



**COLLANA DEL
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**WELFARE MODELS, INEQUALITY AND ECONOMIC
PERFORMANCE DURING GLOBALISATION**

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DIPARTIMENTO DI ECONOMIA

**WELFARE MODELS, INEQUALITY AND ECONOMIC
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Welfare models, inequality and economic performance during globalisation¹

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Abstract

The objective of this paper is to explore whether “the efficiency thesis” concerning the relation between welfare states and globalisation is functional for economic growth or, alternatively, whether “the compensation thesis” produces better results in terms of economic growth. The current crisis (2007-12) was a test for many advanced economies to determine whether the socio-economic model that those countries built in the last several decades was able to cope with the challenges of globalisation. My hypothesis is that the efficiency thesis, according to which globalisation needs to be accompanied by the retrenchment of welfare states in order for firms to be competitive, does not cause growth. The tests are conducted in a sample of 42 countries made up of OECD and EU members. On the contrary, our econometric exercises indicate that the “compensation thesis” (i.e., regulated globalisation and an expanded welfare state) is better able to produce higher economic growth.

Keywords: welfare states, inequality, globalisation, financialisation, economic crisis

JEL: I380, P510, F600, G010

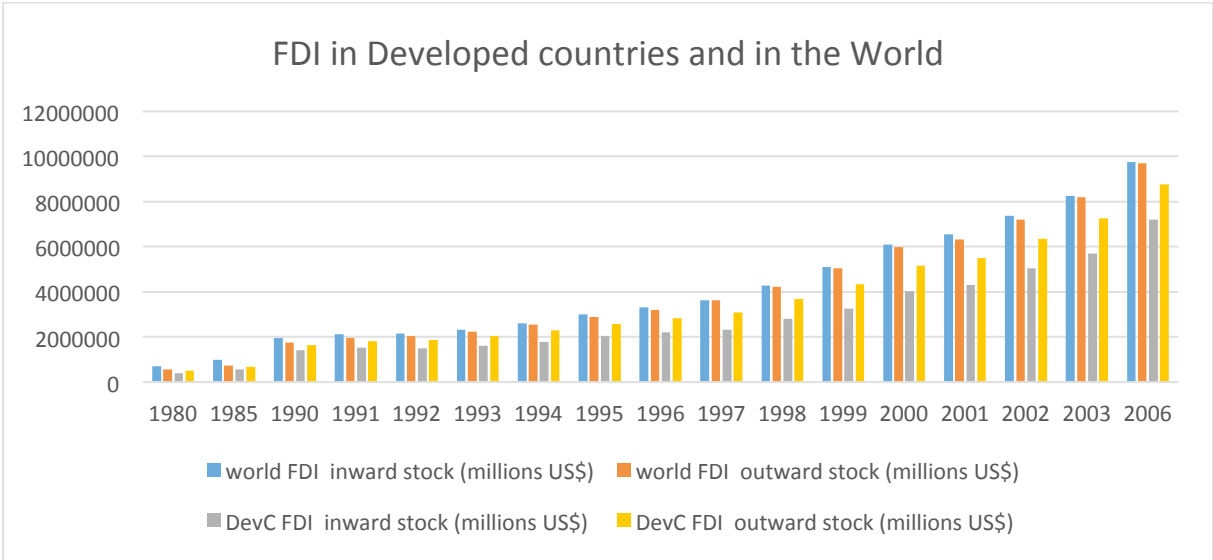
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1. Globalisation: causes and consequences, a brief overview

Globalisation has been one of the most debated topics in at least the last two decades by scientists of different disciplines such as economics, politics, sociology, business, anthropology, engineering and transport studies and environmental studies, among others. In fact, the emergence of globalisation is widely relevant to the subject of human lives from different perspectives concerning incomes, wealth, consumption habits, production, institution, governance, infrastructures, transports, and technology, among others. However, globalisation is still a generic term, which, in most of the definitions, is identified as a process of the *intensification* of, for instance, trade, capital mobility, finance, and labour. By contrast, there are authors such as Hay and Wincott (2012) who disagree with such a definition of globalisation and would rather define globalisation as a process not only of the intensification of those flows but also of *extensive* increase at a planetary level of trade, capital and labour mobility, and technological exchange, among others (Held et al., 1999). Because evidence of this second type of definition of globalisation is missing and not all countries in the globe are part of the globalisation process (quite the opposite; globalisation interests a limited, yet increasing, number of countries), they conclude that it would be more appropriate to speak about regionalisation rather than globalisation. For instance, trade, capital and labour mobility particularly increased in the European Union (Europeanisation), among advanced and emerging economies (trans-regionalism), or among North American countries (with regional agreements such as NAFTA), etc. Hence, the interpretation of globalisation remains quite controversial and remains an on-going and evolutionary process. The figure below attempts to show the asymmetry of globalisation or essentially the intensification of the process in primarily advanced economies during 1980-2006

(i.e., until the eve of the financial crash in 2007), which is considered the period during which globalisation intensified tremendously.²

Figure 1 – Capital mobility in terms of FDI



Source: The World Bank database

Nonetheless, while it is true that globalisation interests more advanced (and increasingly more emerging economies, typically BRIC countries)³ and less poor economies, it is objectively impossible to deny the intensification of this process and the increase in the number of countries involved in the global economy in the last two decades. The figure below is the simplest representation of this kind of globalisation. In particular, a first big wave of globalisation, identified purely according to the *intensive* definition, took place after 1970, which a new international monetary scenario, the change in oil prices and the beginning of the

² Advanced economies mostly correspond to OECD countries, termed in figure 1 as DevC (Developed Countries).

³ Brazil, Russia, India and China.

European Monetary Systems may have generated. However, this first wave of globalisation was unstable and the process of intensification declined during the 1980s. Finally, the process of intensive globalisation, accompanied often by the extensive inclusion of more and more countries in the process, steadily took place at the end of the 1980s, when several institutional, geopolitical and technological changes occurred. I tend to particularly underline the importance of the following six changes to the process of globalisation:

1. The political (and to some extent also ideological) change that occurred during the 1980s, particularly in the United States and Great Britain with the new administrations of Reagan and Thatcher. These two political leaders were able to shape the international political consensus to some extent that the change towards globalisation required. This change occurred initially in the USA and the UK and later was promoted with the help of the major international organisations such as the International Monetary Fund and the World Bank, which were very close to the Washington administration (Stiglitz, 2002) at the international level, along with a new political economic doctrine which became known as the “Washington Consensus”.
2. The financial deregulation that occurred in particular under the stimulus and the policies of the two administrations of Reagan and Thatcher mentioned above, first in the USA and in Great Britain and later in many advanced and developing economies. The financial deregulation contributed to both extend capital globally in search of higher profits and intensify the economy with finance and financial tools so that economies across the world soon became attracted to the process of financialisation.
3. The fall of Berlin Wall in 1989 (and the following dissolution of the Soviet Union in 1991), which caused the end of the Cold War and the end of the division between the East and West of Europe (and in a way of the East and West of the World) with the significant inclusion of the former communist economies in the global economy (or to be more precise, in the

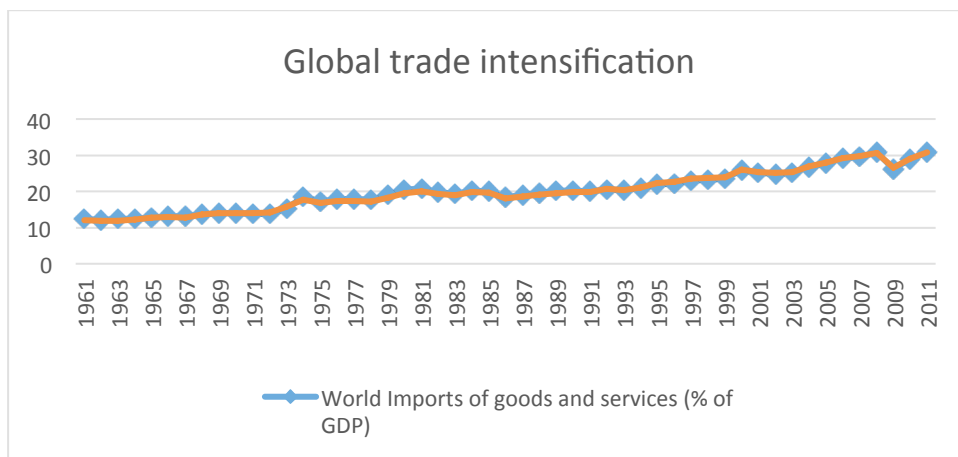
economic system of Western Europe, North America and other few advanced economies).

4. The deepening of the process of integration of the European Union (which in a way is connected with the previous item), which culminated with the Maastricht Treaty, introducing capital mobility along with the liberalisation of trade, service, goods and labour in an important and large market such as the European Union.

5. The tremendous challenges posed by the technological progress that brought about the ICT revolution and all the other great innovations introduced in transport and in telecommunications the contributed to reduce transportation costs enormously.

6. The take-off (during the 1980s and 1990s) of several emerging economies in terms of economic growth, often identified with the term BRIC.

Figure 2 - Globalisation in terms of trade intensification



Source: The World Bank database

Theoretically, globalisation, or to be more precise, openness, was and is supported by the so-called mainstream neoclassical approach. Lewis (1980) and many

economists such as Lucas (1993) and Baghwati (2004) believed that trade is the engine of economic growth. Nevertheless, the experience of globalisation so far has shown that the performance of opened economies can vary consistently. The hypothesis that we are supporting in the paper is that openness *per se*, although it may be one of the indicators of competitiveness, is not an engine of economic growth. Openness (defined as imports and exports as a percentage of GDP) and integration in the world economy should be accompanied by institutions, state strategies and particularly by a consistent welfare state that support internal cohesion and maintain external competitive advantages. According to Rodrik (1999), the best-performing countries are the ones that are integrated in the world economy with appropriate institutions that are able to support the impact of globalisation on the domestic market and social domestic issues. Countries with poor social institutions, weak conflict management institutions (which means poor welfare states) and strong social cleavages suffer external shocks and do not perform well in the world economy. Nevertheless, for most of the globalisation period, the USA has been an example of neoclassical economics, showing that globalisation does not necessarily need a strong welfare state. However, the current financial and economic crisis which started in the USA in 2007 and its consequences that are currently propagated in many advanced economies seems to show that the Rodrik argument still holds true: “*The world market is a source of disruption and upheaval as much as it is an opportunity for profit and economic growth. Without the complementary institutions at home – in the areas of governance, judiciary, civil liberties, social insurance, and education, one gets too much of the former and too little of the latter*” (Rodrik, 1999:96).

For Lucas (1993), international trade contributes to stimulate economic growth through a process of structural change and capital accumulation, as in the case of Ireland, where according to Walsh and Whelan (2000), a structural change had already taken place during the 1970s and created conditions that allowed the Irish economy to grow considerably in the 1990s and later in the 2000s. Capital

accumulation is determined by “learning by doing” and “learning by schooling” in a process of knowledge and innovation spillovers. A country that protects its goods from international competition by raising tariffs on goods made with intensive skilled work will have as an effect a domestic increase in the price of goods that use intensive skilled work. Skilled workers’ wages will increase and R&D will be more expensive. Consecutively, investments in R&D will decrease, and growth will be affected negatively. On the contrary, deleting tariffs on those goods will cause a reduction in the price of goods that use intensive skilled work. R&D will cost less, and investments in R&D will increase, with positive effects on growth (Lucas, 1993). Policies should therefore address such problems and should create conditions for effective and substantial R&D investments.

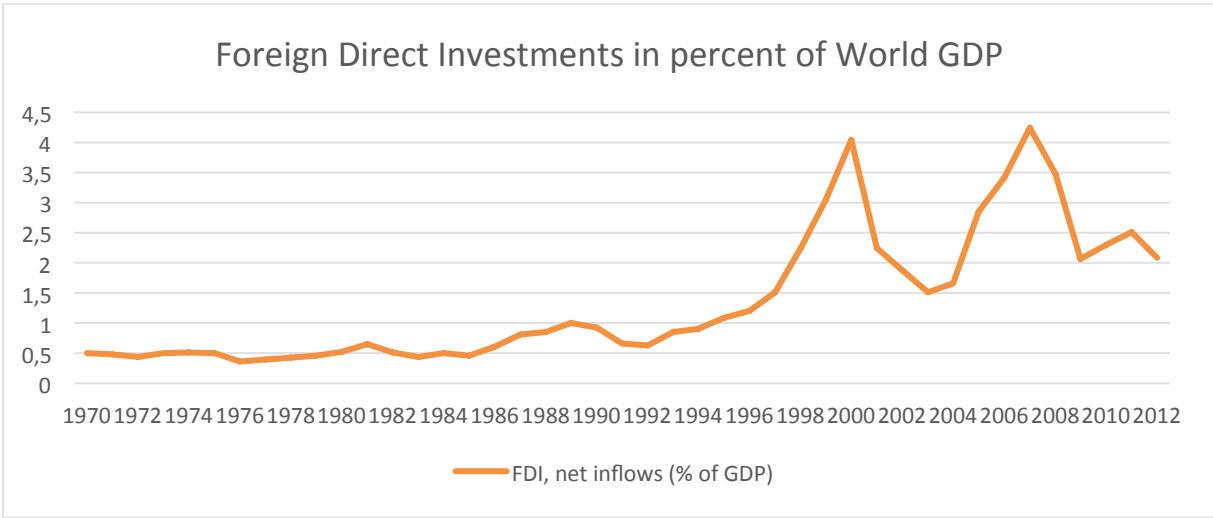
This argument, however, does not take into consideration the inequality and uneven development caused mainly by liberalisation and trade intensification via wage differentials. This risk was already raised by Stolper and Samuelson: according to the Stolper-Samuelson theorem, market integration increases economic inequality and vulnerability because increased international trade raises the incomes of the owners of abundant factors and reduces the incomes of the owners of scarce factors. Since advanced industrial countries are more capital-intensive economies and abundant with skilled labour, trade is expected to be beneficial for capital-intensive economies and skilled labour and detrimental for unskilled labour, increasing income inequality, and for labour-intensive economies, increasing regional disparities.

Similarly, increased capital flows are expected to raise income inequality in advanced industrial economies because capital outflows from capital-rich countries to LDCs reduce domestic investment and lower the productive capability and demands for labour in these economies (Ha, 2008; Tsebelis 2002). Because a reduction in total capital in the production process increases the marginal productivity of capital and reduces the marginal effect of labour, capital outflows

increase the income of capital relative to labour, increasing income inequality. In particular, because foreign direct investment (FDI) outflows from advanced industrial countries tend to be concentrated in industries with low-skilled labour in the home country (Lee 1996), rapidly rising FDI outflows often reduce the demand for low-skilled labour and increase income gaps in industrialised countries. In fact, several studies find that trade with less developed countries is associated with expanded income inequality in industrialised countries (Wood 1994; Leamer 1996; Rodrik 1996; McKeown 1999).

Empirically, it is interesting to observe FDI expansion, which experienced a strong increase in the 1990s due to liberalisation of capital mobility and then a collapse at the beginning of the 2000s due to the global uncertainty caused by the international events of September 11, 2001. A further and bigger increase in FDI flow can be observed immediately later and until the financial crash of 2007, with a peak in the FDI flows in 2006-07. The current crisis, marked by financial instability and depression, caused a further squeeze in FDI, which, however, remains at a much higher level than at the beginning of 1990s.

Figure 3 - FDI in the world economy



Source: The World Bank database

2. Welfare and inequality in the age of globalisation: an empirical analysis

Globalisation poses several challenges to national economies and governments. One of the most important is the consequence on inequality, both within countries and between countries, and its impact on welfare state sustainability (Hay and Wincott, 2012). We will focus on inequality within countries and on the impact of globalisation on the sustainability of national welfare states.

In this context, the debate is very lively, and it has produced two main interpretations of the problem. The first one states that globalisation reduces the share of welfare states because it constitutes a cost for firms. Higher levels of welfare states produce higher income tax levels, social costs and contributions, which reduce profit prospective and increase costs for firms. Firms would be hence pushed to go abroad unless government retrenched welfare state spending and reduced taxes. Hence, in order to maintain higher levels of investments, firms and employment in the country, the welfare state needs to be reduced under the process of globalisation. This interpretation is well known as “the efficiency thesis”. This thesis was developed within the neoclassical (or neoliberal) paradigm, and it argues that globalisation has forced (or should force) states to retrench social welfare in order to achieve a market-friendly environment and attract increasingly mobile international capital and competitiveness (Blackmon 2006; Castells 2004; Allan & Scruggs, 2004).

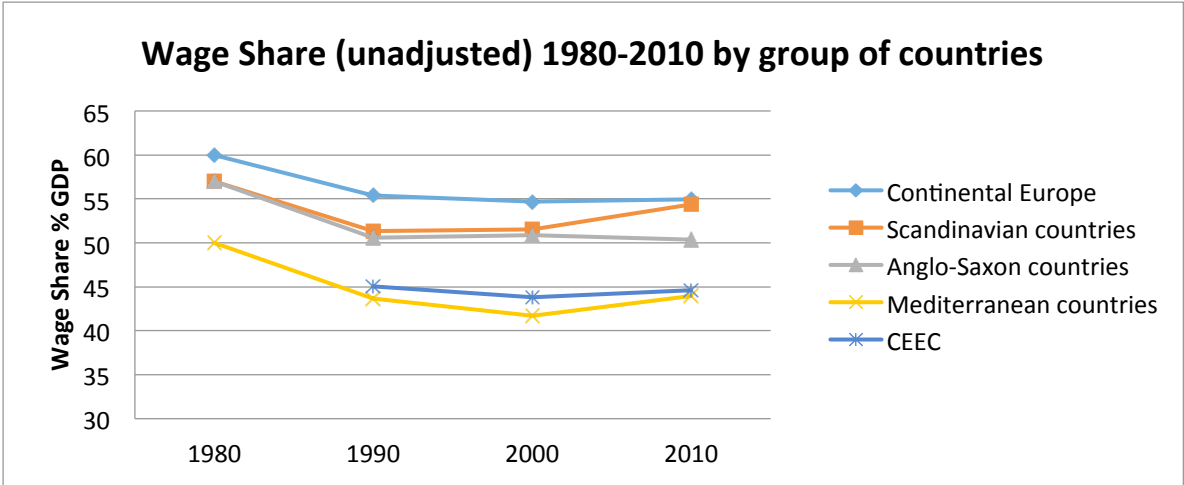
The efficiency thesis is contrasted by “the compensation thesis”, which argues that because globalisation increases inequality, welfare states need to increase. In other words, globalisation pressured governments to expand welfare expenditures in order to compensate for the domestic “losers” of the globalisation process (Brady et al. 2005; Rodrik 1998; Swank 2002). In a way, it can be also argued following the compensation argument that welfare expansion would allow states to further pursue globalisation. An extensive interpretation would then see welfare expansion not as a result but as a condition of globalisation, so that in order to continue (or to start)

with the process of globalisation, policy makers must expand social safety nets. Empirical evidence concerning the relation between globalisation (intensification) and welfare (expansion/retranchment) is often found to be inconsistent and mixed.

However, it is true that with the introduction of outsourcing practices and FDI outflows, globalisation has improved the bargaining position of capital relative to labour in higher-income countries. As Feenstra (1998, p.46) observes, the impact of globalisation on changing the bargaining position of labour and capital has far-reaching consequences. The decline in union power, particularly within trade-oriented industries, may well account for a portion of the increased wage inequality in the United States and in other countries (Borjas and Ramey, 1995). The decision of firms to move capital and production across countries has distributional effects: the position of low-skilled workers in industrial countries is worsened by a combination of 1) globalisation and 2) new technology (Tisdell and Svizzero 2003). The first increases the bargaining power of capital against labour, with the consequence that it is easier for capital to obtain tax reductions and welfare retranchment. The states are willing to embark on tax competition among them in order to keep investments and production at home. The second has a direct and negative impact on unskilled labour and income distribution without welfare support and social institutions.

In this context, wage shares declines dramatically, with negative consequences on the aggregate demand, as the figure below suggests. The figure reports the average data aggregate by group of countries. Anglo-Saxon economies (later included in the liberal competitive market economy model) and Mediterranean economies suffered the most from the restructuring process that occurred since the 1980s and intensified during the 1990s and 2000s.

Figure 4 – Wage share in advanced economies



Note: The unadjusted wage share is calculated as total labour compensation of employees divided by value added.

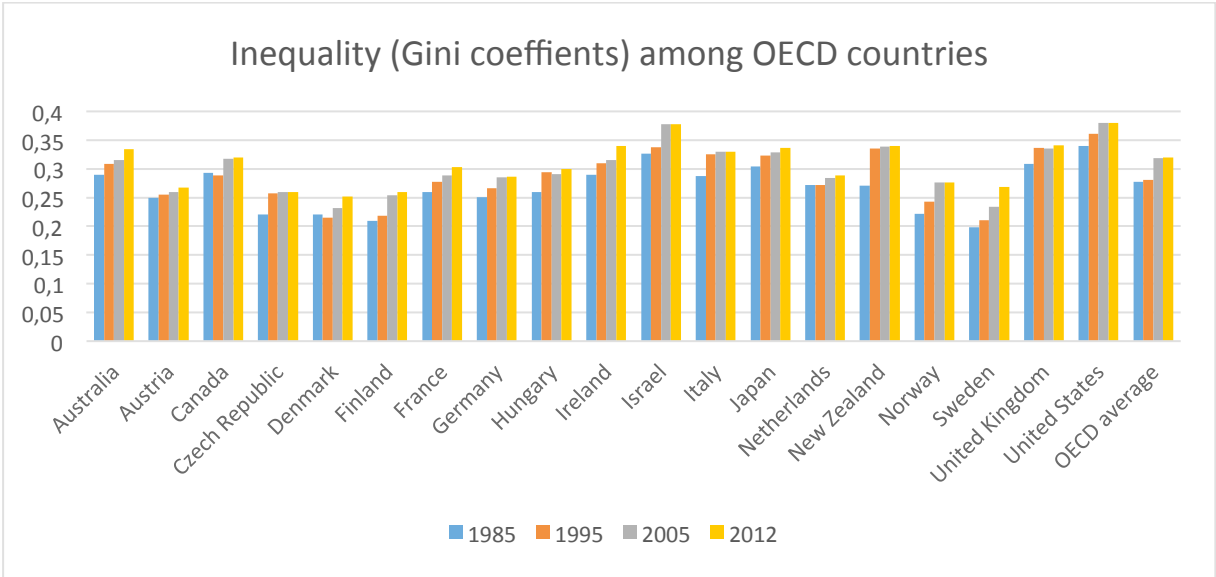
Source: own elaboration on the ILO database

This argument was already very clear to Adam Smith in his “Inquiry into the Nature and Causes of the Wealth of Nations” published in 1776, as the following passage, which helps to understand the tensions between globalisation and welfare, suggests: “The proprietor of stock is properly a citizen of the world, and is not necessarily attached to any particular country. He would be apt to abandon the country in which he is exposed to a vexatious inquisition, in order to be assessed a burdensome tax, and would remove his stock to some country where he could either carry on his business or enjoy his fortune at his ease. A tax that tended to drive away stock from a particular country, would so far tend to dry up every source of revenue, both to the sovereign and to the society. Not only the profits of

stock, but the rent of land and the wages of labour, would necessarily be more or less diminished by its removal” (Smith 1776 [1976]: 848–9).⁴

Inequality during globalisation and particularly during the 1990s and the 2000s increased in most advanced and emerging economies. A simple look at the Gini coefficients across countries shows the worsening of income distribution within countries. The reasons for this are various (Atkinson, 1999; Milanovic 1988; Tridico 2010; Galbraith 2012).

Figure 5 - Inequality



Source: OECD database

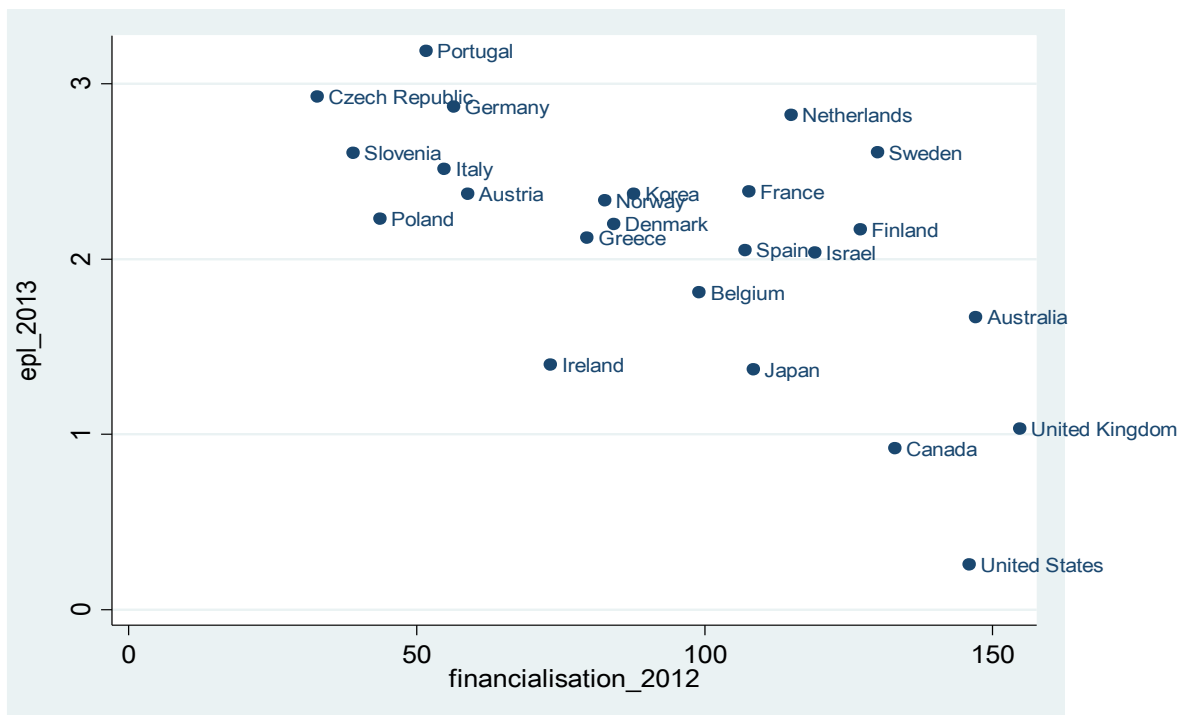
However, most of the arguments raised by the literature in the last several years have to do with the new socio-economic model built around the world in the last two decades as a consequence of the new macroeconomic consensus, which brought about a new and higher level of financialisation in the system under the process of globalisation (Galbraith, 2012; Fontana et al., 2013). The new macroeconomic consensus is strictly linked to, if not completely correspondent with, the

⁴ It should however be remembered that Adam Smith was writing in an age where the state was very much under the vexatious control of a Monarchy. We therefore consider Smith as a pre-cursor of a neoliberal approach favouring a globalised market without rules, institutions and welfare, as many advocates of free market and uncontrolled globalisation would instead argue today.

Washington consensus doctrine, which called for the implementation of some institutional forms that better suit the globalisation process, such as the financialisation of the economy and the introduction of labour flexibility in the economy (see Tridico, 2012). Acemoglu (2011) argues that the policies over the last two decades in particular were more closely aligned with the preferences of a minority of high-income voters; instead of redistributive policies favouring low- and middle-income constituents, politicians implemented financial deregulation policies favouring influential high-income constituents (many of whom worked in, or directly benefited from, the financial sector).

Financialisation and labour flexibility are two institutional forms that go hand in hand and that were introduced across the world by countries in different degrees in order to guarantee the expansion of the globalisation process. Labour flexibility increased everywhere in Europe and in advanced economies in the last 20 years. However, some countries, such as Germany, Austria, Belgium and France, still have more rigid labour markets. Other economies, such as Denmark, Sweden, Finland and the Netherlands, introduced higher levels of flexibility along with higher levels of security. Countries such as the USA, the UK and Ireland increased (or maintained) a very flexible labour market. Finally, Mediterranean countries such as Italy, Spain and Greece and most of former communist economies in Europe combined very hybrid situations (of liberal and corporative elements) with an increasing level of labour flexibility. Interestingly enough, these four groups of countries share similar levels and similar group classifications as far as financialisation is concerned. The highest level of financialisation is found to be in the last two groups, and the lowest level of financialisation in the first two groups, so that a clear and positive correlation, as the figure below suggests, can be found between labour flexibility and financialisation.

Figure 6 - Correlation scatter between financialisation and labour flexibility (EPL)



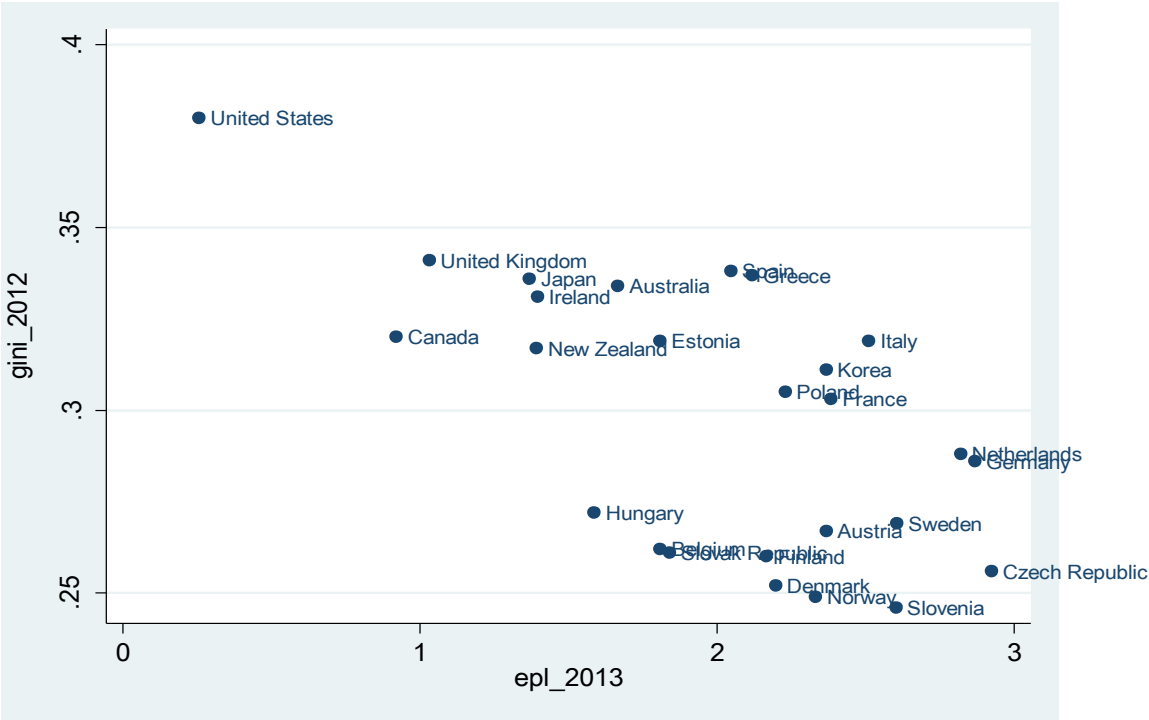
Source: Own elaboration on the OECD and World Bank database

The Employment Protection Legislation (the EPL 2013) is the indicator of the OECD, which measures the level of worker protection in the labour market and consequently the level of labour flexibility. This indicator shows the level of protection offered by national legislation with respect to regular employment, temporary employment and collective dismissal – in other words, regulation that allows employers the freedom to fire and hire workers at will (OECD 2004).

A flexible labour market with compressed wages and poor consumption needs to be supplemented by available financialisation and credit, hence, to have developed financial tools to sustain consumption, which otherwise were compressed by low and unstable wages (Brancaccio and Fontana, 2011). In this context, a large number of financial tools were invented to finance consumption, postpone payments, extend credit, and create extra-consumption (Tridico, 2012). That said, it is difficult to establish a causal relation: we cannot be certain whether financialisation required labour flexibility or if increased labour flexibility brought about hyper-

financialisation. A simple correlation between these two complementary institutional forms of neoliberalism seems more likely.

Figure 7 - Correlation scatter between inequality and EPL



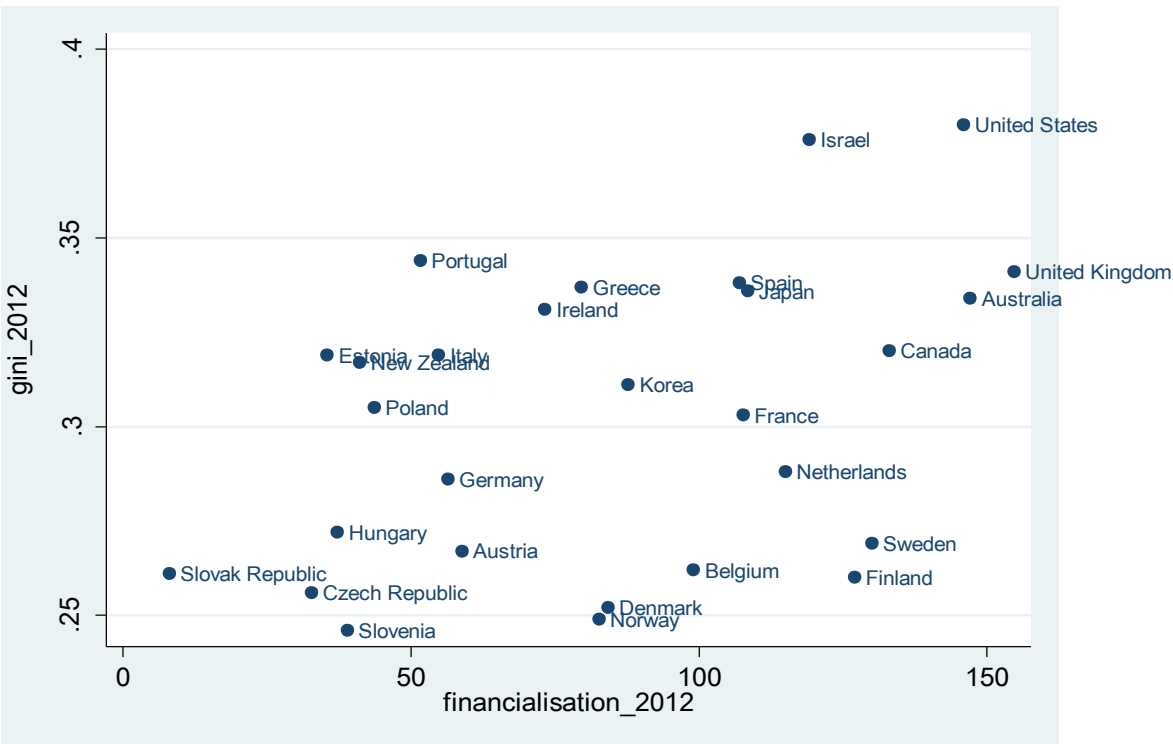
Source: Own elaboration on the OECD and World Bank database

Labour flexibility allows for the reduction of the labour costs and thus wage saving at the expense of wage earners, i.e., consumers. In such a situation, inequality increases and the aggregate demand could be restricted because consumption decreases. It is very interesting to notice an inverse relationship between inequality and the EPL index (labour flexibility): the lower the EPL (higher flexibility), the higher the inequality. Continental and Scandinavian European countries have a higher EPL (lower flexibility) and lower inequality, while Anglo-Saxon and Mediterranean generally show the opposite values of higher inequality and lower EPL (higher flexibility) (See also Tridico 2013).

As a result, one can see in the figure below that high financialisation is typically associated with high Gini coefficients and higher labour flexibility. More

interesting, however, is the parallel trends of these variables: when financialisation increases, one notices both increased flexibility and inequality. In other words, as it was argued elsewhere (Tridico, 2012), the rise of inequality generated in the labour market during globalisation led to an increased demand for credit, which translated into a credit expansion, and the increase of supply was provided for by accommodating monetary policies and financial deregulation.

Figure 8 - Correlation scatter between financialisation and inequality in 2012

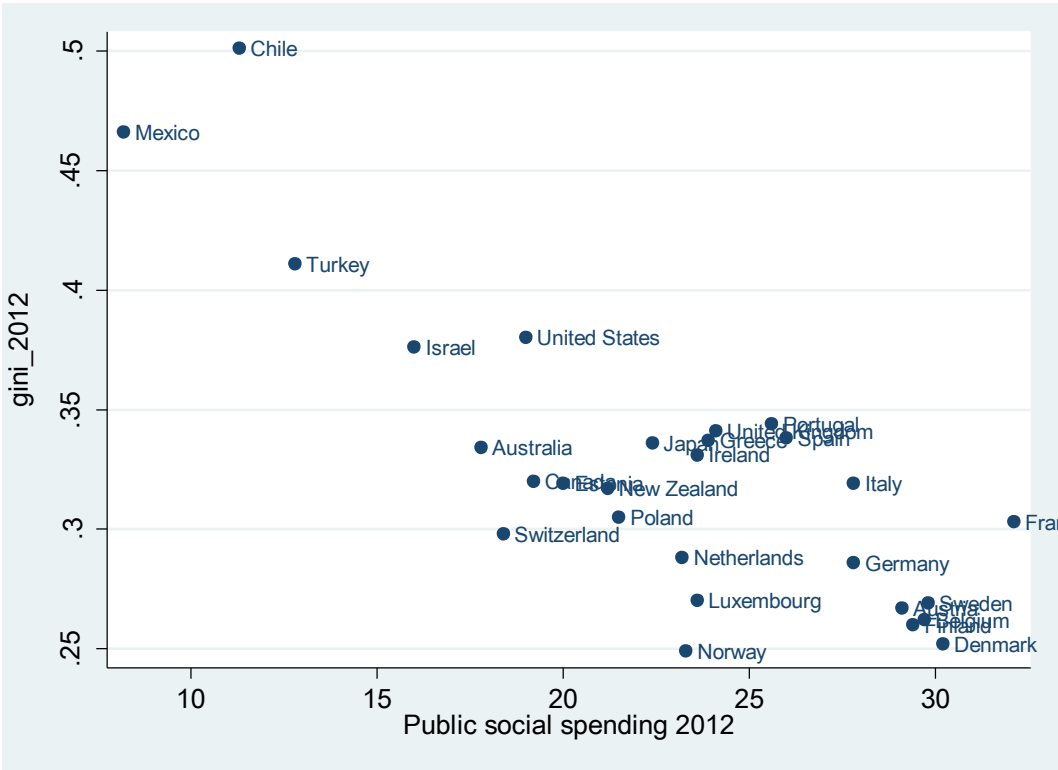


Source: Own elaboration on the OECD and World Bank database

However, what determines whether inequality increases or decreases under the condition of globalisation seems to be the pattern of the socio-economic model that each country built during the decades after the Second World War. More specifically, what is most relevant is the set of policies that each country is currently able to implement in order to cope with the challenges of globalisation both in terms of income distribution and competitiveness (Rodrik, 1999), in particular, the institutions and the conflict management policies that countries put in place during

the last two decades, social protection against unemployment and lower wages, social expenditures against poverty, public expenditures and programmes on health and disease, social policy for housing, and so forth. In this context, our contribution is relevant. A proxy of these patterns can be offered by the relationship among OECD countries – which are considered the most advanced market economies between inequality and welfare expenditures. As the figure below shows, there seems to be a clear relationship between inequality and welfare expenditures in the sense that countries that spend more on welfare have a generally lower level of inequality.

Figure 9 - Gini coefficients and Public Social Expenditure (% GDP), in 2010

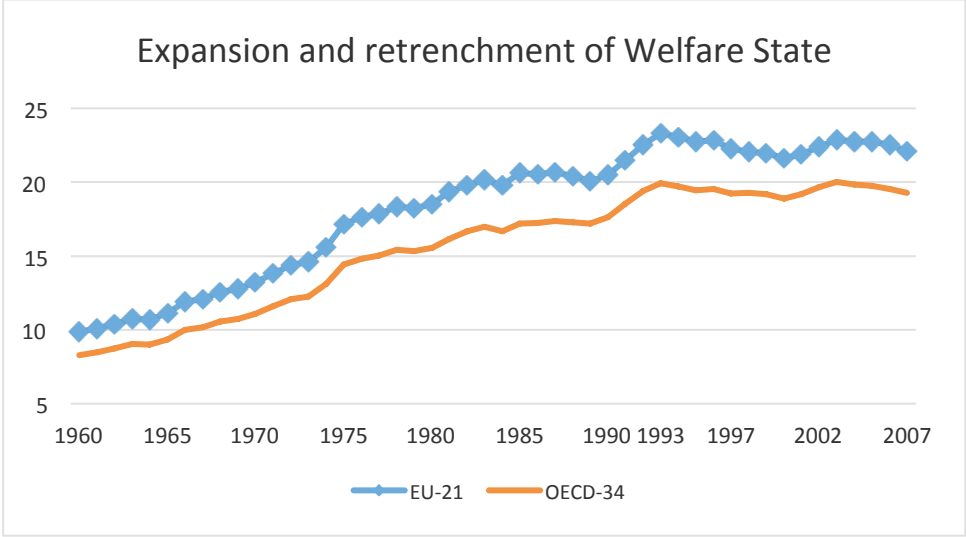


Source: own elaboration on the OECD database and OECD (2012)

After the Second World War particularly since 1960, countries, especially those in Europe, invested increasing shares of their GDP on developing welfare states. This increasing trend continued until the beginning of the 1990s. After that, and particularly after the peak reached in 1993, governments started to retrench welfare

states, and the percentage of welfare expenditures was lower at the eve of the financial crisis in 2007 than in 1993.

Figure 10 - The Welfare States since 1960 (Public Social Expenditure, % of GDP)



Source: OECD (2012)

The efficiency thesis at first glance seems to provide a strong explanation here: advanced economies that embarked on globalisation had to reduce their welfare expenditures in order to satisfy firms’ needs and requests and to increase their competitiveness. However, as I will show, this explanation is not appropriate to understand which countries in the end had actually better economic performance in terms of GDP dynamics and labour market performance.⁵ In particular, we will see that countries that reached a relatively higher level of welfare expenditures and where cuts did not occur or occurred relatively less had better economic performance during the crisis that started in 2007 and continued until today. On the contrary, countries that at the eve of the crisis were found to have poorer welfare

⁵ In this paper, besides GDP growth (g), I also took into consideration two labour market indicators such employment growth (n) and unemployment levels (U). The objective is to avoid biases and to look at the economic performance from a wider perspective: in fact, some countries can have relatively better GDP dynamics but very bad employment performance (and vice versa). For this purpose, I have built a so-called Performance Index for the period 2007-13, taking into consideration g, n and U: Average GDP growth (in 2007-2013) + Average Employment growth in 2007-13 – Unemployment rate (average 2007-13).

states and cut welfare expenditures more profoundly during the 1990s and 2000s had worse economic performance in terms of GDP dynamics and labour market indicators (like employment growth and unemployment). These results will be shown in the following section.

3. The model

In order to test these hypotheses, particularly the consistency of the compensation thesis versus the efficiency thesis, a sample of 42 advanced economies within the OECD and EU members was used.

The equation to test is the following:

$$GDP = \alpha + \beta_1 SocialSub. + \beta_2 EducationExpendit. - \beta_3 Import + \beta_4 Export + \varepsilon$$

The model predicts that countries have higher income if invest more in welfare (SocialSub.), invest more in Education (EducationExpendit.), import less and exporting more (var Import and Export); a term of error, ε is added to the equation.

The model uses longitudinal panel data of six years for the period between 2007 and 2012. These were the years where most of the advanced economies fell into economic crisis and stagnation. The results, presented in the following regression table, confirm the predicted model of the above equation, according to which GDP per capita in 2012 is higher if countries invest more in welfare (as percentage of the social subsidies on GDP), in education (as percentage of education expenditures on GDP) and manage to import less and to export more (Import and Export as percentages of the GDP). All the data refer to the period 2012-2007, for a total of 240 observations.

Table 1 - Regression results

| Regression Model on a Longitudinal Panel | | |
|--|---------------------------------|-----------------|
| Dep Var.: GDP per capita (Log Natural) | | |
| Variable | Coeff. (standard errors) | P-values |
| Public Social subsidies (% of GDP) | .0085532 (.0029786) | 0.008 |
| Education_Expend. (public), % of GDP | .1323674 (.0372624) | 0.001 |
| Import, % GDP | -.026967 (.0068556) | 0.001 |
| Export, % GDP | .0223626 (.0061447) | 0.001 |
| Investment (capital formation), % GDP | -.0041776 (.0034335) | 0.234 |
| FDI (out), % GDP | -.0008266 (.0005231) | 0.126 |
| FDI (in), % GDP | -.000998 (.0085615) | 0.908 |
| Constant | 10.34326 (.7078016) | 0.000 |
| Time dummies (Years 2007, 2008, 2009, 2010, 2011, 2012): YES | | |
| R-sq (between) = 0.8097 | | |
| sd(u_i + avg(e_i.))= .1875238 Prob > F = 0.0000 | | |
| Number of obs = 240; Number of groups = 42 Panel (2007-2008-2009-2010-2011-2012) | | |
| Between-group effects (BE) | | |
| Hausman Test (BE vs FE): | | |
| b (BE) = consistent under Ho and Ha; obtained from xtreg | | |
| B (FE) = inconsistent under Ha, efficient under Ho; obtained from xtreg | | |
| Test: Ho: difference in coefficients not systematic | | |
| chi2(12) = (b-B)'[(V_b-V_B)^(-1)](b-B) = 138.73 Prob>chi2 = 0.0000 | | |
| Hausman Test (BE vs RE): | | |
| b (BE) = consistent under Ho and Ha; obtained from xtreg | | |
| B (RE) = inconsistent under Ha, efficient under Ho; obtained from xtreg | | |
| Test: Ho: difference in coefficients not systematic | | |
| chi2(11) = (b-B)'[(V_b-V_B)^(-1)](b-B) = 97.00 Prob>chi2 = 0.0000 | | |

Note: In the sample, there are 39 Countries: Australia, Austria, Belgium, Bulgaria, Canada, Switzerland, Chile, Cyprus, Czech Republic, Germany, Denmark, Spain, Estonia, European Union, Finland, France, the United Kingdom, Greece, Croatia, Hungary, Ireland, Iceland, Israel, Italy, Japan South Korea, Lithuania, Luxembourg, Latvia, Malta, Netherlands, Norway, New Zealand, OECD members, Poland, Portugal, Romania, Slovak Republic, Slovenia, Sweden, and the United States, plus average values for the Euro area,

European Union and OECD members. Total: 42 observations. **Public Social subsidies** are subsidies, grants, and other social benefits including all unrequited, non-repayable transfers on current account to private and public enterprises; grants to foreign governments, international organisations, and other government units; and social security, social assistance benefits, and employer social benefits in-cash and in-kind (World Bank definition, see World Bank database).

As the regression table suggests, social subsidies and education expenditures, both with positive and significant coefficients, are functional to higher GDP. Positive coefficients and significance are noted for the variable Export (as a percentage of GDP), while a negative significant coefficient is noted for the variable Import (as a percentage of GDP). Hence, richer countries export and are more competitive than countries that import more instead. However, they also have a stronger welfare state. Moreover, other openness variables used as control variables such as FDI (inward and outward) and Investments (as a percentage of GDP) are not significant. In this sense, the “compensation hypothesis” is confirmed: regulated globalisation and an expanded welfare state are better able to produce higher GDP per capita. In other words, countries that perform the best during this period (2007-12), results suggest, invested more in welfare state (social subsidies and public education expenditures) and adopted mercantilist policies, importing less and exporting more without being as open towards FDIs. These countries do not properly represent an orthodox model of liberal capitalist economy. On the contrary, they represent a corporative or social market economy model: in fact, most of these best-performing countries are Continental and Scandinavian European economies.⁶

⁶ One can obtain similar results if we consider as dependent variables in a cross-section regression the cumulative rate of growth (instead of the per capita GDP in 2012) that countries experienced during the last years, when the crisis occurred (2007-12). It is clear again in this context that countries that implemented unconventional policies managed to get better results in terms of growth. In fact, the cross-section regression shows that countries that performed better implemented their own way of globalisation that is more regulated, with higher levels of tax on trade, and always with higher levels of welfare expenditures and education expenditures. The results suggest that these countries followed mercantilist policies typical of the corporative model pursued in Germany (and other countries such as Switzerland, Austria, Luxembourg and Netherlands), then reaching higher levels of imports and surplus in the balance of payment.

In other words, from these results, it follows that richer countries are those that rely on a corporative socio-economic model rather than on a liberal competitive model. This means that countries that managed to keep higher levels of public expenditure on the welfare state in the global economy are better off today.

The method used, a regression model on a longitudinal panel data, with a “between-group effects” is more relevant in this case, since I am mostly interested in the differences between groups of countries. Moreover, the Hausman test, which checks for the validity of the between effect (BE) against both the fixed effect (FE) and the random effect (RE), produces positive results in the sense that the hypothesis zero (Ho), of consistency of the BE, is accepted with the maximum level of significance, against the alternative hypothesis (Ha) of consistency of BE and RE.

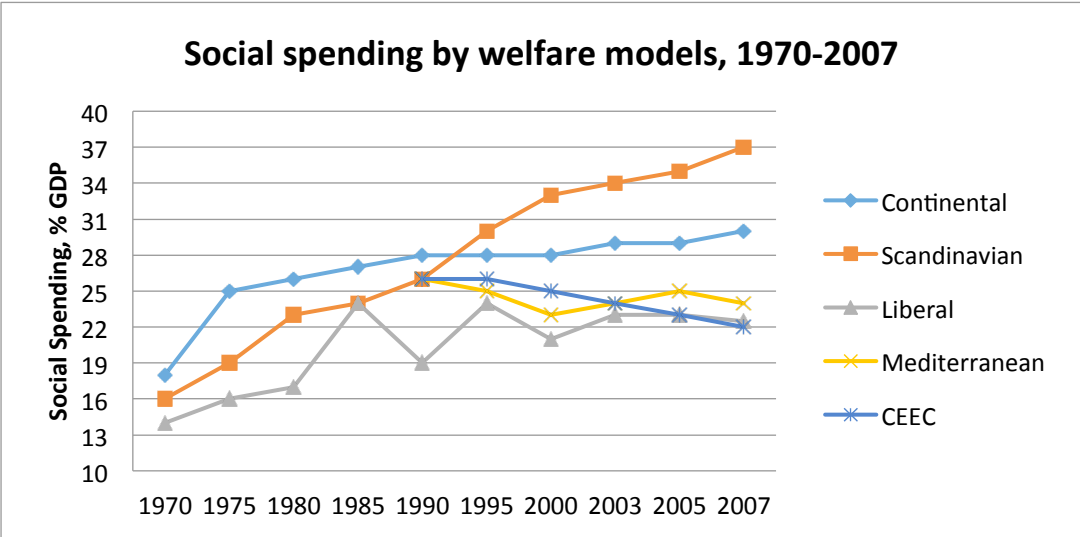
4. Welfare models and economic performance

As far as socio-economic model classification is concerned, I used a revised and updated version of the approach used by Esping-Andersen (1990) according to whom welfare models can be divided into three groups, Liberal, Continental and Scandinavian models.⁷ This classification, although methodologically still very relevant, was based on data from before 1990. Therefore, I updated that classification to the new evidence, following in particular the work of Hay and Wincott (2012). Hay and Wincott follow more or less the same methodology as Esping-Andersen (1990), taking into consideration the evolution of these models in the last two decades. They extended this classification to five models: the three models used by Esping-Andersen plus the Mediterranean group and the Central and East European Countries (CEEC) group, claiming that a strong difference can be observed among these groups in general patterns. Moreover, since 1990, welfare patterns are diverging even more with the Scandinavian model, which seems to clearly have followed a compensation thesis in order to cope with the challenge of

⁷ Esping-Andersen, Gøsta (1990) ranks welfare models mainly according to the level of social spending, to the level of (de)commodification of welfare and to degree of extension of welfare among citizens.

globalisation; the continental model, which maintained stable or increased slightly the level of welfare spending in the same period; and the other three groups, the Liberal, the Mediterranean and the CEEC, which converge among themselves in the sense that they reduced the level of welfare spending clearly following a sort of efficiency thesis during the last two decades of globalisation, as the figure below suggests.

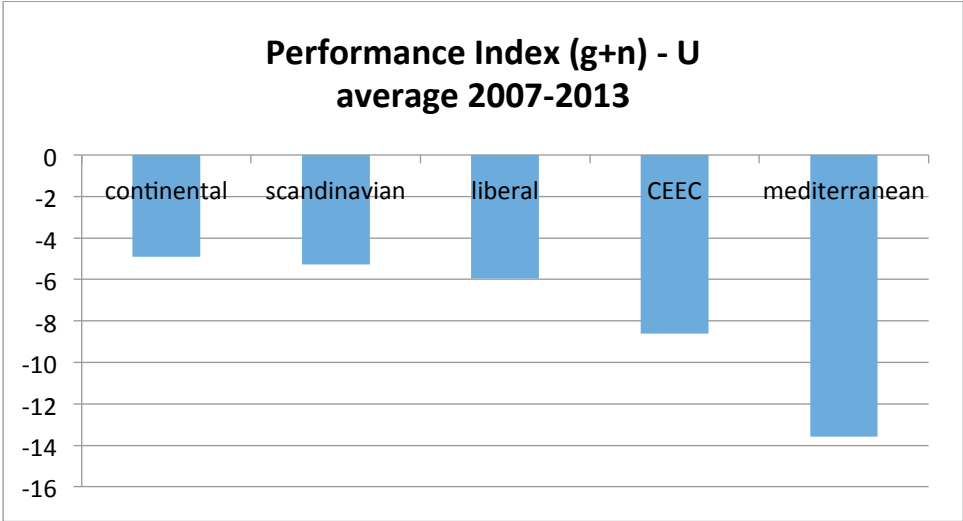
Figure 11 – Welfare expenditure by models



Notes: Social spending (% of GDP): is the sum of “social benefits in-kind” and “social transfers other than in-kind” as defined as well before (OECD definition). Continental: Belgium, Germany, Luxembourg, the Netherlands, Austria; Scandinavian: Denmark, Finland, Sweden, Norway; Liberal: UK, Ireland, USA, Australia, Canada, New Zealand; Mediterranean: Greece, Spain, Italy, Cyprus, Malta, Portugal; CEEC): Czech Republic, Estonia, Latvia, Lithuania, Poland, Slovenia, Slovak Republic, Romania and Bulgaria. Source: Own calculation on the OECD database. See also Adema and Ladaique (2009).

Once we compare these data with the performance in the years of the crisis (2007-13) we discover interesting results that confirm our hypotheses: countries that had better performance are those that managed not to retrench the welfare state under the process of globalisation and therefore reached the eve of the crisis in 2007 better equipped in terms of the welfare state, as the figure below shows.

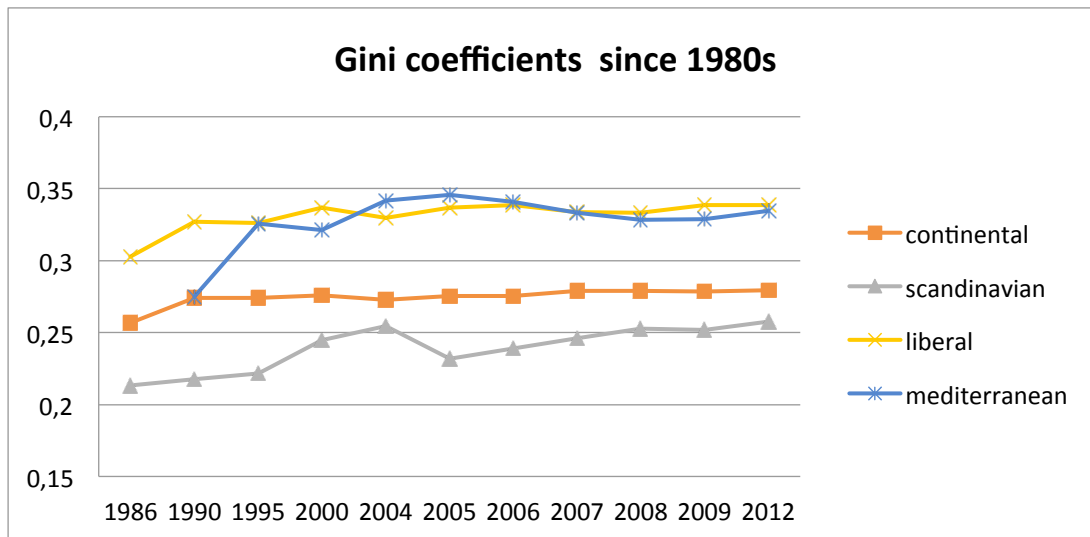
Figure 12 - The Performance Index



Note: The Performance index here is built simply by aggregating GDP and labour market performance in the following way: (Average GDP growth in 2007-13 + Average Employment growth in 2007-13) - Unemployment rate (average 2007-13) (See note 6 for an explanation). Source: own elaboration on the WEO IMF, and OECD database

The compensation approach in these countries contributed to both maintain lower levels of inequality and to have better performance in terms of GDP and the labour market.

Figure 13 -Inequality by welfare models



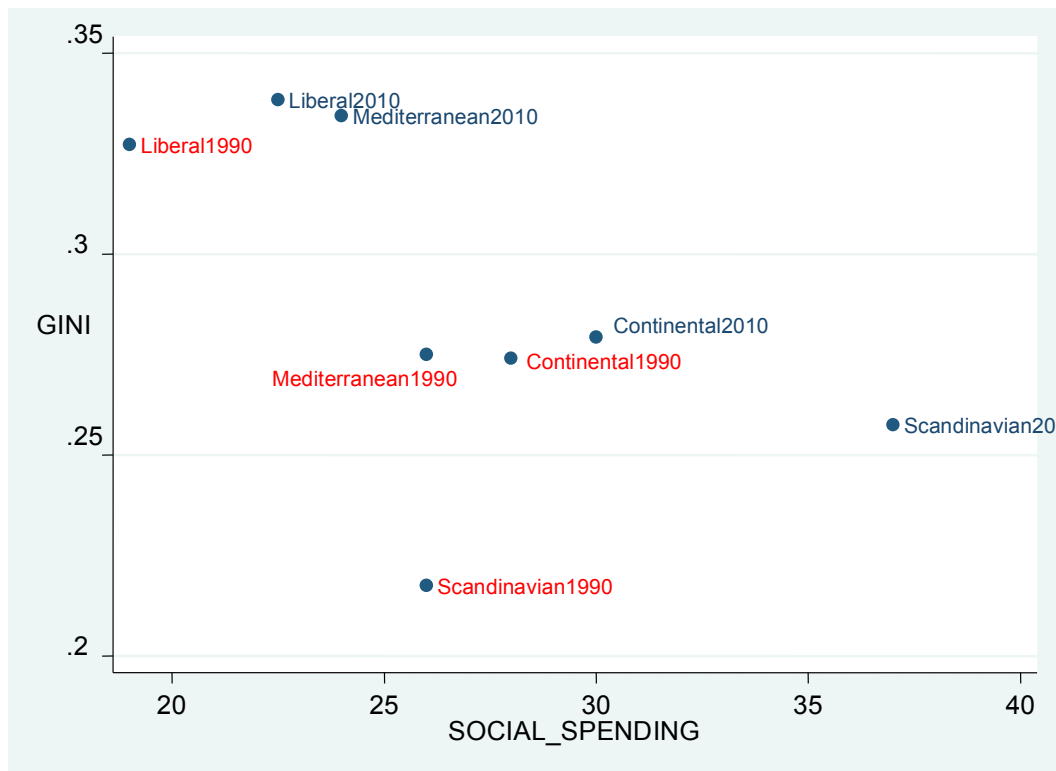
Note: Because of the lack of historical data, is not possible to reconstruct the variables for the CEEC group.

Source: OECD database

This emerges clearly in particular when we group countries in the respective model with simple calculations, and we account for the average values of inequality (Gini coefficients in 1990 and 2010) and welfare (social spending in 1990 and in 2010). Given all that, several lessons can be learned.

First of all, it appears clear from the figure below that some countries that were rightly included by the Esping-Andersen (1990) classification in the continental model, such as Italy, can no longer be included in this model. On the contrary, Italy, along with Greece, Portugal and Spain, constitute a specific model, which has a pattern closer today to the liberal model rather than to the continental model. When data are available, the same pattern is also confirmed for Cyprus and Malta.

Figure 14 - Inequality and Social spending by welfare models in 1990 and in 2010



Note: Because of the lack of historical data, it is not possible to reconstruct variables for the CEEC group.
 Source: own elaboration on the OECD database

1. Second, there is a strong and steady correlation between welfare spending and inequality. Countries in the Scandinavian and Continental models maintain higher levels of social spending along with lower levels of inequality. On the contrary, the countries of the liberal and Mediterranean models, which in the last two decades retrenched the welfare state or did not increase it, also experienced increasing inequality.
2. Third, the evolutionary path of welfare models under the condition of globalisation presented a challenge for all countries involved in the process. Some countries, typically the Mediterranean countries, did not manage to increase welfare spending, and they ended up with both higher inequality levels and the worst performance in terms of GDP and labour market performance. The case of Scandinavian economies shows exactly the contrary: the challenges and the threats to income distribution and competitiveness of globalisation could be better coped with by increasing welfare spending.

3. Fourth, countries that are winners in the process of globalisation are also countries that did not embrace *tout court* financialisation along with globalisation and managed not to retrench welfare states. The persistency and/or the expansion of the welfare state found to be in place in Scandinavian and in Continental European models functioned under the condition of globalisation to produce better performance during the years of the crisis (2007-13). As the econometric results suggest, investing in social dimensions (such as public education expenditures and social subsidies) is the best policy option not only because it allows us to reduce or to keep lower inequality levels but also because it produces better performance in terms of GDP growth and labour market performance (employment growth and unemployment). Hence, from the trilemma (globalisation, welfare and financialisation), it is better to adopt globalisation and welfare because any other solution would contribute to poorer socio-economic performance.
4. Last but not least, the evolution of welfare states, particularly the evolution that occurred during globalisation, leads us toward a new classification of only two socio-economic models among advanced economies that are quite polarised to each other: the Financial Capitalism regime versus the Welfare Capitalism regime. Countries that rely more on the financial nexus, having higher levels of financialisation in the economy, as measured by the market capitalisation index shown in figure 4 above, fall clearly into the Financial Capitalism category. These countries have also relatively lower levels of welfare spending. Countries that rely more on the welfare nexus, having higher levels of welfare spending and lower levels of market capitalisation index, fall clearly into the Welfare Capitalism category. The Financial Capitalism category clearly embeds the Liberal and Mediterranean groups, while the Welfare Capitalism category clearly embeds the Scandinavian and the Continental groups.

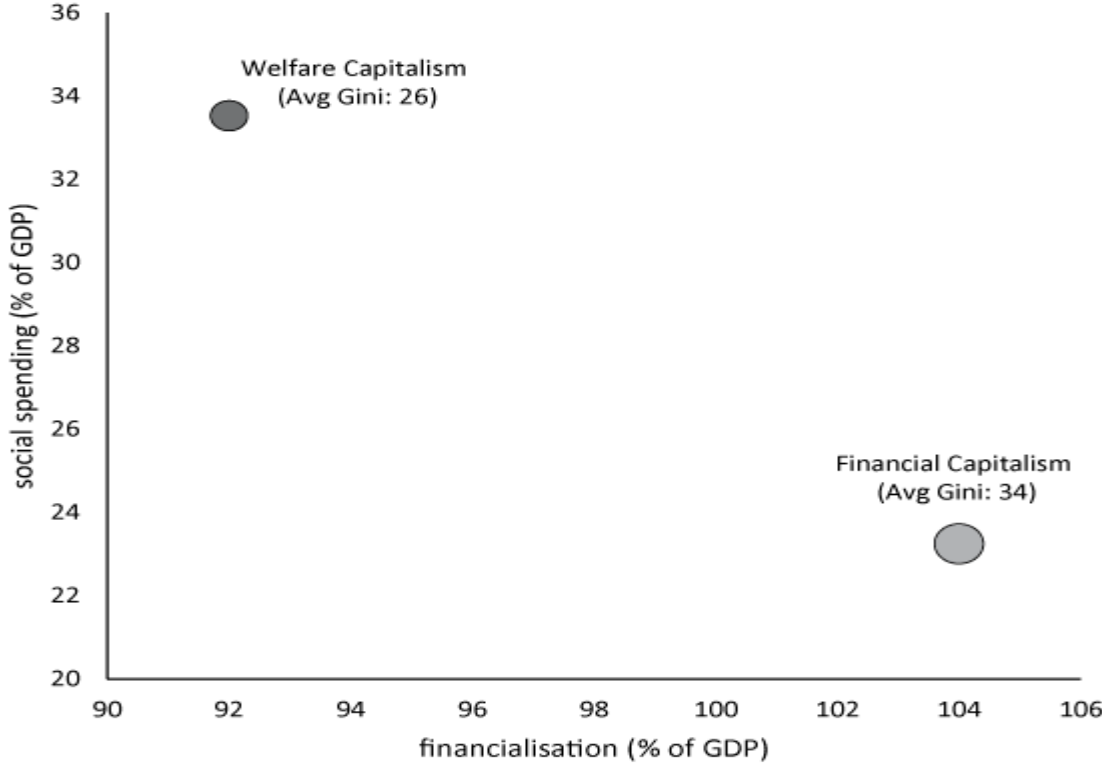
Table 2 - Welfare Capitalism versus Financial Capitalism

| | | Welfare Spending (% GDP) | | |
|--|-----------|--------------------------|--------|---------------------|
| | | Very high | Middle | Very low |
| Financialisation (market capitalisation index, % GDP) | Very high | | | Liberal Model |
| | middle | Scandinavian Model | | Mediterranean Model |
| | Very low | Continental Model | | |

Source: own elaboration

The figure below illustrates well this type of classification with a clear polarisation between the two categories, which also suggests the end of “The Three Worlds of Welfare Capitalism” described by Esping-Andersen. Countries of the Continental and Scandinavian models are aggregated in the Welfare Capitalism type, sharing higher levels of social spending, lower levels of inequality (indicated in brackets with the average Gini coefficient), and from middle (the Scandinavian group) to very low levels (the continental group) of financialisation. On the contrary, the Liberal and the Mediterranean models are aggregated in the Financial Capitalism type, sharing lower levels of social spending, higher levels of inequality (indicated in brackets with the average Gini coefficient) and from very high (the Liberal group) to middle levels of financialisation. In terms of performance, the Welfare Capitalism regime proved to be superior to the Financial Capitalism regime not only as far as inequality is concerned but also in terms of economic performance (GDP and labour market).

Figure 15 - Poles apart: Welfare Capitalism and Financial Capitalism (data 2010)



Source: own elaboration

Conclusions

In this paper, I argued that globalisation and financialisation posed important challenges to countries on several domains of economics, particularly in the last two decades. I investigated the challenges of income distribution and welfare states. In

this context, I indicated that countries that reacted to these challenges by the implementation of the efficiency thesis, according to which globalisation needs to be accompanied by the retrenchment of welfare states in order for firms to be competitive, did not achieve better economic performance and particularly during the current economic crisis suffered the most (these countries belong to the Liberal and Mediterranean market economy models). Moreover, their income distribution worsened and inequality increased. On the contrary, our econometric exercises show that the “compensation thesis” (i.e., regulated globalisation and an expanded welfare state) was better able to produce higher economic growth along with better labour market performance and better income distribution.

On the basis of this, a new type of classification emerged between Welfare Capitalism and Financial Capitalism. Countries of the Continental and of the Scandinavian models may be aggregated in the first category, sharing similar values of the relevant variables (welfare spending, financialisation and Gini coefficients), while Liberal and Mediterranean models fall into the second category, sharing similar values of the same relevant variables. Countries of the Welfare Capitalism category exhibit better economic performance (i.e., a better Performance Index) and lower inequality; on the contrary, countries of the Financial Capitalism category have worse economic performance (a lower Performance Index) and higher inequality.

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