of Japanese descent (Fujimori) to become president of a country , Peru, that had been the center of the empire of the Incas! Manifestations of globalization were also the conquests of Alexander the Great or the expansion of the British empire in the XIX Century. All these actions changed areas of the world in fundamental ways.

In this paper we shall focus largely on economic aspects of globalization and particularly on the impact that it may have on the economic risks faced by the citizens of countries exposed to this phenomenon and on the role that government play, or can play, in protecting citizens against these risks. We shall argue that the story is a complex one and that recent attempts, on the part of some economists, to establish clear relationships between measures of globalization (such as the openness of the economy) and measures of the government's role in social protection (such as public spending) are not entirely convincing.

Unless one focuses on the communication revolution of the past two decades, the process of economic globalization has been going on for a long time accelerating in some periods, when new technologies or new policies helped it, and slowing down, or even reversing itself, in periods when wars, plagues, or policy changes put obstacles to it. Obviously different parts of the world have been affected differently by these events.

There has been a broad consensus among economists that the period that went from around 1870 to the beginning of the First World War in 1914 was a period of intense globalization. Technological developments (railroads, cars, telegraphs, steamships) and the economic policies of the time that gave free reign to market forces, together with the gold standard that, in a way, provided a world money for intercountries payments, contributed to globalization. In this period many countries became more open than previously to trade, capital movements, and even to the movements of person. Millions of people emigrated to new countries in this period. Indexes of openness to trade and to capital movements for industrial countries were, at that time, broadly similar to those registered in recent years. See Baldwin and Martin (1991).

However, much of the information available and the attention on the part of economists has come from, or been directed to, the industrial countries. Information on other countries has been limited. Many of these other countries were colonies of European powers so that their commercial dealings with the rest of the world were determined by the policies of those powers. Recent information has indicated that, for example, the Latin American countries, that in the 1870-1914 period were mostly independent, may not have been as "globalized" as the industrial countries.

A recent paper by Coatsworth and Williamson (2004) has shown that the Latin American countries had the world's highest tariffs in that period.

"Tariffs in Latin America were far higher than anywhere else from the 1860s to World War I, long before the Great Depression. Indeed, tariff rates in Latin America were even on the rise in the decades before 1914...." p. 67

However, they conclude that:"....revenue needs were....the key to these exceptionally high tariffs, and this motivation had its roots in the exceptional levels of military conflict in the

region..." p. 67. In other words, military conflicts created a strong needs for higher tax revenue, not globalization.

Given the prevailing structure of these economies at that time, which depended mostly on agricultural production, tax revenue could be obtained mainly from foreign trade taxes. In fact in that period the United States also depended on foreign trade taxes for a large share of its government revenue. This conclusion is consistent with the "general theory of tax structure change" a theory that was very popular 3-4 decades ago. This theory, much ignored in recent writings, had shown that foreign trade was the best "tax handle" for many countries. The larger the share of imports and exports of a country, the easier it was for it to raise revenue. See Tanzi, (1973), for a description of this theory and Musgrave (1969) for a discussion of "tax handles"..

II. Globalization and Public Spending

In the period between 1870 and 1914, governments played a limited role in the economy. As a consequence, public spending for social protection was very small. At that time the share of public spending in GDP was in many countries around ten per cent. See Tanzi and Schuknecht, 2000; Maddison, 1997; and Lindert, 2003. At the same time, there were many activities undertaken by churches, civil societies, or extended families that provided considerable protection to individuals against various economic risks. To some extent the protective policies of the welfare state that developed later crowded out many of these private activities. Thus the successive growth in public spending may have contributed less to protection against economic risks than generally assumed. This is an area that has not been well researched leaving the impression that government programs for social protection always filled a vacuum and represented a net positive improvement.

Events after 1914 brought an end to the globalizing trends that had characterized the previous decades. These events were World War One; the Great Depression; and World War Two. At the same time autarkic policies were introduced by the governments of Germany, Italy, Russia and other countries that contributed to the closing of these countries economies. These events were not conducive to the creation of a "global village".

Economic policy lost its enthusiasm for openness and the world went through a long period when borders became relatively close for trade and very close for the movements of capital and persons.

It was exactly in this period that the role of the state in the economy started to change and to grow. See Tanzi and Schuknecht (2000). In many countries welfare states or so called "mixed economies" started coming into existence first slowly and then at a faster pace. In many countries, public spending, as a share of GDP, more than doubled between 1913 and 1960 and grew explosively between 1960 and 1980. This phase lasted until the end of the 1970s or the middle of the 1980s when a new phase began. It is, thus, important to realize that the growth of public spending had nothing or little to do with globalization. On the contrary it took place before the world became globalized in the current sense and well before much of the recent discussion of globalization started.

In the late 1970s, intellectual winds started changing. More conservative views, as those of Milton Friedman, gained currency. The fact that individuals with strong conservative views, such as Thatcher and Reagan, could be elected in two important countries is an indication of this change. This period brought progressively more free trade, more capital movements, and more skeptical attitudes vis-à-vis the large role that governments had assumed over the years in the running of the countries' economies. In time this would bring what came to be called the "Washington Consensus". That consensus represented the affirmation of the role of the market over the role of the state in the economy. In the early 1990s this Consensus became popular indeed and led to important policy changes that promoted globalization. For example, it brought large scale privatization and, because the privatized enterprises were often bought by foreigners, it brought large cross-country capital movements.

The current phase of globalization was given its special characteristics by technological developments in the communication field and by the liberalization of capital movements. The internet network made possible for individuals to communicate with any part of the world where computers were available. Furthermore, the exchange of information became cheap and almost instantaneous. The drastic fall in the price of computers over the years and their growing capacity increased their popularity. They

became particularly important in relation with the movements of financial capital and the development of a global financial market. The combination of new technology and new policies, together with better-developed payment systems capable of handling millions of transactions a day and of reducing greatly transaction costs made it possible and more convenient to shift funds around the world in seconds. These developments allowed for the creation of a truly global and, in some sense, efficient capital market. Government and private agents could now access the market, as providers of funds or as borrowers, at levels and with a facility that would have been impossible in earlier times.

International speculation was also facilitated by these developments and the likelihood of behavior driven by "herd instincts" and "contagion". The conditions for more frequent financial crises were in place. A statement by Harold James (2001, p. 200) is worth quoting: "What made the Great Depression "Great" was a serious of contagious financial crises in the summer of 1931 and the subsequent trade response." And 1931 was long before the communication revolution and the development of a global financial market. A lot of evidence indicates that the past two decades have witnessed more frequent and possibly deeper financial crises than earlier decades.

These financial crises have at times led to sharp falls in the countries' gross domestic products, to large fiscal costs associated with the subsequent restructuring of the banking sectors, to short term sharp increases in unemployment and in poverty in the affected countries and to calls on the governments of some countries to provide safely nets for the populations. These calls became particularly strong during the financial crises of 1997-98 because the countries most affected by these crises (Korea, Thailand, Indonesia) did not have government-provided safety nets. The existing safety nets depended mostly on culture and on regulations such as life tenure for employees. In these countries individuals that had belonged to the middle classes found themselves in poverty almost overnight when the enterprises in which they worked closed down.

As an IDB book put it: "Social protection is an economic as well as a social imperative". See IDB, 2000, p. 3. In other words, a strong case can be made, and has been made, that globalization has implications for the role that the state should play in the economy. It can be argued that the more globalized the countries become, the greater

should be the economic and especially the protective role of the state. Thus, according to this line of reasoning, globalization should lead and does lead to increases in public spending and especially in public spending for social protection. This view has been made popular by Dani Rodrik in a series of papers. See, especially, Rodrik, 1997 and 1998. It should be realized that, here, a normative statement ("should lead") has been transformed in a positive statement ("does lead").

The connection between globalization and public spending cannot be limited to the role that the state should play to protect individuals from economic risks that may increase because of globalization. That connection must also be considered in terms of the role that the state is capable of playing. That role might itself be affected by globalization. These issues will be addressed in the rest of this paper. Before moving to the next section, it should be pointed out that much of the increase in public spending in industrial countries over the past several decades was connected with spending for public pensions and for public health. To a lesser extent it was connected with public spending on education. For details see Tanzi and Schuknecht (2000); and Tanzi (2002). This spending is clearly related to important economic risks associated with becoming old, ill or being illiterate or undertrained. However, while real and significant, these risks, and especially those associated with old age and poor health do not derive from globalization. Whether a country is globalized or not, its citizens will get old and ill. Globalization does not raise the probability of these risks except in the event that it makes easier for inflective diseases to cross frontiers.

The same is to a large extent true for public spending on education. Whether a country is globalized or not it will be better off with an educated population. However, in this case an argument could be made that a globalized country will have a greater need to be competitive. To the extent that public spending for education and research helps in this direction, an argument could be made linking this spending to globalization. In conclusion, only a small part of public spending can be said to become necessary because of higher risks created by a more open economic environment. These points must be kept in mind in the rest of the paper.

Details on the growth of total public spending and on various categories of public spending as shares of GDP for 18 industrial countries, for more than a century, can be found in the cited book by Tanzi and Schuknecht (2000). The categories include defense, education, public health, pensions, unemployment benefits, interest on public debt and public investment.

III. Testing for Links Between Globalization and Public Spending

Hypotheses About Links

In several frequently cited papers Dani Rodrik has advanced the thesis that there is "...a robust association between an economy's exposure to foreign trade and the size of government" measured by the ratio of public spending to GDP. For Rodrik "the explanation is that government expenditures are used to provide social insurance against external risk." (italics added) See Rodrik, 1998, p. 997. In other words globalization raises the openness of a country's economy and this larger exposure to foreign trade, coupled with "volatility of the terms of trade and the product concentration of exports" increases external risk and leads to "greater volatility in domestic income and consumption." This increased volatility can be reduced by a larger share in GDP of government purchases of goods and services. In other words the public budget becomes the shock absorber for the individual risks. He concludes that "causality should run from exposure to external risk to government spending." Rodrik, 1998, p. 998. He then proceeds to provide some empirical backing to his thesis. On the basis of his empirical analysis, he specifies that "governments have expanded fastest in the most open economies" and especially "in economies that are subject to the greatest amounts of external risk". p. 1028.

This is indeed a powerful and important thesis. Rodrik refers to a precursor paper by David Cameron (1978) that had also linked statistically tax revenue to the economy's openness. Strangely, however, he ignores the very large literature by public finance economists that in the decades of the 1960s and 1970s also found a relation between openness and tax burden. These economists, however, had argued that the causation of the relationship, was different from the one assumed by Rodrik. Put it simply, for these writers, openness provides a convenient "tax handle" for governments that would like to

increase tax revenue but are unable to do so through taxes other than those associated with trade. See, inter alias, Tanzi, 1973 and 1967; Musgrave, 1969; many others. For these writers external risks had little to do with the level of taxation or the level of public spending. The role of government was larger in open economies simply because these economies found it easier to collect higher tax levels. This literature focused explicitly on developing countries because, it was assumed that industrial countries have more control on the level of taxation and on the use of specific tax categories.

There are also theoretical questions about the relationship between trade reform or openness and individual income risk. As pointed out by Krebs, Krishna and Maloney 2004, <u>in the short run</u> the reallocation of capital and labor across firms and sectors brought about by trade reform and by increasing openness can raise individual income risk. However, beyond the short run a better integrated world economy would produce more stable prices and better macroeconomic outcomes. Their assessment is that, "...theoretically, the openness-volatility relationship is ambiguous, that is, the theoretical literature does not offer a strong prior on the sign or magnitude of this relationship [for the long run]." It could be added that a country that has made the initial adjustment to join this new world as, say, Chile has done, it would have an easier ride in future years. Thus a process of trade integration that is gradual, rather than sudden, could very well make the world economy more stable and thus reduce rather than increase income risks. However, there is no certainty of this and furthermore this conclusion refers to globalization related to trade and not to capital movements.

Sudden capital movements, especially if associated with portfolio investments and with speculation, rather than with real investments, could increase risks by creating financial crises even over the longer run. These sudden capital movements often originate from the domestic policies of the affected countries but they can also be induced by contagion or, less likely, by developments in major industrial countries, such as sudden large increases in interest rates. This is the reason why there has been so much talk in recent years about reforming the "architecture" of the international financial system and some actions have been undertaken to achieve this goal. A reform of this architecture, combined with sound macroeconomic policies at the national level that increased

transparency and sharply reduced foreign borrowing, especially when associated with large structural fiscal deficits or overvalued fixed exchange rates, would reduce the risks deriving from free capital movements. The greater provision of good data on the part of many countries would also reduce the probability of these crises. The IMF has been active in encouraging countries to provide systematically and at regular intervals basic data.

Apart from the above considerations, related to the impact of openness on income risk, it has been pointed out that there are two possible and conflicting hypotheses about the impact of globalization on public spending: one is the "efficiency hypothesis"; the other is the "compensation hypothesis." See Garrett (1999a and 1999b).

The efficiency hypothesis stresses the fact that high level of public spending, especially if directed toward welfare, reduces a country's ability to compete globally. The reason is that this welfare spending, that necessarily raises the level of taxation in a country, makes the country's economy less efficient. Therefore, as the global market becomes more integrated, and more open to competition, pressures are created to make the economy more efficient. These pressures may lead to the liberalization of labor markets, to the reduction of inefficient regulations, to the freeing of goods market, to the privatization of public enterprises and, even, to the reduction of tax rates and public spending including on pensions and other social spending. In fact one consistent result of recent trends has been the widespread drop in marginal tax rates for the personal income tax and in the tax rates that apply to the profits of enterprises. Over the past two decades these rates have dropped sharply in practically all industrial countries. These pressures to become more efficient have been recognized, for example, by Harold James (2000. p. 213) when he writes that "….states are faced by contradictory pressures: on the one hand, to reduce tax levels, because of the enhanced mobility of factors of production; and on the other, traditional consideration requiring additional expenditures".

The "efficiency hypothesis" can be combined, especially for the welfare states that have very high tax burdens, with a concern, advanced by the author of this paper, that globalization has created "fiscal termites" that are progressively weakening the bases of the tax systems and that will make it progressively more difficult for countries to maintain high tax levels. We shall refer to this as the "fiscal termite hypothesis". As a consequence, the

role of the state must be reconsidered in order to reduce public spending while possibly preserving the protection against some risks. See Tanzi, 2001; and Tanzi, 2002. We shall return to this theme in the following sections.

The "compensation hypothesis" on the other hand, is essentially the one that argues that social spending must be maintained or even increased to compensate workers for the risks and the costs associated with globalization and, possibly, to improve the quality of "human capital" so that the countries can remain competitive in a more integrated global economy. Thus, in some ways, social spending can acquire some of the characteristics of public goods. It can also have the function of maintaining political support for the globalization and pro-market policies.

These are to some extent competitive hypotheses. It is possible that some countries may opt for the policies implied by the first hypothesis while other countries may try to follow the policies of the second.

Empirical Tests

A detailed empirical analysis of these two contradictory hypotheses is beyond the scope of this paper but a few observations are in order.

First, it is improbable that, as Rodrik maintains "the social welfare state has been the flip side of the open economy." As argued at length in a recent book, the intellectual winds that produced the welfare state were long in coming and became strong exactly in those years when the economies became less open. See Tanzi and Schuknecht, 2000, especially Chapter 1. The New Deal and the Keynesian Revolution were late products of the Great Depression, a period when economies that had been relatively close became even more close. The level of public spending did not grow in the 1870-1913 period when the economies were particularly open and before they started closing because of the First World War. On the other hand, by 1926 Keynes was already calling for an end to laissez faire. See Keynes (1926). In the early 1950s, long before the current globalization process got under way, there were already complains about the creation of welfare states (see de Jouvenel, 1952) and calls for the creation of what could be considered a welfare state in the relatively closed American economy. See Galbraith, 1958.

Second, his sample of OECD countries is biased by the fact that the countries where public spending grew the most (mostly those of Northern Europe), were all small countries which, being small, tend to be more open. These were also countries with more ethnically homogeneous populations. It has been shown in some studies that countries that are more ethnically homogeneous tend to have higher levels of public spending. See inter alias, Alesina, Glaeser, and Sacerdote (2001) and Alesina and La Ferrara (2003).

Third, there are major problems with the data when the sample is expanded by Rodrik beyond the OECD countries to the "100 plus-country sample" that includes the developing countries. These problems are not random but systemic. There is no data source that gives public spending for developing countries for the general government. Comparable data that include sub-national public spending for these countries simply do not exist beyond the OECD sample. The mother of all other sources, the IMF Government Finance Statistics, provides data for central government only. Since larger countries (Brazil, Argentina, Nigeria, India, South Africa, Indonesia, China, etc) have often large sub national governments, the spending of which does not show in the data, and since these countries tend to be less open, this statistical deficiency biases the relationship between openness and public spending. Interestingly, the most closed Latin American country – Brazil – is also by far the country with the largest level of public spending—about 40 percent of GDP in 2004. The next most closed economy, Argentina follows Brazil with public spending of around 30 percent.

A study that attempted to deal with this problem by assembling from various sources more comprehensive data for public spending from 1973 to 1997 for 14 Latin American countries concluded that *"...the most striking finding is the strong negative effect of trade openings on changes in aggregate social spending.* (Italics added). See Kaufman and Segura, 2000, p. 6. This result is not surprising to anyone familiar with the Latin American situation. Trade opening leads to the fall of foreign trade taxes and capital liberalization to the fall of taxes on financial incomes. This forces countries to spend less. There is a large literature on the negative impact of trade opening on tax revenue for developing countries. See inter alias, Ebrill, Stotsky and Gropp, 1999; Peters, 2002; and

Abed, 2000. There is also a lot of evidence that taxes on incomes from financial sources have fallen in most countries.

Finally, it is worthwhile to point out that over the past two decades, when the process of globalization was most intense, the most open countries were the ones that reduced the most their total public spending. We turn to this evidence next.

Table 1 provides information on what has happened to public spending in some of the most open OECD countries in recent years during the period when concerns about globalization have been most intense. Public spending seems to have collapsed rather than increased. This behavior supports either the efficiency hypothesis or the fiscal termites hypothesis. More likely it reflects some combination of the two hypotheses because their effect on public spending would be the same.

Another way of addressing the link between openness and public spending for industrial countries is to plot openness against public outlay as done by Rodrik. We do this for two years, 1987 and 2002. In Chart 1 public outlay is on the vertical axis and openness on the horizontal axis for 1987. Chart 2 has the same information for 2002. Openness is defined as imports plus exports as percentages of GDP for OECD countries. For these countries the spending data for general government are available from the OECD. The openness data are from IMF sources.

Chart 1 supports the Rodrik hypothesis, that openness and public spending are positively correlated for OECD countries. The correlation between the two variables is a positive 0.41. Chart 2 shows the same statistics for 2002. Because the period between 1987 and 2002 was one of intense globalization, the scatter diagram for 2002 should show a much closer positive relationship between the

Table 1

Highest and 2002 Shares of Public Spending in Selected Countries

(Percentages of GDP)

Country	Level and Year When Reached	2002 Level
Austria	53.3 (1993)	48.8
Belgium	57.1 (1985)	46.2
Canada	49.9 (1992)	38.2
Denmark	58.9 (1996)	50.1
Finland	59.1 (1993)	45.2
Ireland	50.7 (1985)	31.8
Netherlands	53.3 (1987)	41.8
New Zealand	51.8 (1986)	39.0
Norway	52.0 (1992)	42.3
Sweden	67.5 (1993)	52.6
Average	55.3	43.6

Source: Adapted from OECD Economic Outlook

CHART 1

Openness vs. Outlay: 1987

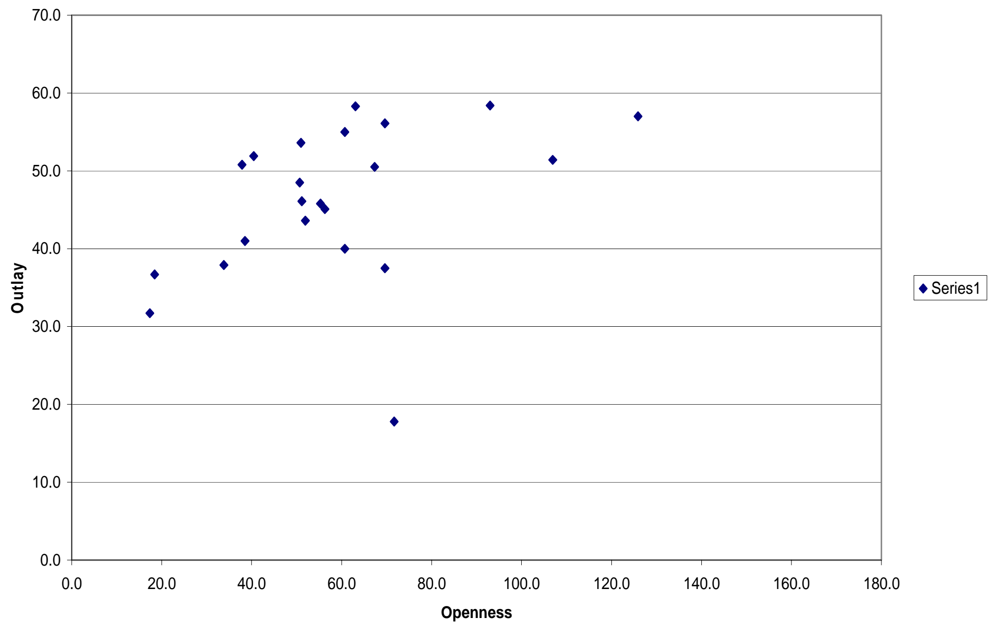
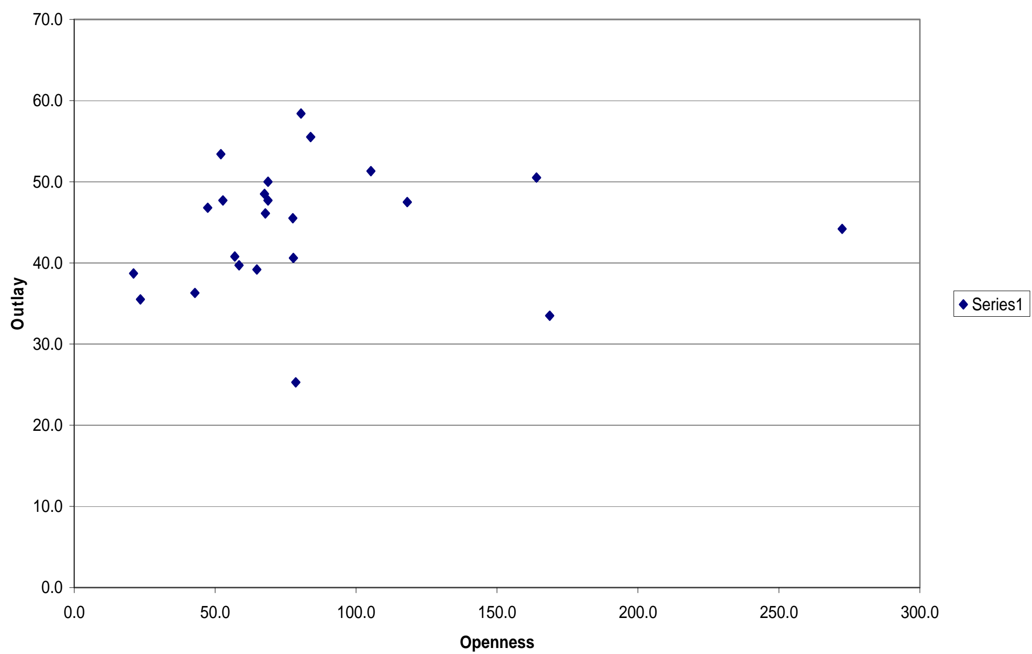


CHART 2

Openness vs. Outlay: 2002



two variables than the scatter diagram for 1987. However, this is not what happened. The two variables seem to be much less correlated in 2002 than they were in 1987. In fact the correlation coefficient falls from 0.41 for 1987 to 0.07 for 2002.

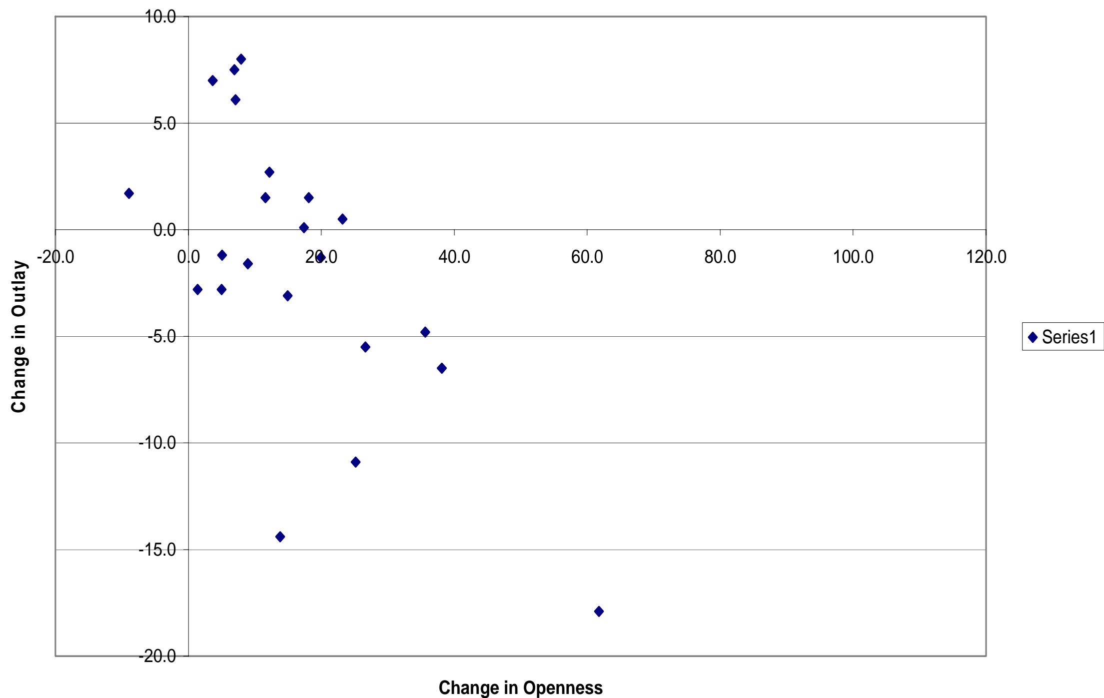
A stricter empirical test is to correlate changes in public spending over the 1987-2002 period against changes in openness over the same period. If more openness brings about more public spending, as theorized by Rodrik, we should have a positive relationship between these two variables. Chart 3 provides a scatter diagram which shows changes in openness on the horizontal axis and changes in public spending on the vertical axis. The scatter diagram shows clearly that the relationship is negative rather than positive. The more open the economies of the countries became, the less their governments spent. This is confirmed by the correlation coefficient that is -0.67. This chart confirms the validity of the efficiency or the fiscal termite hypothesis rather than the compensation hypothesis. Thus, it would seem that the compensation hypothesis can be put to rest at least with respect to public spending.

IV. Looking Beyond Public Spending: Normative Insights on Social Protection

The previous section discussed a possible association between globalization and the level of public spending. However, governments have at their disposal other instruments besides public spending through the use of which they can provide some protection against risks with economic consequences such

CHART 3

Change in Openness vs. Change in Outlay: 1987-2002



as old age, illness, being unemployed, disable, illiterate, and so on. See Tanzi 2002. There are three main instruments of social protection, namely: (a) public spending programs; (b) tax expenditures; and (c) particular forms of regulations.

In this section we discuss these three instruments in a general way. In the next section we shall discuss more directly the ways in which different groups of countries have used these instruments.

First Instrument: Public Spending

Most authors identify social protection with public spending. They also identify high levels of public spending with the welfare state. Two recent books have traced the growth of public spending in industrial countries and more specifically the growth of social transfers over a long period of time. See Tanzi and Schuknecht, 2000; and Lindert, 2004. Unfortunately no such study is available for developing countries and none would be possible because of lack of data. Such a study, however, might be possible for a few individual countries using national data. Brazil might be a good test case because it saw its tax burden go up from 14 percent of GDP in 1947 to 37 percent of GDP in 2004.

In welfare states, social protection through public spending has been provided with programs that are universal and, thus, they are essentially entitlements for all citizens. They cover poor citizens as well as richer ones who could have bought insurance against the risks directly, without the intermediation of the government. Because of their universality, these programs tend to be expensive and, thus, to require high levels of taxation. Therefore, countries that (a) choose to provide protection to their citizens against risks with economic consequences (being ill, old, unemployed, handicapped, illiterate, young and orphan, etc.); (b) that choose to do so through public pending; and (c) that elect to provide this protection to the whole population, must be able and willing to have high tax burdens. In some European countries these tax burdens have at times exceeded 50 percent of GDP. In most of them they still exceed 40 percent of GDP.

There is, however, a cheaper alternative: to provide the government protection only to those who, through means testing, are identified as needing it. These tests would eliminate a large proportion of the population. By reducing the cost to the government, it would reduce the need for imposing high taxes. Lower taxes imply that many people who were paying the higher taxes would end up with higher disposable or after-tax incomes. This transfer of income from the government to the families should make it possible for many of these families to buy some of the needed protection directly from private providers. This is already happening for protection against the risks of old age in several countries, where private pensions have replaced (part of) public pensions. It is also happening for protection against the risk of getting ill, with private providers supplementing or replacing the services of public health. It is also happening, especially in Latin American countries, in the educational area where the risk of ending up with an inadequate education is being reduced for many students by the proliferation of good private schools especially at the university level.

Given the opportunity, the private market, under competent government supervision, can play a greater and better role than in the past especially for the population that, instead of "buying" this protection from the public sector, through the payment of taxes that are actually prices for these services, it can buy it from the private sector. Globalization makes this alternative more likely because some protection can be bought

from private providers located in other countries who can offer it more cheaply and more efficiently. See, on this, Tanzi, 2004. The alternative of providing better-targeted public protection is cheaper in terms of public resources. However, it is more demanding politically, administratively, and in terms of the needed information. These are among the reasons why many countries chose the universal or entitlement route. The key question is whether the universal route can survive in a truly globalized world where remaining efficient and competitive becomes a fundamental need for countries.

Second Instrument: Tax Expenditures

A less obvious instrument of social protection is the use of so-called "tax expenditures". The tax system can be linked to social protection, through (a) its generation of tax revenue; (b) its tax structure; and (c) its targeted, implicit subsidies, given through the tax system, referred to as "tax expenditures". A high level of tax revenue can help finance publicly a higher level of social expenditure. It is thus essential for a welfare state. A more progressive tax structure shifts the burden of taxation towards richer people leaving more disposable income in the hands of poorer families thus giving them more resources to protect themselves directly against risks with econmic consequences. For this reason, on equity grounds, progressive income taxes tend to be preferred over consumption taxes which tend to be regressive with respect to income.

Targeted provisions of the tax system, especially those given through tax deductions or tax credits for socially important expenditures by individuals—those for health, education, training, housing, etc.—are "tax expenditures". For taxpaying individuals, they reduce the cost of these expenses thus potentially helping them to better cope with particular risks. In this way, for many but not all taxpayers, tax expenditures aim at producing results, in terms of social protection or similar objectives, similar to those that the government would have produced through direct spending. Governments often consider tax expenditures as direct substitutes for spending programs. For example, as Van den Ende, et al. write: "A tax expenditure is a government spending in the form of a loss or deferment of tax revenue…" p. 135.

At least 10 OECD countries, including six of the G-7 countries publish tax expenditure budgets that estimate the revenue losses to the governments that are caused by these tax expenditures. Most of these countries do it annually. See Swift et. al., 2004, pp. 9-11. Several of these countries prepare the tax expenditure budget as an annex to the budget document. Germany goes as far as to include the tax expenditure report in the subsidy section of the budget document.

Tax expenditures are particularly relevant when they are connected with personal income taxes and when the personal income taxes are imposed with high tax rates and low personal exemptions. Their shortcomings are that they cannot be targeted precisely and that, especially when applied with tax deductions rather than tax credits, they are more valuable to individuals subjected to high tax rates than to individuals with low tax rates. Individuals who are too poor to pay income taxes (after the personal exemptions) do not get any benefits from the tax expenditures, unless these are given through credits against taxes rather than credits against taxable income. Thus, tax expenditures may end up providing social protection to many individuals but not to some most in need of this protection.

A combination of public spending targeted to those at the lower end of the income distribution or, in the short run, to those most exposed to economic risks, together with well designed tax expenditures for the middle classes could reduce significantly both the level of public spending and the level of taxation in countries. This combination would make it possible for countries to follow the "efficiency hypothesis" during periods of accelerating globalization while maintaining protection for those most in need of it. However, there are significant informational and political requirements or difficulties in designing such a strategy. To target expenditures, it is necessary to decide who the beneficiaries should be. This is always a politically difficult question. It also requires specific and not easy to obtain information on them. The provision of the benefit should not lead to an increase in the number of qualifying individuals, as it may happen for example when unemployment compensation replaces for a long time a substantial proportion of lost wages. Politically and also administratively, it has been easier to enact universal programs than programs that would only benefit particular groups. But, as already said, universal programs tend to be very expensive.

Third Instrument: Regulations

A third important instrument of social protection, at least in intention if not always in results, is regulations. Regulations are at times substitutes for taxes and expenditures. For example the government can either provide subsidies to people with handicaps or require enterprises to have a given proportion of their workforce made up of people with handicaps. As an other example, the government can constrain the price of basic food or subsidize its consumption.

These regulations aim at providing protection for some categories of people against particular risks. They implicitly tax some sector (say the enterprises or the agricultural sector) to subsidize some groups (say the handicapped or the urban workers). See Tanzi, 1998. Therefore, public spending for protection against economic risks and "tax expenditures", can be replaced to some extent by well-targeted regulations. Through these regulations the government can try to achieve specific goals for groups of individuals.

The use of regulations for social goals was adopted widely by the centrally-planned economies where state enterprises were directed to absorb all the workers that became available and to provide them with health care, retirement benefits and often even food and housing. The prices for the output of these enterprises were controlled. These economies, de facto, created a kind of "regulatory welfare state". Of course, economies organized around these principles are far from efficient. However, if the main goal is not efficiency but social protection, the centrally planned economies broadly achieved that goal. They protected their citizens against many economic risks. The proof of this is that a recurrent complaint, heard from the citizens of the economies in transition, has been that the move to a market economy has made their lives more risky. The safety net provided by the past system is no longer there.

Socially-oriented regulations concerning: the labor market (minimum wages, restrictions on firing of workers, requirement to hire disabled individuals, etc.); the housing market (rent controls and restrictions on rental contracts); the credit market (requirements to give subsidized loans to some sectors such as farmers, students, enterprises in poorer areas); the product market (price controls); the foreign trade market (multiple exchange

rates, quantitative restrictions on imports); public enterprises (requirement to provide services at reduced prices for particular categories of citizens), and so on can be used to pursue systematically particular social objectives. The use of these regulations, in centrally planned economies but also in many developing countries, helped create a kind of rudimentary system of social protection that, at least in developing countries, did not require high levels of public spending or tax burdens. Even in the centrally-planned economies the tax burdens were lower than in the welfare states. These regulation-based systems or safety nets are easy to criticize because of the economic inefficiencies that they generate. They were the object of sharp criticism from mainstream economists against the centrally planned economies and from Washington Consensus economists against developing countries.

These regulation-based safety nets can also be criticized because the protection that they provide is random and imperfect. For example the urban middle classes often end up receiving far more protection than the rural poor. Those in formal employment benefit more than those in the informal economy. Still this rudimentary system is very important to many individuals who often are the most vocal and the better organized. These individuals can be expected to oppose the elimination of these regulations. They can also be expected to blame globalization when the pursuit of the "efficiency hypothesis" leads to the dismantling of this rudimentary system. Some of the recent criticism against globalization and against the Washington Consensus comes from the pressure that they have exercised against the existence of these regulations.

V. The Use of the Instruments of Social Protection By Country Groups

The relative use on the part of countries for the three categories of instruments described in the previous section depends on (a) cultural preferences on the part of citizens and policymakers, and (b) on the extent to which the policymakers have access to these instruments. For example, industrial countries could conceivably use all three instruments. However, the developing countries that are, for the most part, unable to raise high levels of

taxation and are unable or unwilling to use personal income taxes, with some exceptions, are limited to the use of regulations and possibly, targeted social spending. We shall deal, first, with the OECD countries and then with the developing countries trying to describe the relative use of these instruments on the part of different groups of countries. By necessity the description will be broad-brush. Far more effort would be necessary to give a more refined description, or to break down the groups of countries into more subgroups.

Industrial Countries

Most OECD countries would be able to use all three instruments described above if they chose to do it. To some extent they have done so. However, closer observation reveals that their relative preferences have been different in the sense that some countries have used a particular instrument more intensively than others. Unfortunately the information available on this issue is limited. Solid data have not been compiled. Therefore, the following paragraphs are based partly on (hopefully informed) impressions and partly on hard facts.

The Scandinavian countries have relied more than other countries on public spending. See Table 2. In 1997 they spent almost 34 percent of their GDP for public social expenditure. These welfare states have provided protection against risks with economic consequences through universal, government- financed programs. These programs have aimed at protecting all citizens "from the cradle to the grave." Naturally, to finance these expensive programs, they have had to impose some of the highest tax burdens in the world. At the same time these countries are reported to have made relatively little use of tax expenditures and of the kind of regulations as discussed above. As to tax expenditures for social purposes, Adema, 2001, p. 23, states that "Information on Finland, Norway, and Sweden has not been included as it concerns very small items: less than 0.05 percent of GDP". Presumably the same is true for Denmark. None of these countries prepares tax expenditure budgets.

In spite of their high tax burdens, these countries have now relatively high ratings in the world competitiveness tables. They are also seen as having relatively efficient and competitive economies.

This good performance may be attributed to three factors: first, their spending has been partly directed toward the creation of greater human capital through good educational standards and substantial and efficient contributions to research and development; second, bureaucratic constraints and regulation of the "red tape" type have been kept to a minimum while the existing well-designed regulations are transparent and enforced objectively. As a consequence the indexes of corruption for these countries are among the best in the world; third, some economists have argued that the existence of an effective safety net, provided by the welfare state, may encourage individuals to take more risk in their economic decisions knowing that if they fail they will not end up in the streets because the state will somehow take care of them. See Sinn, 1998. This argument goes in the opposite direction from the standard one that high tax rates and government subsidies reduce incentives and damage economic growth.

Table 2

Public Social Expenditure for Country Groups, 1997

(Percent of GDP at factor cost)

Country Groups	Percent of GDP
Denmark	35.9
Finland	33.3
Norway	30.2
Sweden	35.7
Scandinavian Countries Average	**33.8**
Australia	18.7
Canada	20.7
Ireland	19.6
New Zealand	20.7
United Kingdom	23.8
United States	15.8
Anglo-Saxon Countries Average	**19.9**
Austria	28.5
Belgium	30.4
Germany	29.2
Italy	29.4
Netherlands	27.1
Other European Countries Average	**28.9**

Source: Arranged from Table 7 in Adema, 2001, p. 27.

` A different approach has been followed by the Anglo-Saxon countries. As Table 2 shows these countries have spent less than 20 percent of GDP on public social expenditure, compared to the 34 percent of GDP spent by the Scandinavian countries. This is an enormous difference. These countries have not created welfare states and generally have kept their public spending and their tax burden considerably lower, as shares of GDP, than the Scandinavian countries. Their safety nets have been much less tight. They have been also parsimonious in the use of regulations. This has allowed them, for example, to have lower unemployment rates than the continental European countries. At the same time they seem to have made greater use of tax expenditures thus subsidizing through the tax system socially beneficial expenditures.

In these countries estimation of what is called the "tax expenditure budget" has given high values. The "tax expenditure budget", measures the tax revenue given up by a government because of the tax preferences. This tax expenditure budget indicates what the government could spend if it eliminated the tax expenditures. The calculation of these tax expenditure budgets is not easy. In fact, because of the difficulties, some years ago, the OECD abandoned the idea of publishing the estimates for different countries. Also the estimates available for different countries do not follow similar principles. For example in some cases regular tax incentives given to enterprises are considered as tax expenditures while in other cases only tax expenditure that have social objectives are estimated. Still, an attempt by Adema to calculate tax breaks for social purposes for 1997 gives the highest values, among 18 OECD countries, to Australia, Canada, Ireland, the United Kingdom, and the United States. See Adema, 2001, p. 27-28. Thus, it seems logical to conclude that what the Anglo-Saxon countries did not do with social spending, they tried to do with tax expenditures. The contrast between this group and the Scandinavian countries in the use of instruments of protection is remarkable.

Several OECD countries do not fit as neatly in a specific pattern as the Nordic countries and the Anglo-Saxon countries. France, Germany, and Italy for example have relied to some extent on all three instruments without showing a specific preference for any of them. They do not seem to be driven by any specific model. However, more

information would be needed to reach firm conclusions. Some of these countries are shown in Table 2.

We turn now to the developing countries. With relatively few exceptions, of which Brazil, Argentina and Uruguay are important examples, developing countries have not tried or have not had the luxury of choosing from among the instruments. The structure of their economies, (with large agricultural sectors and much informality) together with political and administrative obstacles to taxation, have kept their average tax revenue low except in countries such as Brazil, the tax burden of which is now, at 37 percent of GDP, much higher than that of the United States. Because of lack of tax revenue most of them have been prevented from using public spending as an effective instrument of universal social protection. When they have done so using debt finance, they have often got into economic difficulties. On the average, the tax burden of developing countries has remained below 20 percent of GDP, compared with twice that level for OECD countries. Over the years, the positive impact that administrative improvements could have had on tax revenue was partly neutralized by the losses of foreign trade taxes due to the lowering of taxes on foreign trade.

The second instrument, tax expenditure, has also not been available to many of these countries because, as mentioned earlier, this instrument can work best when a country has a personal income tax with high rates that generates high tax revenue. In general developing countries have not had progressive and productive income taxes. However, if the concept of tax expenditure includes also exonerations from value added taxes and traditional tax incentives for enterprises, some estimates of tax expenditures in developing countries are also high. For example, Simonit (no date) reports tax expenditures of 3.02 percent of GDP for Argentina (2001), 1.51 percent for Brazil (2001), 3.8 percent for Chile (1998) and a remarkable 9.2 percent for Colombia (1999). The definitional problems of these estimates must be kept in mind. Most developing countries have been left with the alternative of the regulatory instrument which many of them have exploited intensively especially to the advantage of the urban middle classes.

Regulations have been used to keep low the prices of agricultural products, thus penalizing the agricultural sector in favor of the urban middle classes. Regulation, through

the use of multiple exchange rates, has been used to allow the importation of essential products, such as medicines or basic food, at lower prices in domestic currency. Regulations kept low for many years the prices of the products and services sold by public enterprises. Furthermore, some of these enterprises, such as those selling electricity, water, and urban-transportation, were required to apply price discrimination in favor of those who consumed small amount of these products or who could prove to have low incomes. Regulations forced some public enterprises (railroads, bus companies, national airlines) to continue providing services to distant or isolated communities at costs that far exceeded the revenue obtained. Regulations kept interest rates low or forced banks to extend cheap credit to activities considered socially important. Regulations imposed minimum wages or wage increases not always fully justified by market conditions.

These and other forms of regulations created, for those benefiting from them (mostly the urban middle classes) a kind of rudimentary safety net or even a rough welfare state not based on public spending. It was a safety net that would be criticized by economists and that created many inefficiencies. However, to those who benefited from these regulations, the safety net was important and real. They often reacted strongly when some of these benefits were removed as it occurred when public enterprises were privatized, price controls were removed, interest rates were set free and multiple exchange rates were replaced by single flexible rates. The so-called Washington Consensus was largely a frontal attack against this system. It promised uncertain and delayed benefits for the general public interest against, for some, certain and immediate costs. To the extent that the Washington Consensus was identified with globalization, there was an almost natural opposition to it on the part of the groups that had benefited, or thought that they had, from the old system.

There is not much formal information on the growth of the regulatory state. It can be speculated that until the early 1980s, the regulations that were not specifically of the "red tape" type, and there were many of these, as shown, for example by Hernando De Soto, were directed at the creation of rudimentary safety nets as described above. Often governments with populist biases favored these regulations. However, after the early 1980s, and especially after the time of Thatcher and Reagan, the regulations started

changing character. This change was in part brought about by the need to become more efficient in a globalizing environment. The regulations became less redistributive and more directed towards increasing the efficiency of the economy. In other words they aimed at replacing the regulatory welfare state with "regulatory capitalism or neoliberalism". In more recent years there have been pressures to extend these new regulations at the global level to make the process of globalization work more efficiently with less crises and less difficulties for specific countries.

A recent paper has traced the "...explosive growth of regulatory agencies (not regulations) across different sectors and nations in Latin America". See Jordana and Levi-Faur, 2004, p.l. The authors report that this process started in the 1920s and continued until the present time. Along the way its objectives changed. As Jordana and Levi-Faur put it: "Reforms should be understood against the background of four related characteristics of the [Latin American] region: the crisis of the old "developmental" model, the widespread diffusion of economic reforms, democratization and the problem of state consolidation". With the passing of time there was a shift from reliance on taxing and spending and on redistributive regulations to rule-making regulations. At first this shift was towards giving the state more power and promoting its view of state-led development. Later the shift was toward giving more power to progressively more independent regulatory authorities. To the extent that those who ran these regulatory authorities were progressively more market oriented individuals, the activities of these "authorities" would have reflected this shift.

VI. Concluding Remarks

How will national policy respond to a continuation of the process of globalization in the future? Although it is dangerous to try to predict the future, a realistic assumption at this time is that the current process of globalization will continue, driven mainly by real factors such as new technologies, decreasing costs of travel, realization that a country needs to be integrated in the world economy in order to grow, and so on. Of course a major crisis such as the one that occurred in the 1930s or an intensification of terrorist threats could change this forecast. The impact that terrorism and plagues could have on globalization is

still not fully appreciated. If terrorism came in the form of the spreading of infective diseases, this could be a disaster for the globalization process.

Some literature has worried that this process will weaken the power of the state and will reduce its ability to protect citizens from, presumably, increasing economic risks associated with globalization. Some have worried that the state will leave the fate of the people in the hands of economic forces which is automatically assumed to be a bad outcome. Cepal, 2003, p. 25. These dire predictions are somewhat alarmist. It is not likely that the state will fade away. There is really little evidence that this is happening although the need to cooperate with other governments in areas where there are important international externalities and in the areas of public goods is becoming everyday more evident. See Kaul et al., editor (2003). However, as happened in the past under different circumstances, the state will have to adjust its role to the new reality and to use the instruments available or new instruments in the best possible way. It is not wise to assume that only the private sector will have to adjust.

For all countries there has been a growing need to deal with global problems through global responses. In the absence of a world government, there has been a growing role played by international institutions that have been acting as proxies for the non-existing world government. See Tanzi, (1999). To the extent that the countries participate fully and democratically in this process and that the policies assigned to the international institutions deal with global public goods and international externalities, there should not be complaints about national governments losing their power.

However, globalization is affecting the ways in which countries deal with particular national objectives. In this paper we have focused on the national goal of providing some protection to citizens against economic risks. This is an objective that became a legitimate one for governments only during the last century. Some of these risks, such as getting old, or getting ill, or disable have little to do with globalization. These risks have always been there. These are the one that have caused much of the increases in public budgets. Others might or might not have increased because of globalization, as for example losing once job, or going out of business because of foreign competition, or losing one's financial wealth. But generally governments spend very little to protect individuals against

these specific risks. The key question is whether globalization has reduced the power of the state to deal with these objectives regardless of whether globalization has contributed or not to these risks.

In a recent paper (Tanzi, 2001) it was argued that, in fact, globalization has decreased the ability of countries to maintain high tax burdens. That paper concluded that there are “fiscal termites” at work, many connected with the phenomenon of globalization, that are making it more difficult for some OECD countries to maintain the high tax ratios of a few years ago. We can already observe a process of lowering average tax ratios in many high tax countries. This process is likely to continue so that high tax countries, and especially the so-called welfare states, will need to learn to cope with their needs with progressively lower tax revenue.

This scaling down of tax revenue would leave the countries with two options. First, to reduce the generosity of the benefits that individuals receive from the welfare states or to make these benefits less universal and thus better targeted. Second, to force citizens to buy at least parts of their insurances against social risks from the private sector. In these decisions government could play an important regulatory role. For example, they already force drivers to have to buy car insurance. In the same way they could force citizens to have insurances against old age or against poor health subsidizing those who, because of low incomes, could have difficulties in buying these protections. This is already going on in the area of pensions and, to a lesser extent, in the area of health. Given the right incentives, the private sector could play a much greater role in this area. See Tanzi, (2004).

The need to become more competitive will not only reduce tax burdens but it will also reduce the countries’ ability to rely on “tax expenditures” and on redistributive regulations. See Tanzi, (2002). Regulatory authorities should use their regulatory power to improve the efficiency of the economy and not to redistribute income.

Globalization has probably increased the economic instability of developing countries thus increasing economic risks for some individuals in those countries. As a consequence, governments might wish to play larger roles to deal with these risks. However, given the lesser sophistication of their private markets, compared with those of

industrial countries, and given the fact that globalization is progressively dismantling the rudimentary system of protection that had, in the past, relied on redistributive regulations, the developing countries must follow a different strategy. For many of them, it should still be possible to make their tax systems more productive especially through a greater use of personal income taxes. The tax levels of many developing countries are generally so low that it should be possible to raise them. With additional resources the governments of these countries could focus on developing targeted programs that, at relatively low costs, can provide protection to those who most need it. Some evidence of good programs that have these characteristics have begun to appear. Progress in Mexico is a good example of such a program. It is hoped that these best practices can be generalized. See Inter-American Development Bank, 2000, p. 153-156; and De Ferranti et al., 2003, pp. 376-384. However, the dilemma that they will face is whether countries, that have many poor people, should direct their resources at alleviating permanent poverty or at providing safety nets for middle classes.

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This article focuses on how globalization is influencing social policies and policy making in nation-states in the South. The paper argues that social policy making is displaced from the national arena because international institutions and capital are globally assuming the control of major social and economic decisions. By examining various factors driving globalization and using cases and examples, the paper demonstrates that neo-liberalism, supported by international financial institutions, is the underlying force permeating the poverty reduction strategies, NGOs and aid policies so that th