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Foreign direct investment under globalization dilemma: economic insecurity, tax competition, and funding for social welfare

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FOREIGN DIRECT INVESTMENT UNDER GLOBALIZATION DILEMMA: ECONOMIC INSECURITY, TAX COMPETITION, AND FUNDING FOR SOCIAL WELFARE

by

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of the requirements for the Doctor of
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Thesis Supervisor: Professor John A. C. Conybeare

CERTIFICATE OF APPROVAL

PH.D. THESIS

This is to certify that the Ph.D. thesis of

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has been approved by the Examining Committee
for the thesis requirement for the Doctor of Philosophy
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Raymond G. Riezman

For my parents and family

Men was/is born free, and everywhere he is in chains.

Jean-Jacques Rousseau, *On The Social Contract*

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ABSTRACT

My dissertation examines the question of how foreign direct investment (FDI) affects social welfare spending across countries. To date, there have been three important challenges to studies of the globalization-welfare state nexus. First, most scholars understand market internationalization in terms of the trade of goods and services while minimizing how other aspects of globalization fit into this discussion. Second, scholarly attention to economic globalization has been mistaken when understanding the relationship between demand- and supply-side mechanisms for social welfare provision. Thus, the argument that trade stimulates demand for social welfare has been incorrectly used to oppose the argument that capital mobility significantly undercuts a government's capability to fund welfare states. Lastly, existing studies on this topic mostly center around affluent democracies; various theories of welfare states require further elaborations to increase their external validity.

My dissertation aims to overcome these challenges. For this purpose, I focus on one of the most important aspects of globalization, FDI, which bears meaningful implications for both demand- and supply-side functions of social welfare provisions when explaining variations of social welfare spending across countries. I argue that since the late twentieth century, FDI has been a major cause of the "globalization dilemma," proposed by Rodrik (1997), who argues that in an age of globalization

governments face increased demand for social welfare and decreased capabilities to supply it. In other words, FDI has conflicting influences on welfare states. On the one hand, FDI works *for* welfare states as the ensuing economic insecurity increases demand for social welfare. At the same time, however, FDI works *against* welfare states because governments will experience reductions in capital taxation due to competition among themselves to attract and retain production capitals. I further argue that there is an interesting consequence of this dilemma. Due to the conflicting influences of FDI on welfare states, the expansion of social welfare provisions requires governments to secure additional revenues. Governments will address this concern through a strategy that is both effective and politically less expensive: an increased reliance on indirect taxation. As indirect taxes are mostly born out of labor and thus notoriously regressive, the very effort to supply social welfare provisions goes against the fundamental principle of welfare states: the redistribution of income from the rich to the poor.

PUBLIC ABSTRACT

This study examines the impact of foreign direct investment on social welfare spending across countries. In understanding the relationship between economic globalization and welfare states, my dissertation is particularly interested in how one of the important aspects of globalization, FDI, affect both demand- and supply-side functions of social welfare provisions. It shows that since the late twentieth century, FDI has been a major cause of the "globalization dilemma," in which that governments face increased demand for social welfare and decreased capabilities to supply it.

FDI has conflicting influences on welfare states. On the one hand, FDI works *for* welfare states as ensuing economic insecurity increases demand for social welfare. At the same time, however, FDI works *against* welfare states because governments will experience reductions in capital taxation due to competition among themselves to attract and retain production capitals. I further argue that there is an interesting consequence of this dilemma. Given the conflicting influences of FDI, social welfare provisions requires governments to secure additional revenues. Governments will address this concern through a strategy that is both effective and politically less expensive: an increased reliance on indirect taxation. As indirect taxes are notoriously regressive, the very efforts to supply social welfare provisions goes against the principle of welfare states: the redistribution of income from the rich to the poor.

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CHAPTER I

Introduction

Conventional wisdom says that *the age of big government is over.* With the collapse of the postwar economic booms in the early 1970s, skepticism began to mount regarding a government's ability to manage the economy. This skepticism was further reinforced throughout the decade as recession coupled with inflation, and spread in the following years with the rapid pace of global market integration in general, and the dramatic increase of international capital mobility in particular. Austerity policies become a macro-economic priority across regions while big government is now largely considered ineffective in dealing with economic downturns, and even harmful to the economy. As global markets provide such a harsh environment for big government, welfare states are largely expected to be retrenched (see e.g. Andrews 1994; Cerny 1997; McKenzie and Lee 1991).

Contrary to this expectation, we still live with big government. In most industrial countries, for example, government expenditure has not been constrained under the pressure of the global market, and the general features of welfare states persist (Esping-Andersen 1990; Hall and Soskice 2001; Hollingsworth and Boyer 1997; Traxler 1994; Zysman 1994). Even in the most market-oriented welfare states, Britain and the United States, where small government was once extolled by Margaret Thatcher and Ronald Reagan, the general system of social protection has remained intact (see e.g. Pierson 1994). In Northern European countries, at the same time, where an egalitarian welfare state was established during the postwar period, governments continue to spend a considerable amount of their resources on generous social programs, such as income transfers, job training, health care, housing, and even child-care.

A dominant approach to the development of welfare states suggests that welfare states persist because they have their own domestic built-in mechanisms to weather an environment that may be harmful to big government. In particular, within the tradition of comparative welfare state researches, welfare states are considered predominantly to be a reflection of *domestic* policy mechanisms through which social stability and equality are achieved. For example, a welfare state is a tool for addressing anxieties associated with both economic and political development (Deutsch 1961; Meltzer and Richard 1981; Wilensky 1975), a political outcome of traditional class struggles over redistribution (Korpi 1989; Huber and Stephens 2001), the legacy of past policy decisions, or an institutional setting for social protection (Hall 1986; Pierson 1994; Zysman 1994). Interestingly, however, these arguments resemble the retrenchment arguments in a sense that they are based on a clear distinction between globalization and domestic politics. While the retrenchment theories argue for the ascendance of the former, the scholars of welfare states argue for the latter.

Beginning in the late 1970s, some scholars began to recognize a positive relationship between globalization and domestic politics in explaining welfare state development. Market internationalization can have structural and positive influences on the growth of welfare states (Cameron 1978; Garrett 1998; Katzenstein 1985; Rodrik 1998). Although different ideas have surfaced regarding the proposed link, scholars in this camp agree that welfare states operate as a *compensation* mechanism for those hindered by globalization; or as an implicit compromise between a government and its citizens in which the former provides social protection against the vagaries of the global economy in return for the latter's support for trade liberalization. In establishing a positive causal relationship between globalization and welfare states in this way, the compensation hypothesis, or new embedded liberalism hypothesis[1], took a

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[1]It follows John Ruggie (1982), who names the postwar combination between Keynesian counter-cyclical macro-economic management with trade liberalization as 'embedded liberalism.' As the connection seems alive even though Keynesian welfare states lost most of its credits since the 1970s,

significant departure from existing studies of welfare states that assumed a dichotomy existed between the two.

Despite the theoretical significance, my hypothesis demands further elaboration. First, the concept of globalization has been narrowly defined as the international trade of goods and services while largely ignoring how other aspects of globalization fit in to the discussion. Although trade is, and will continue to be, an important aspect of globalization, market internationalization is more than the movement of products. In the 1980s, economic globalization began to take on new facets due to the rapid advances in information and communication technologies (see e.g. Schenk 2011). These include global production chains of multinational corporations, short-term financial flows, the migration of workers, etc. Second, in scrutinizing the positive relationship between globalization and welfare states, scholars often fail to seriously consider the negative relationship as proposed by the retrenchment arguments. Thus, in a sense, the argument that capital mobility significantly undercuts a government's ability to fund welfare states has been incorrectly used to counter the argument that trade stimulates demand for social welfare. Lastly, existing studies have a strong bias toward affluent democracies, allowing for speculation as to how other government are affected.

My dissertation aims to overcome these challenges in order to enhance our understanding of the relationship between economic globalization and welfare states. For this purpose, I focus on the globalization of production, or foreign direct investment (FDI), by multi-national corporations (MNCs)[2]. In several ways, this focus is criti-

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compensation hypothesis is often labeled as the 'new' embedded liberalism hypothesis.

[2]As an important dimension of global finance, FDI is defined as international investment made with lasing interest over foreign enterprises which operate outside the country of an investor. Technically, when foreigners purchase more than 10% of the voting share of local enterprises, the investment is considered as FDI, and is otherwise considered foreign portfolio investment (FPI) (Goldstein and Razin 2005; Spero and Hart 2009). Of course, this does not mean that other dimensions of globalization do not matter, such as other forms of global capital or international trade. Regarding international trade, there is ample evidence that trade naturally generates losers who can potentially turn to government for social protection (see. e.g. Gourevitch 1986; Rogowski 1989; Hiscox

cal to overcome the challenges we face in the literature of the globalization-welfare state nexus. First, it helps us to elaborate the link between international markets and domestic politics by examining how an important aspect of global capital can affect the domestic politics of welfare states. To date, there has been no attempt to examine how FDI affects social welfare expenditure.[3] In a similar vein, this can also shed new light on the retrenchment argument by elaborating the causal mechanism whereby global capital affects the demand-side function of social welfare provisions. While global capital has been widely recognized as the main culprit of welfare state retrenchment, its effect on welfare state development has rarely been studied. Lastly, this focus also helps us to further explain the supply-side function of social welfare with a new angle. In the literature of tax competition, the focal point has been always on capital mobility, or financial liberalization, while minimizing specific forms of global capital fit into the discussion.

What impacts does FDI have on welfare states in an age of globalization? In particular, how does FDI affect both supply- and demand-side functions of social welfare provisions? As an important aspect of economic globalization, would the compensation mechanism still hold for global production capital? At the same time, as an important type of global capital, could FDI project retrenchment pressure on welfare states? I argue that, surprisingly, we can say yes for both questions. In other words, FDI has conflicting influences on welfare states. On the demand side, FDI works *for* the growth of welfare states by increasing economic insecurity, and, thus, by increasing demand for social welfare. On the supply side, FDI works *against* welfare states

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2002). How trade affects the fiscal capabilities of governments to supply social welfare, however, still remains an open-ended question (see. e.g. Genschel and Seelkopf 2012). Concerning foreign portfolio investment (FPI), the situation is the exactly the opposite. Given the rapid pace and volatility of its growth and flows respectively, FPI might stand at the core of welfare state retrenchment arguments, dictating the reduced fiscal viability of welfare states. On the demand side, however, we know little about how FPI generates demand for social welfare.

[3]The only exception could be Scheve and Slaughter (2004), who studied the question of how the globalization of production affects individuals' economic insecurity in Great Britain.

as competition among governments for attracting and retaining FDI will negatively affect capital taxation. Taken together, the dilemma—between increased spending and decreased taxation—will require governments to secure additional revenues for social welfare provision. As both an effective and politically less expensive method, governments will rely more on indirect taxation, which is mostly borne out by labor and thus notoriously regressive. Thus, through this dilemma, the effort to supply social welfare will go against the principle of welfare states: the redistribution of income from the rich to the poor.

1.1   Retrenchment of Welfare States

Since the late twentieth century, the sentiment that "national governments cannot afford welfare states anymore" has been widely discussed. Through the two decades of economic booms following World War II, a Keynesian counter-cyclical management of demand worked smoothly under a favorable international monetary order—the Bretton Woods system. As a multilateral compromise among industrial countries, it regulated cross-border capital migration by establishing a gold exchange standard. Fixing the values of the US dollar to gold ($35 per ounce), other currencies were pegged into US dollars with gold convertibility. With a firm control over foreign exchange and capital mobility, governments can effectively manage the economy through fiscal policies. The favorable economic order for big government, however, dramatically collapsed in 1971 when US President Nixon unilaterally suspended the gold convertibility of the dollar. Furthermore, as the management of the oil crises of the 1970s proved to be ineffective, it is now widely recognized that the national governments lost most of its credibility in managing the economy.

The widely recognized culprit is *capital mobility.* The so-called "Impossible Trinity" or "Unholy Trinity" theorem provides a succinct explanation of how capital mo-

bility structurally limits the role of government in the economy. According to Mundell (1963), three macro-economic goals—capital mobility, exchange rate stability, and autonomous monetary policy—cannot be achieved all at once without sacrificing one of them. As foreign exchange rates began to float and most countries liberalized their financial markets after the collapse of the Bretton Woods system, the mobility of international capital was dramatically increased. In this situation, there ought to be a trade-off between foreign exchange rate stability and autonomous monetary policy. The latter makes foreign exchange rates unstable as mobile capital actively reacts to the policy changes which affect the values of national currency, and thus the rate of return for capital. In order to make the foreign exchange rate stable, the priority of monetary policy is to defend the national currency values against the free movement of global capital. In other words, while governments cannot rely on monetary policies to regulate the business cycles of the economy, they can use it to defend foreign exchange rates. Given the importance of exchange rate stability in economic activities, the active management of the economy seems to be structurally constrained in an age of capital mobility (see e.g. Schenk 2011; Spero and Hart 2009).

In this background, the orthodox economic theory, or neo-liberalism, expects that national governments could not, or should not, sustain the existing system of social protection. According to Hall (1993), there has been a "paradigmatic shift" in macro-economic policy practices in the late twentieth century. By examining the history of economic policy in Britain, he shows that the previous macro-economy policy framework (Keynesian welfare states) begins to break down while generating recurrent anomalies (stagflation) and the conservative framework (monetarism) begins to gain support among policy makers. Now, the dominant view is to consider the welfare state as a source of inflationary pressure, public debt accumulation, labor market distortion, and reduced investment incentives of capital (see e.g. Moses 1994; Siebert 1997). In order to manage these pitfalls of welfare states today, austerity policies

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should take priority over other macro-economic goals. In sustaining expensive social welfare programs, national governments would have a difficult time increasing national competitiveness, market stability, and economic growth (see e.g. Cerny 1997; Strange 1996; Andrews 1994).

There are further arguments to support that small government is not a matter of choice. In an age of global capital, governments are structurally engaged in the "race to the neo-liberal bottom;" while the increased mobility of capital limits national governments' macro-economic tools, it also provides a unique opportunity for national governments to boost its economy by simply securing more capital than others. This seems to be sufficient motivation for a government to participate in this competition. As we can see in Figure 1.1, economic growth rates have plummeted and public debts have accumulated across industrial countries since the 1970s. In this case, the existence of global capital can refer to an important opportunity for governments to boost the economy in order to address chronic unemployment rates and public debts. Given such opportunities, governments are structurally engaged in the competition over fiscal policies for attracting global capital (Andrews 1994; Cerny 1997; McKenzie and Lee 1991). Welfare states that not only distort the market process, but also increase the tax burdens on capital can trigger capital outflows as well as hinder capital inflows. Competitive de-regulations for retaining and attracting capitals inherently project retrenchment pressures on welfare states.

The argument of welfare state retrenchment, however, does not refer to the abolishment of governmental interventions to the economy. In a sense, welfare states are compatible with neo-liberal arguments. Markets need governmental regulations in order to function properly. Markets do fail from time to time. As Cerny (1997) aptly points out, however, it is the dichotomy found in the neo-liberal perspective—that between the market and the state, the latter is logically "characterized by a mode of operation which undermines market discipline and substitutes 'arbitrary prices' for

Figure 1.1: Economic Growth and Public Debt since the World War II
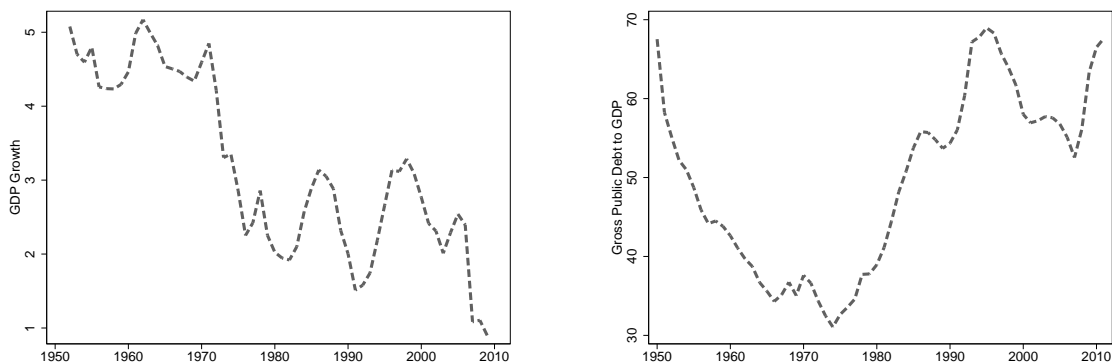
Note: Lines are unweighted averages for 16 advanced countries from 1950 to 2012. Economic growth rates are expressed in 5 year moving average.
Source: IMF Public Finances in Modern History Dataset (see, Mauro et al. 2013)

'efficiency prices'—at best a necessary evil, at worst inherently parasitic on wealth created through the market" (p. 261). Thus, within the neo-liberal perspective, the retrenchment of welfare states is considered an imperative of the day.

1.2 Theories of Welfare State Development

Scholars of welfare states disagree with the retrenchment argument. Even if we admit that there are fiscal constraints resulting from economic globalization, welfare states are still surviving and evolving. Figure 1.2 provides strong evidence for this argument: measured by public social expenditure[4] as a percentage of Gross Domestic Protect (GDP), we can see on the right side of the figure that there is no evidence for welfare state retrenchment among industrial countries. Rather, social welfare expenditure has a long-term growth pattern since 1980. We can also draw a similar conclusion on the left side of the figure on government finance statistics: again, we do not see evidence for welfare state retrenchment. Since the mid-1970s, governments have spent more than what they earned and there is no evidence to support

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[4]Public social expenditure is the sum of public pension, health, income support, and other social services.

Figure 1.2: Historical Government Finances since the World War II
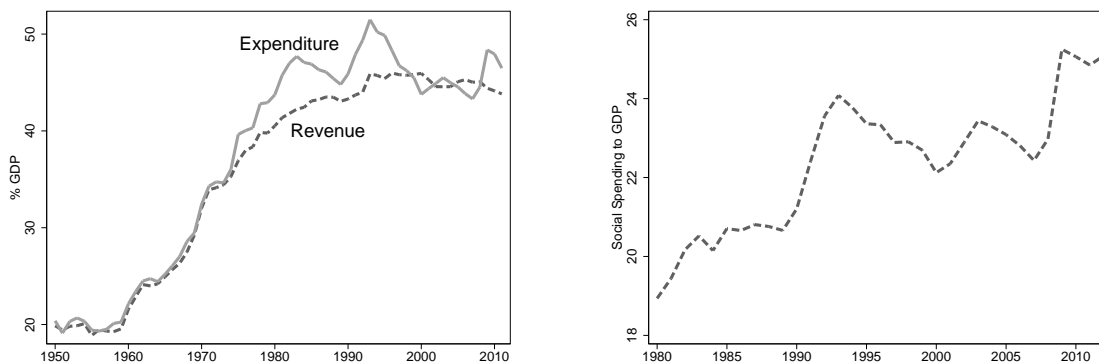
Note: Lines are unweighted averages for 16 advanced industrial countries.
Source: IMF Public Finances in Modern History Dataset (see, Mauro et al. 2013) & OECD Social
Expenditure Database (SOCX) (from www.oecd.org/els/social/expenditure)

an argument that the revenue generating capability of these governments is in danger. Although the pace of revenue growth deceases, there is no systematic decline in the overall levels of government revenue. Welfare states are surviving the age of globalization.

In the political economy literature, there have been insightful and plentiful explanations about the development of welfare states. Despite the wide variety of theoretical conjectures, however, the literature on welfare states can be divided into four groups according to two criteria. First, based on the origins of demand for social welfare, a large body of literature can be classified into either the endogenous or exogenous camp. The endogenous camp emphasizes a socio-economic process by which demand for welfare states is generated domestically. The exogenous camp, on the other hand, puts more emphasis on the stimuli that come largely from the outside: invariably, economic globalization. Second, based on the assumption about how demand for social welfare is processed in each polity, each camp can be further grouped as either structural or contextual. The former relies on a pluralist view, in which demand for social welfare naturally finds its place in the policy-making process. As for the latter, the political process for public welfare demand is perceived to be

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contingent on the specific national context. Taken together, we have four categories of scholarly camps, which provide important insights in explaining the survival of welfare states under pressures for retrenchment.

1.2.1 Endogenous-Structural Explanations

Theories in this category understand the development of welfare states as a spontaneous outcome of social progress. The earlier formulation of these thoughts came from modernization theory, which understands political advancement as an outcome of economic development. In understanding the process of political development, it emphasizes certain aspects of the modernization process, such as urbanization, increased education, changes in social structure, the advancement of factory systems, or mass media (Cutright 1963; Deutsch 1961; Inkeles and Smith 1974; Lerner 1958; Lipset 1960). The ensuing ideological and psychological transformation encourages individuals to act as modern-participatory citizens who demand more of their rights. According to Deutsch (1961), for example, as people adopt a modern way of life on a substantial scale through economic development, what he calls the "social mobilization" process, "they need a wide range and large amounts of new government services" (p. 498).

In line with modernization theory, some functionalist explanations for the growth of welfare states also emphasize the role of economic development: namely 'the logic of industrialism' and 'the logic of capitalism' (Myles 1984; O'Connor 1979; Pampel and Williamson 1988; Wilensky 1975). Each camp answers the question of why governments launch social welfare programs from different angles. For the logic of industrialism, the function of a welfare state is to establish both a political and economic order (Wilensky 1975). The "logic of capitalism" within the neo-Marxist tradition, on the other hand, sees the development of the welfare state as an outcome of the "legitimation function" of a state in perpetuating its political power (O'Connor

1979, p. 5). Interestingly, however, they both agree that economic development generates a vulnerable group of people who have the potential to dismantle the path to social progress. For both, the welfare state is basically a tool to alleviate anxieties emanating from industrialization. While the neo-Marxist side fails to provide robust empirics, the logic of industrialism does (Aaron 1967; Cutright 1963; Pampel and Williamson 1988).

Lastly, some scholars see political development itself as an endogenous impetus for welfare state development. Meltzer and Richard (1981) argue that the advancement of democratic institutions—both universal suffrage and majority rule—widens the gap between median and mean income groups. Given the median voter's decisive role in democracy, democratization generates inequality which will, in turn, increase the demand for social welfare. In a similar vein, democracy pressures political leaders to emphasize the provision of public goods. According to Bueno de Mesquita et al. (2003), political leaders spend their limited resources on political survival. As the political system evolves, the increased size of the winning coalition, whose support is necessary for leaders to remain in office, encourages political leaders to refrain from focusing on a small set of supporters. Although this theory mostly considers the supply-side of the public economy, it also assumes that the new-comers to the system bring new demand for more public services.

Interestingly, these endogenous-structural explanations agree that economic or political development will generate a similar pattern across countries in the growth of the public economy. There are "hypothetical equilibrium points toward which each nation is moving (Cutright 1963)." Other scholars largely accept this evolutionary thesis of modernization theory. Wilensky (1975) argues: "However reluctant the government or the more affluent citizens may be, they are moved toward the welfare state (p. 16)." Implicitly, this structural argument assumes that countries with a similar level of economic development would have a similar level of social welfare

spending (see e.g. Myles and Quadagno 2002). We know this is not the case in reality. Based on the social expenditure database (SOCX) provided by The Organization for Economic Co-operation and Development (OECD), for example, the total public social expenditure as a proportion of GDP in 2000 was 14% for the United States, compared to approximately 30% in Sweden while both countries have more or less a similar level of economic development.

1.2.2   Endogenous-Contextual Explanations

In explaining variations in social welfare spending among advanced economies, some scholars provide endogenous-contextual explanations. The power resources theory stands at the center of this group of ideas (Hicks and Swank 1984, 1992; Huber, Ragin and Stephens 1993; Huber and Stephens 2001; Korpi 1989; Korpi and Palme 1998). In this theory, the policy outcomes for social welfare demand are not structurally determined. Rather, welfare states can be understood as an outcome of political struggles over the redistribution of income between left-wing and right-wing organizations. Having left-wing political parties in government as an outcome of the struggle, welfare states grow as the incumbent parties advocate and push for social redistributive policies. With right-wing parties in majority, on the other hand, the opposite situation could occur. Thus, the growth of welfare states requires not only the existence of demand for social welfare, but also the organizational strength of the demand. Here, the theory emphasizes the link between left-wing organizations and vulnerable social classes, especially the working class. Thus, the pattern of welfare state development depends on national contexts, in which left-wing organizations compete with right-wing organizations over social welfare provisions.

Esping-Andersen (1990)−in his landmark book: *The Three Worlds of Welfare Capitalism*−explains how different types of welfare state regimes can be born out of class struggles over redistribution. In Nordic countries, where social democratic

parties successfully wooed both the middle and working classes, an egalitarian welfare state emerged. In Anglo-Saxon countries, where the middle class heavily relies on market-based social insurance, a residual welfare state emerged, in which means-tested based social welfare is provided for the poor. Lastly, in Continental European countries, where the middle class is conservatively dedicated to the existing social structure, an occupation-based welfare system has been established. This influential theory about the emergence of different types of welfare state regimes is in line with the power resources theory. In a sense, each type of welfare state regime is understood as a distinctive outcome of contextual class-based political struggles over redistribution.

At the same time, however, the theory also leads us to the new institutionalist arguments that emphasize the persistent growth pattern of each welfare state regime (Hall 1986; Hall and Soskice 2001; Hollingsworth and Boyer 1997; Pierson 1994, 2000; Soskice 1999; Zysman 1994). Scholars have different ideas as to why each type of welfare state regime follows their own distinctive pattern of growth: the "comparative institutional advantages" of welfare state institutions for employers (Hall and Soskice 2001; Soskice 1999); historically determined trajectory of growth (Hall 1986; Zysman 1994); or "policy feedback" through which social policies generate their own beneficiaries (Pierson 1994). Despite the diverse reasoning for the persistence of welfare state regimes, however, there is consensus among new institutionalists that once a welfare state regime is institutionalized, the regime itself determines the preferences or interests of actors, reproducing momentum for its own growth. In new-institutionalists' terms, welfare state institutions have their own "path-dependent" dynamics.

Although these endogenous-contextual theories are superior to the endogenous-structural theories when explaining the different types of welfare states in affluent countries, they quickly take what Streeck and Thelen (2005) call, the "conservative bias." In other words, they tend to underestimate the importance of new changes

to their old theoretical framework. Thus, ironically, the theoretical tools that are specifically designed for understanding the different types of social welfare practices become difficult to use when explaining changes in them. In this vein, the abrupt advancement of Irish corporatism in the late twentieth century, for example, was surprising and unexpected for new institutionalists (see e.g. O'Donnell and O'Reardon 2002). Since Ireland had a long tradition as a liberal Anglo-Saxon welfare states, the emergence of national-wide corporatist bargaining for recovery programs could not be explained by the path-dependent nature of the Irish welfare state's institutional settings.[5]

1.2.3 Exogenous-Structural Explanations

Watching over the dramatic global market expansion in the late twentieth century, many scholars began to emphasize economic globalization as an important factor stimulating demand for social welfare provisions (see e.g. Cameron 1978; Garrett 1998; Katzenstein 1985; Rodrik 1998). Among them, some embrace the structural perspective concerning how these demands are processed in the political system—the economic openness thesis falls into this category, with Cameron's (1978) argument being exemplary. The economic openness theory emphasizes the increased competition for firms in the exposed sector. Since the small and less-efficient ones are unable to remain viable under fluctuations of the global market, trade openness leads to the concentration of industry. This, in turn, eases the process of collective bargain-

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[5]According to new institutionalists, the Anglo-Saxon model differs greatly from European models (both Continental or Northern European models). The national institutional settings for the former consist of several market-oriented components: short-term corporate finance, flexible labor market, wide income differentials, nationally uncoordinated trade unions, and multiple intra-company and militant labor unions. On the other hand, European institutions are differently arranged through long-term corporate finance, compressed income differentials, nationally coordinated trade unions, and national wage bargaining through corporatism. Soskice (1999) argues that it is almost impossible to transform the Anglo-Saxon model into a European model because actors have their own embedded interests in the existing institutional settings. In this sense, the Irish case was surprising because a seemingly impossible mission was accomplished.

ing through labor unionization, upon which left-centered governments are frequently elected. The expansion of the public economy can be an outcome of this sequential and thus, structural process. As the industrial concentrations ease the process of collective action, the voice of labor in the exposed sector has a higher chance of becoming nationally organized, and thus create pressure for the growth of welfare states.

In understanding the positive influences of economic globalization on welfare states, scholars in the exogenous camp focus on economic insecurity, or economic risk, resulting from market internationalization. Garrett (1998) shows this point clearly as such:

> The most important immediate effect of globalization is to increase social dislocations and economic insecurity, as the distribution of income and jobs across firms and industries become increasingly unstable (p. 7).

In line with Cameron (1978), Garrett (1998) also emphasizes the role of left-centered governments which embrace new support for welfare states and grow from economic globalization. The political significance of social class, which was emphasized by the power resource theory, might not exist in an age of globalization (Inglehart 1997; Kitschelt 1988). However, left-wing political parties could be still electorally viable in attracting economically insecure groups of people by promising to redistribute wealth. In other words, economic openness generates political support for left-of-center parties among the general public by imbuing economic insecurity into domestic labor markets.

In this economic openness thesis, demand for social welfare is assumed to be automatically processed through the political system, stimulating the growth of welfare states. The economic openness thesis, however, remains more or less silent concerning a precise mechanism that could explain how the newly-generated demand is processed through the political system. It is instead assumed that those who become economically insecure in an age of globalization would automatically agree with the policy platforms of left-wing political parties. As the endogenous-contextual theories

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discussed above imply, the demand for social welfare provisions become an object of the political mobilization process. Due to the inattentiveness to the organizational dynamics of the new demand, these arguments face a similar criticism as the endogenous-structural theories; the theory explains why globalization goes hand-in-hand with the expansion of the public economy while failing to provide rationales for both divergence and persistence of welfare state development.

1.2.4 Exogenous-Contextual Explanations

Among those who emphasize the role of globalization in stimulating demand for social welfare provisions, the compensational hypothesis provides a contextual explanation (Adserà and Boix 2002; Katzenstein 1985; Swank 2002, 2003; Hays 2009). According to Katzenstein (1985), the development of welfare states depends on how each country adjusts their domestic market economies to the global market. Focusing on small states in Europe, he shows that social democratic corporatism was born out of the compensational mechanism through which those negatively affected by globalization receive social protection in return for their support of liberal trade policy. In this context, trade liberalization was imperative due to their smallness in the world market, otherwise they would have faced either severe trade policy retaliation or increased input costs for their products. In soliciting support for liberalization, governments designed a domestic compensation system, which works with collective wage bargaining, increased welfare transfer, and indirect or flexible governmental control over the market economy.

In the sense that those who are disadvantaged by globalization are compensated through social welfare provisions, the compensational theory is similar to the economic openness theory. However, they are different in regard to how the newly-generated demand is processed in the political system. Rather than assuming that demand for social welfare will be automatically transferred to empower left-of-center parties

in government, the compensational theory considers how the design of social welfare programs can be affected by each nation's individual context. For Katzenstein (1985), it is the vulnerability of small states in Europe, which makes welfare states an effective tool with which to compensate globalization losers. By expanding the sample of countries beyond advanced economies, Adserà and Boix (2002) also show that as trade openness increases, the size of the public economy grows in a democracy. Here, what makes the compensational theory contextual is the fact that policy makers have other options to combine trade policies with social welfare provisions: either economic isolation or authoritative openness without compensation.

Another line of thought embraces the new-institutionalist framework in understanding the impact of globalization over welfare states. Against arguments about welfare state retrenchment in an era of globalization, for example, Swank (2003) argues that different types of welfare state institutions persist because the welfare regime itself undergirds the "pro-welfare state interests to defend social protection (p. 72). It is implied that those who are negatively affected by globalization are already embedded in a distinct welfare state regime, which tends to reproduce its own beneficiaries and supporters (see e.g. Pierson 1994). Thus, the influences of economic globalization differ across countries which have different capacities to absolve its impacts (Hays 2009; Swank 2002). Here, welfare state regimes work as a bumper to fend off the negative influence of globalization, through which the demands for social welfare provisions are managed.

In general, the compensational theory fails to provide a thorough explanation as to why some countries compensate more than others. Beyond affluent economies, democracy could be a good indicator, as Adserà and Boix's (2002) study clearly shows. Among the affluent countries, however, the theory cannot provide an adequate explanation because these countries had been fully democratized by the late twentieth century. As Katzenstein (1985) argues, small countries tend to spend more than large

ones. The fact that big countries still compensate the losers of globalization and that some small democratic countries also have an Anglo-Saxon-style social welfare program reveals the weakness of this theory. Of course, using the new-institutionalist framework in order to explain the persistence and divergence of welfare states appears promising. By doing this, however, scholars again face similar theoretical limitations as those theories in the endogenous-contextual category of ideas.

It is quite challenging to summarize the existing literature on welfare state development. Although I classify diverse theories into four categories in this section, I admit that the classification is not exclusive and perfect. Thus, in some cases, one might think that a theory could not be perfectly classified into a certain category. For example, Cameron's (1978) arguments could be also interpreted as an exogenous-*contextual* explanation because he partly agrees with the power resources theory that emphasizes the nationally distinctive patterns of political struggles over redistribution among political organizations. After all, his arguments could also be about small states in Europe, with which Katzenstein (1985) develops an exogenous-contextual explanation. What divides Cameron's (1978) argument from Katzenstein's (1985) might be his theory's deterministic, sequential, or structural process that connects economic globalization with welfare states. In any case, however, the overall classification of ideas should be considered as a heuristic typology.

1.3 Stories Overlooked: Demand and Supply of Social Welfare

From the existing literature, we know a lot about *why* welfare states persist in an age of globalization: welfare states might be functionally required for sustaining economic and political order; their existence could be a reflection of class interests over social welfare programs, which could be persistent over time or institutionalized in each society; economic globalization might work to strengthen the demand of

social welfare beneficiaries through intensified market competition. At the same time, welfare states could be effective tools to address the anxieties coming from the global market. Despite various conjectures, it is astonishing and unfortunate that we know little about *how* national governments address fiscal stress in order to sustain the level of social spending. I argue that the fundamental cause of the situation is the failure of welfare state scholars to scrutinize both the supply- and demand-side functions of social welfare provisions: there are stories being overlooked.

First of all, the supply-side function of social welfare provisions has been over-looked in the literature of welfare states. Most explanations concerning the survival of welfare states heavily emphasize the role of public demand. As a systematic review of the literature reveals, we can broadly scrutinize most of the welfare states theories by a single criteria: the origins of social welfare demand. While recognizing the possibility of exaggeration, we might say that welfare states are established and sustained by what people want. I do not necessarily disagree with the importance of demand for social welfare in understating the subject matter. I do argue, however, that the demand-side function of social welfare provisions alone cannot explain how governments address fiscal burden in sustaining welfare states, which has been strongly proposed by the retrenchment theories. We need a balanced explanation.

Of course, there are some considerations in regard to the supply-side function of social welfare (Bueno de Mesquita et al. 2003; Katzenstein 1985; Meltzer and Richard 1981; Pierson 1994). In most cases, however, scholarly attention focuses on the calculation of political leaders in terms of the allocation national resources for their political survival. It is clear that the focus is not technically on how governments secure additional revenues for supplying social welfare. As discussed in the previous section, the main focal point of the retrenchment arguments, against which a large body of welfare-state literature has been accumulated, is not about how politicians are pressured by domestic interests in distributing resources, but about how national

governments are fiscally constrained by the global market. The mismatch in the analytic focal point between neo-liberalists and welfare-state scholars has seriously biased the analysis of the latter. In a sense, scholars of welfare states are attacking a straw man.

At the same time, some might argue that we do not need to worry about supply-side constraints for sustaining social welfare programs. The fact that welfare states persist under the global market is self-evident, and belies the arguments about welfare state retrenchment. In other words, the fiscal capability of national governments to sustain the level of social expenditure is intact or, at least, not negatively affected by economic globalization (see e.g. Garrett 1995; Swank 1998). Apparently, as we can see in Figure 1.2, there is no sign of retrenchment in government social welfare spending. At the same time, there seems to be no sign of systematic constraints on governments' capabilities to sustain the level of revenues. We need to admit that welfare state retrenchment has not occurred—at least not yet. From here, it is illogical to conclude that there is no race to the bottom or fiscal stress in sustaining social welfare provisions. As Garrett (1995) aptly points out, "The propensity to deficit-spending is the political economic *sine qua non* of social democracy." In other words, the fact that governments continue to sustain their level of social spending does not necessarily go against the argument that welfare states are under fiscal stress in an age of austerity.

The other gap in welfare-state literature is somewhat ironic. Given the general focus on demand in explanations of welfare state dynamics in an age of globalization, demand for social welfare itself has rarely been the central focal point of the existing analyses. As discussed above, scholars identify two different sources of social welfare demand and two different modes of political process regarding it. Without seriously considering the foundational dynamics of welfare states, most studies simply assume that demand is important in understanding the dynamics of welfare states under

globalization. A closer look at the demand-side function of social welfare provisions is required.

Of course, scholars have recently begun to recognize that individual-level analysis of welfare states deserves our special attention (Anderson and Pontusson 2007; Bleke-saune and Quadagno 2003; Brooks and Manza 2008; Hays 2009; Rehm, Hacker and Schlesinger 2012; Walter 2010). I welcome the recent surge of attention to micro-level dynamics of social welfare provisions, which have great bearing on the existing macro-level theories of welfare states. At the same time, however, it is also true that we need further theoretical and empirical elaborations. In particular, our understanding of the individual-level dynamics of welfare states is greatly limited by the fact that different implications of various macro-level theories are rarely studied together. Rehm, Hacker and Schlesinger's (2012) analysis might be the only exception. For example, they examine how two different sources of social welfare demand—lower income and economic insecurity—interactively determine macro-level patterns of public support for welfare states. Despite the empirical breakthrough, however, their analyses remain at the macro-level. Here, my dissertation goes one step further by examining how various types of economic hardship determine welfare state demand at the individual level.

1.4 Toward a Balanced Explanation: FDI and Welfare States

In filling up these gaps, my dissertation aims to provide a balanced explanation as to the growth of welfare states in an age of globalization. For this purpose, I focus on one of the important aspects of globalization, FDI, which bears meaningful implications for both demand- and supply-side functions of social welfare provisions in explaining variations of government spending across countries. How then does FDI affect both demand- and supply-side functions of social welfare provisions? I argue

that FDI has conflicting influences on welfare states. On the demand side, I embrace the logic of the exogenous camp which understands economic globalization as an important source of economic anxiety, or economic insecurity, and thus of welfare state demand. As globalization increases market competition, the frequent market dislocations generate new demand for social welfare (Cameron 1978; Katzenstein 1985; Rodrik 1998). The impact of FDI, however, is more direct and intense than normally considered by scholars in the exogenous camp. When FDI is made in a host country, market competition becomes intensified by the appearance of multinational corporations (MNCs) in the host market. It is a well known fact that FDI is mostly made by MNCs and that MNCs have distinctive sets of advantages over local businesses (see e.g. Caves 1971; Dunning 2000). To the extent that FDI refers to the advances of powerful competitors to the host economy, it works for welfare states by intensifying market competition and thus generating new demand for social welfare.

At the same time, FDI also works for welfare states through its mobility. It might sound strange because FDI is famous for its stability and thus for its potential contribution to the economic growth of a host country. This is typical when we compare it with other types of global capital, such as FPI (Goldstein and Razin 2005; Spero and Hart 2009). After all, FDI is an investment with *lasting* interests in foreign enterprises. When we confine our focus exclusively on FDI, however, the stability of FDI varies according to investment motives and types of target industries (Jensen 2008). While FDI in general intensifies competition in the host market, the competition-generating or insecurity-generating effect of FDI becomes prominent with its mobility. While footloose FDI tends to have a higher level of elasticity in labor demand, it also refers to frequent advances of new competitors to the host market. As for the relatively immobile FDI, on the other hand, it introduces foreign actors into a host country, who would behave as native economic actors in the long run. Taken together, the mobility of FDI would have a prominent effect in generating economic

insecurity and thus stimulating demand for welfare states.

As such, my theory on FDI-welfare states is in line with the arguments raised in the exogenous camp that economic globalization is an important source of social welfare demand. Two important questions follow. First, does the proposed hypothesis work against the arguments of the endogenous camp? At the individual level, I do not necessarily disagree with the arguments that welfare state demand has endogenous origins. Economic disadvantage largely defined by socio-economic factors is a strong determinant of individual economic need and, thus, materialistic interests in social redistributive policies. However, I argue that economic insecurity is as important a determinant of materialist interests in social redistributive policies as economic disadvantage. Thus, at the individual-level, both endogenous and exogenous sources of demand might work together in determining individuals' political attitudes toward social policies.

Second, if demand for welfare states has an exogenous origin, how is it processed through the political system? On a societal level, upon the traditional demand for welfare states from the economically disadvantaged, economic insecurity will contribute to the expansion of overall demand for social welfare policies (see e.g. Rehm, Hacker and Schlesinger 2012). The societal-level growth of economic preferences for welfare states, however, will not automatically empower the left-wing political parties in government (Cameron 1978; Garrett 1998). First, the expansion of the scope in demand will necessarily increase heterogeneity among the group that hinders collective actions in order to make their voice effectively heard. Second, to the extent that the group with economic insecurity deviates from that of economic disadvantage, it necessarily generates cleavages within labor. Taken together, economic insecurity rather destabilizes the left-wing organizations capability to mobilize their power resources. Although the political significance of partisan struggles for redistribution decreases, the enlarged scope of demand will increase the level of social welfare provisions by

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stimulating government' efforts to secure social stability and equality.

On the supply side, FDI has the exact opposite impact on welfare states. It limits the fiscal capabilities of governments to satisfy the demand it generates. Broadly speaking, national governments are structurally engaged in a bidding war against each other for attracting more FDI than others. Through competition for FDI, governments provide various sorts of either monetary or fiscal incentives that could increase the rate of return for foreign capital. At the same time, however, the competition is also fought to secure domestic production capitals in their territories. In other words, governments' efforts to attract and retain production capital are not confined only to foreign businesses, but directed to capital in general. As a result, as the pressure for competition increases, government efforts to win the race will necessarily harm capital taxation.

Taken together, FDI stands at the center of the "dilemma of globalization" (Rodrik 1997). While FDI increases public demand for social welfare provisions, it can potentially reduce a government fiscal capabilities to deal with it. As two conflicting influences of FDI collide, I argue that the very principle of welfare states is in danger. "Welfare state" is a policy mechanism through which income is socially redistributed from the rich to the poor. In this sense, the progressive tax has been the central piece of welfare states, in which high income people takes on a higher tax burden. Faced with the dilemma of FDI—decreased capital taxation and increased demand for social welfare—governments' will try to manipulate the structure of taxation to secure additional revenue by relying more on indirect taxation that is effective in generating additional revenues, politically less expensive and notoriously regressive by compelling lower income earners to take on a higher tax burden.

In providing an empirical analysis of the proposed causal mechanisms, I expand the scope of my analysis both longitudinally and cross-sectionally. Despite the fact that welfare states are one of the most highly discussed issues in the literature of

political economy, it is surprising that our knowledge of the subject is somewhat limited beyond affluent democracies. Only a few pioneering studies provide some insights about how welfare states evolve in developing countries (see e.g. Rudra 2002). At the same time, the existing empirical studies of welfare states have been mostly confined to the last several decades of the twentieth century, what we often call the age of globalization. Given the focus on FDI, however, we need to go beyond this time period, as the age of global production capital arrives later at the end of the twentieth century. According to UNCTAD (2008), for example, the first record of global FDI flows is reached in 2000 and again in 2007. As a result, with both cross-sectional and longitudinal expansion of the sample countries under consideration, my dissertation takes the existing studies one step further.

1.5   The Organization of Analysis

In the following chapter, I examine the individual-level assumption of the exogenous argument that economic insecurity is an important determinant of demand for welfare states. In doing so, the mechanism is also examined alongside two traditional sources of welfare state demand, which are largely implied by scholars in the endogenous camp: both the level of income and social class identification. First, I show that economic insecurity is as important a source of welfare state demand, either economically or politically, as the traditional ones. Second, I also examine how economic insecurity determines individual demand for welfare states interactively with other traditional sources of it. As emphasized above, I do not argue that the individual-level assumption of the endogenous camp does not matter for the growth of welfare states. Instead, I argue that without considering the role of economic insecurity, our understanding of welfare state demand could be seriously biased.

The macro-level analysis of the mechanism, whereby FDI affects welfare states,

consists of two parts. First, I model and test a theory about how FDI functions *for* welfare states. In particular, the theory states that both FDI inflows and its mobility will increase the size of the public economy. As emphasized earlier, there has been no attempt in the literature of welfare states to understand the relationship between globalization and welfare states in terms of global production capital. In their study, Scheve and Slaughter (2004) show that FDI spreads out economic insecurity in a host country by increasing elasticity of labor demand. Through their analysis we can implicitly understand the subject matter in conjunction with the conclusion of Chapter 2 that economic insecurity is an important source of demand for welfare states. From the literature of both MNCs and welfare states, Chapter 3 examines the direct linkage between FDI and government expenditure.

Second, I also model and test a theory about how FDI works *against* welfare states. I theorize that national governments are structurally engaged in a competition to attract and retain FDI. As the pressure for FDI competition increases, it is expected that national governments will experience reductions in capital taxation. An empirical analysis of Chapter 4 provides strong evidence for this proposed hypothesis. Taken together with the conclusion of Chapter 3, we can say that FDI stands at the center of the "globalization dilemma" between increased demand for social welfare and decreased capacity of governments to supply it Rodrik (1997). Lastly, Chapter 4 also examines the impact of the dilemma on the general structure of taxation. Increased demand should be met by securing additional revenues. For that purpose, national governments will distort the progressive taxation structure for welfare states by relying more on regressive taxation in which lower-income earners take on higher tax burdens. As the dilemma strengthens the tension between demand and supply of social welfare, the principle of redistribution is in danger.

Lastly, I provide a sensitivity analysis against two potential criticisms of the mechanism whereby FDI benefits welfare states. First, some might argue that the size of

the public economy is not technically equivalent to that of welfare states. Second, some might also argue that the proposed mechanism could work for affluent democracies, but not for developing countries. Given the unfavorable environment for the growth of welfare states in developing countries—both unstable political regimes and a lower level of economic development—the impact of economic globalization, in particular FDI, on welfare states could not function as proposed in Chapter 3. Taken together, the criticisms suggest that the conclusion cannot be supported if we examine the mechanism by narrowing down our focus on social welfare spending in developed countries. Even if FDI generates economic insecurity, an unstable political regime would hinder the growth of a welfare state (see e.g. Adserà and Boix 2002). At the same time, even if developing countries expand the level of government spending as proposed, it is hard to believe that the spending is equivalent to social welfare spending of affluent countries. Against these potential criticisms, I specifically examine how FDI affects the level of social welfare spending in a sample of developing countries in Chapter 5. In doing so, I place the mechanism in a complicated web of interactions of contextual factors, which are largely considered as providing an unfavorable environment for welfare states in developing countries: political regime, economic development, and economic globalization.

CHAPTER II

Social Welfare Demand: Economic Hardship and Political Activism

The development of welfare states is a highly discussed issue in the literature of political economy. Theoretical explanations are abundant and sophisticated, however, it is unfortunate that our knowledge of the subject matter is somewhat limited by the fact that different schools of thought rarely communicate with each other. As a result, if an argument arises between two different scholarly camps, it is difficult to discern which argument has the upper hand. Furthermore, it is also difficult to draw a more unified picture in which different theoretical mechanisms work together in shaping the course of welfare state development.

It may be worthwhile to attempt to balance out these different views on a macro level. However, when doing so we might face varying assumptions from different theories about sub-national political dynamics, which cannot be easily reconciled across scholarly camps. If we construct a theory incorporating different perspectives, it is highly likely that we will add another layer of macro-level theory to the existing ones. At this point, it would be surprising to find a common theoretical building block connecting macro-level theories of welfare states; that is the role of *public demand* for welfare states (see e.g. Brooks and Manza 2008). At the risk of oversimplification, we might argue that welfare states are established, developed, and sustained based on what people want. It is upon this common ground that this chapter explores different implications of various macro-level theories to individual-level determinants of welfare state demand. In doing so, I am particularly interested in how economic insecurity affects social welfare demand at the individual level alongside with other sources of

it.

What accounts for individual demand for welfare states? As most scholars of welfare states agree, conventional wisdom suggests that economic disadvantage is strongly linked to favorable attitudes toward social redistributive policies. Welfare states are to redistribute income from the rich to the poor; as the primary beneficiary group of social welfare programs, those who belong to *lower income* strata or *lower classes* are natural supporters of welfare states. The "revisionist theories"[1], on the other hand, provide a different picture. Historically, it is difficult to assume that welfare states have been exclusively pushed from below. In other words, the economic sources of social welfare demand are not necessarily confined to those who are economically marginalized. High income earners can also develop positive attitudes toward welfare states when they perceive that the economy is treating them poorly. Among scholars in the exogenous camp, *economic insecurity* is the proposed alternative source of individual demand for welfare states.

Intuitively, we know that the proposed mechanisms, whereby economic hardship affects individuals' attitudes toward welfare states, are not inherently distinctive. For example, it is reasonable to assume that those who belong to lower income strata are likely to identify themselves as lower class, and have a relatively more insecure job than others. If this is the case, scholars in both camps are seeing the sides of the exact same coin differently, hence rendering the current study pointless. As I will discuss later in this chapter, these types of economic hardship—disadvantage, lower class or insecurity—considerably deviate from each other across time and space. Thus, the ways in which each aspect of economic situation affects individual demand for welfare states, and, more importantly, how these different mechanisms work together

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[1] I follow Rehm, Hacker and Schlesinger (2012) to define a set of arguments as the *revisionist* theories. Since the arguments de-emphasize the role of traditional class cleavage and provide an alternative source of welfare states attitudes, the term revisionist clearly captures their theoretical position against those who heavily rely on the conventional wisdom.

in determining individual demand for social welfare deserve a thorough empirical analysis.

Based on the potential overlap between the proposed mechanisms, this chapter establishes an integrated model that incorporates different concepts of economic hardship into a single analytic framework. In this way, we can draw some interesting hypotheses about the implications of macro-level theories on individual-level determinants of demand for welfare states. To begin with, the integrated model expects that the materialistic preferences for social welfare become stronger as two different concepts of economic hardship overlap, with all else being equal. In other words, the lower class identifiers who also feel insecure would develop stronger positive attitudes toward social redistributive policies than others. Second, it also expects that those individuals who can be uniquely identified by each mechanism can also develop favorable attitudes toward welfare states. Although the magnitude might be relatively weak, each model provides rationales that assume both lower class identifiers without job insecurity and insecurity identifiers without lower class identification would develop positive attitudes toward welfare states.

Furthermore, the model incorporates another important definition of economic hardship: lower level of income. In line with conventional wisdom, theories in the endogenous camp assume that a lower level of income is an important indicator of economic disadvantage. As economic need for public welfare decreases as income increases, a lower level of income will strengthen the effect of other economic hardships on demand for welfare states. In other words, income will negatively condition the effects of economic hardship on attitudes toward welfare states. Among others, we will observe the strongest materialistic preferences for social welfare when both lower class identification and economic insecurity overlap with a lower level of income. Second, conversely, the revisionists suggest opposite conditional effects of income on the proposed mechanisms. Although the risk model does not necessarily argue for a

certain income group, the gist of the revisionist arguments is that high income earners can develop a favorable stance on social welfare when they feel the economy treats them poorly.

Thus far, I focus on *economic* sources of individual demand for welfare states. In doing so, I only consider preferences toward social redistributive policies. Of course, a favorable attitude is an important aspect of social welfare demand. In general, however, demand could refer to actions that reflect an individual's underlying preferences. In this vein, an important question arises: If an individual develops more positive attitudes toward social welfare policies than others, to what extent will this preference come with political influences? In other words, if individuals who are economically struggling are likely to develop positive attitudes toward social welfare policies, how likely is it that these individuals would actually push governments for the social welfare provisions for their own benefit?

In answering this question, I establish an additional hypothesis concerning how the economic sources of welfare state attitudes are associated with individual political activism. In other words, I am interested in the political capabilities of those people who are identified by the integrated model. As widely recognized, socio-economic status is an important determinant for political activism (see e.g. Verba, Schlozman and Brady 1995). Based on this logic, the model expects that, in general, economic hardship would have negative influences on individual political activism. At the same time, among individuals identified by the integrated model, political activism would become stronger as the economic situation is relieved. In other words, income will positively condition the effects of other economic hardships on political activism.

As mentioned earlier, macro-level analysis is a dominant mode of research in welfare state literature. It is equally the case that macro-level analysis dominates the discussion of the role of public demand in explaining variations in social welfare spending (see e.g. Brooks and Manza 2006*a*,*b*, 2008; Pierson 1994). Scholars have only

recently begun to explore the implications of macro-level theories at the individual level (Blekesaune and Quadagno 2003; Ha, Lee and Amri 2014; Rehm 2009; Walter 2010). In most cases, however, the empirical analyses have failed to incorporate insights from various macro-level theories. This chapter fills this gap.

Of course, this chapter is not the first attempt to incorporate various theories of welfare states. For that matter, Rehm, Hacker and Schlesinger's (2012) study is worth mentioning in more detail. Given the potential overlap between economic disadvantage and economic insecurity, they show that when correlation between lower income and economic risk is high, public support for welfare states is polarized and contested. As correlation decreases, at which time higher income earners are exposed to higher levels of risk, public support becomes moderate and less polarized. This analysis is both pioneering and insightful. In particular, it clearly shows that economic insecurity can expand the general scope of welfare state demand along with economic disadvantage. Despite both empirical and theoretical significance, however, this analysis still remains at the macro-level. Thus, an important assumption remains unexplored: that combinations of economic hardship generate strong support for welfare states at the individual level. At the same time, their analysis does not consider how social class identification—which has been widely recognized as an important individual-level determinant of welfare state demand in the endogenous camp—fits into the relationship between income and economic risk.

This chapter is divided into four parts. First, I identify two causal mechanisms—social class and risk models—concerning the economic foundation of social welfare demand at the individual level. Second, based on the World Values Survey (WVS), I visualize each mechanism in terms of how different concepts of economic hardship are distributed. From the survey, several interesting patterns arise: (1) Interestingly, there is no strong relationship between level of income and social class identification. (2) The relationship between income and insecurity is also fluid. (3) Despite similar

patterns of distribution between lower class and insecurity identifiers over range of income, evidence suggests that no two types of economic hardship are identical. Third, I integrate two mechanisms and establish some testable hypotheses about the economic determinants of individual demand for welfare states. In doing so, I also consider the political aspect of such demand. Fourth, in the empirical analysis section, I explain the data measurement and estimation process. Lastly, I explain the outcomes and discuss their implications on macro-level theories of welfare state development.

2.1   Class Model versus Risk Model

Conventional wisdom suggests that economic disadvantage is a strong determinant of an individual's favorable attitude toward social welfare policies. Most scholars in the endogenous camp agree with this assumption, citing that those who are economically marginalized are strong supporters of welfare states. According to scholars in the endogenous camp, ranging from modernization theory to new institutionalism, it is economically disadvantaged groups of people who develop strong economic interests in welfare states (see e.g. Deutsch 1961; Huber and Stephens 2001). From this stand-point, the traditional class model states that those who belong to *lower income strata*, or *lower class*, are likely to develop positive attitudes toward welfare states. However, the revisionist perspective, which is mostly shared by scholars in the exogenous camp, emphasizes economic insecurity as an alternative source of economic demand for welfare states: it is not economic disadvantage *per se*, but social risk, upon which individuals across different social groups can share favorable attitudes toward social redistributive policies (see e.g. Baldwin 1990; Mares 2003*b*).

2.1.1 Static Social Class Model

The traditional perspective suggests that economic disadvantage takes a central role in shaping individual demand for social welfare policies. A welfare state is a policy mechanism primarily designed for the redistribution of income from rich to *poor*. As a primary beneficiary group of social redistribution, those with lower incomes are largely considered to have strong materialist interests in public welfare policies. It is in this sense that Rehm, Hacker and Schlesinger (2012) measure economic disadvantage with lower level of income. Deutsch (1961) makes this point clear:

> In developing countries today, the increasingly ineffective and unpopular traditional authorities cannot be replaced successfully by their historic successors in the Western world, the classic institutions of 18th and 19th century liberalism and laissez-faire. For *the uprooted, impoverished and disoriented masses produced by social mobilization*, it is surely untrue that that government is best that governs least. *They are far more likely to need a direct transition from traditional government to the essentials of a modern welfare state* (p. 498, italics added).

The idea that *lower income earners* would have strong preferences over social redistributive policies is widely shared among scholars of welfare states. Lerner (1958), for example, who studied the modernization processes of six countries in the Middle East, emphasizes the role of urban dwellers who are drawn from rural areas, develop empathy to other people with a similar economic situation, and subsequently push governments for public services from below. As for Inkeles and Smith (1974), who also studied the modernization process of another six developing countries, it is factory workers who take a similar role with the poor urban dwellers. The political development thesis agrees with this view too. According to Meltzer and Richard (1981), it is those who have equal political rights but unequal economic status that put strong upward pressure for the provision of public goods. As a primary beneficiary, lower income earners are expected to develop strong economic demand for welfare states.

Beginning in the early 1970s, some scholars began to take this assumption one step further by defining economic disadvantage in terms of social class. Here, the power resources theory takes the lead. In developed democracies, in which every citizen has equal opportunities to participate in politics, social welfare policies are understood by the economically disadvantaged as a tool to expand their social rights by alleviating their economic situations. Korpi (1989) succinctly summarizes the argument as such:

> Relative to most other groups or collectivities in Western societies, *wage earners and workers can be assumed to be disadvantaged in terms of individual market resources.* The power resources approach thus generates the hypothesis that the majority of wage earners can be expected to have greater interest than other groups in using political interventions to modify market processes and market criteria in distribution, and therefore in extending social rights and social citizenship (p. 313, italics added).

As such, economic disadvantage is now widely re-defined in terms of social class. In particular, it is those in the working class who usually have a lower level of income and develop a strong materialistic demand for social welfare policies. In this sense, Hicks and Swank (1984) states, "Class distinctions are important for identifying groups with salient interests in income transfer payments (p. 84)." In line with the idea of traditional modernization theorists that welfare states develop out of public pressures from below, scholars emphasize the role of social class, given its organizational powers to exert pressure on the government. While the working class is often depicted as having great interests in and organizational power for the expansion of welfare states, the middle class is often considered as "ideologically and organizationally fragmented (Hicks and Swank 1984)."

The distinction between level of income and social class is still largely unclear in the endogenous camp; because it is implicitly assumed that the working class stands on the lower end of the income scale there seems to be no *a priori* reason for distinguishing between them. The theoretical elaborations in the literature, however, show

that subtle relationship may exist between them. As most modernization theories imply, the process by which individuals press governments for the expansion of public services requires them to embrace modern values (Deutsch 1961; Inkeles and Smith 1974; Lerner 1958). According to Inkeles and Smith (1974), for example, it is the dramatic changes of an individual's life experiences that transform her into a modern participatory citizen with modern values—such as, efficacy, innovations, planning, etc.—through factory systems and with the capabilities to push governments from below. In other words, it is not just a lower level of income, but the psychological or cultural aspect of economic disadvantage that is conducive to the formation of positive attitudes toward social welfare.

New institutionalism discusses the idea that in understanding demand for social welfare income level does not solely define an individual's attitudes toward social welfare policies. In explaining the resilience of welfare state regimes against the retrenchment pressure, these scholars take the power resources theory one step further. Despite various theoretical elaborations in this line of thought, the overarching theme claims that human interactions, and ensuing social institutions, determine the preferences of individuals (see e.g. North 1990). Institutions, through a broadly defined set of rules, punish (or reward) certain behaviors over others while generating particular patterns of growth for themselves (Hall 1986; Hall and Soskice 2001; Pierson 2000; Soskice 1999; Zysman 1994). This implies that it is not just individual level of income that automatically generates demand for social welfare; it is instead the distinct experiences of an individual through social interactions that are conducive to the formation of positive attitudes toward welfare states.

Despite the subtle relationship between social class and income in understanding the economic sources of welfare state demand, it is reasonable to assume that there is a stable and strong correlation between them. Hypothetically, it is possible that two concepts of economic hardship might deviate from each other in a way that

Figure 2.1: Hypothetical Income Distribution for Lower Class Identifiers
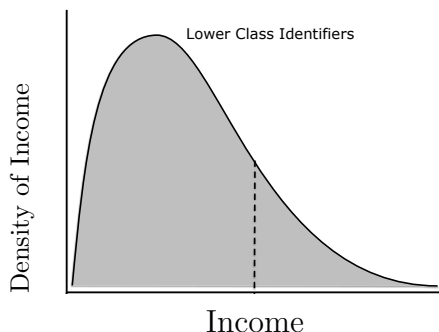
high income earners might develop lower class identification. However, according to conventional wisdom, this case would be rare and lower class identifiers commonly tend to have a lower level of income. This is at least so among scholars in line with the conventional mechanisms whereby economic disadvantage determines individual demand for welfare states. Thus, if we can identify individuals who identify as lower class, we can hypothetically draw a frequency distribution of income for those people as shown in Figure 2.1. The income distribution of the lower class identifiers is positively skewed so that lower class identifiers are more or less clustered over lower level of income. At the same time, the distribution would be stable in a sense that we would consistently observe the right-skewed distribution of income for lower class identifiers even if we allow some fluctuations across countries and time.

2.1.2 Fluid Social Risk Model

Revisionist scholars largely dismiss the centrality of economic disadvantage in understanding the dynamics of welfare state development. In particular, they are suspicious of the assumption that the economically marginalized would behave as a unitary actor. Historically, class politics itself has never been solely defined by a certain class, but by a group of classes. According to Przeworski and Sprague (1986), the working class has never been numerically large enough to take left parties to

the government. At the same time, labor unions have not been able to successfully mobilize workers for empowering left-wing political parties in government (Przeworski 1980). As a result, democratic socialist parties have consistently watered down class ideology in order to be electorally viable by attracting other natural allies, such as farmers, the lower middle class, women, or youth. In this vein, Baldwin (1990) asserts, "in the evolution of the welfare state there has been no one uniform and consistent, objectively solidaristic class" (p. 9).

While denouncing the centrality of social class, revisionist scholars provide an alternative framework to understanding the underlying mechanism for welfare state development. If economic hardship is an important source of materialistic need for social welfare, then there is no *a priori* reason for it to be solely defined by either social class or level of income. Economic hardship can be mostly, but not solely, about the economically disadvantaged. In this vein, Swenson (1991) argues, "there were winners and losers within labor, as well as divisions among capitalists (p. 514)." If employers stand on the higher end of the income scale, as is often the case, it is also possible that high income earners could develop materialistic preferences for social welfare when they feel the economy treats them poorly. Consequently, the development of welfare states could be understood as an outcome of cross-class alliances, in which losers in both labor and capital share positive sentiments toward social welfare policies.

The idea that economic hardship does not discriminate against any certain income group has been elaborated. First, there have been critiques of the long-held belief that capital-owners are invariably opposed to of social redistributive policies (Hall and Soskice 2001; Hollingsworth and Boyer 1997; Mares 2003*a,b*; Soskice 1999; Swenson 1991). According to Hall and Soskice (2001), for example, employers are sometimes willing to take on additional labor costs when they see a system of social protection as being favorable for their businesses. In these terms, each system of social protection, either uncoordinated liberal or coordinated social democratic regimes, has

Figure 2.2: Hypothetical Income Distribution for Risk Identifiers
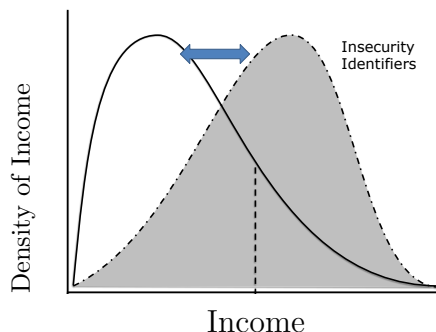
its own "comparative institutional advantages," upon which employers can develop a favorable stance on social welfare policies in countries with the latter type of welfare state regimes. This reasoning implies that a higher income earner can also develop positive attitudes toward welfare states.

Second, scholars explore why materialistic need for social welfare policies would vary among lower classes. If income is inversely related to economic disadvantage as the social class model assumes, it is clear that among lower classes the materialistic preferences for social welfare decreases as income increases. Some scholars, however, argue that the higher the level of skill specificity workers have in their industry, the higher the risks they face in times of unemployment (Cusack, Iversen and Rehm 2006; Iversen and Soskice 2001). In other words, if they lose their jobs, workers who have a set of skills that are specific to their industries have a difficult time finding job in other industries without tolerating a loss of income. Here, skill is a type of investment which comes with its own risk. To the extent that the level of skill specificity varies among workers, some workers develop a more favorable stance for social welfare policies than other workers.

In line with revisionist arguments, scholars in the exogenous camp rely on an alternative framework in understanding individual demand toward social welfare policies. It is the category of social risk or economic insecurity which does not necessarily

overlap with the traditional class cleavage between capital and labor. Rather than considering welfare states as an exclusive measure for the social protection of the lower class, scholars in this camp see welfare states as having a social insurance function to reallocate risks across classes (see e.g. Garrett 1998; Scheve and Slaughter 2004). As we can see in Figure 2.2, the risk model is different from the previous model in that the income distribution of economic insecurity does not discriminate against any particular income groups, and that the distribution could be fluid across countries and time. In this vein, Baldwin (1990) argues, "The social identity of such actors has not been fixed once and for all, nor has it remained constant throughout the evolution of the welfare state (p. 17)."

2.2 Distribution of Economic Hardship

In this section, I visually examine the distributions of each economic hardship proposed by each model. In order to provide a reliable comparison of the distributions across countries and times, I confine my analysis only to countries covered in the WVS. Among 87 countries in the survey, I exclude the least developed countries (LDCs), low income countries, small countries (total population below 1.5 million) and member countries of the Organization of the Petroleum Exporting Countries (OPEC)[2]. I further exclude observations that do not belong to the working age population (15 - 64). As a result, the analysis in this section is confined to 60 countries with 232,145 observations.

The study plan for this section is simple: I first construct two dummy variables for both lower class and economic insecurity identifiers, and then visualize the distri-

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[2]LDCs are Bangladesh, Burkina Faso, Ethiopia, Mali, Rwanda, Uganda, Tanzania and Zambia (United Nations Conference on Trade and Development, UNCTAD). Lower income countries are Zimbabwe, Kyrgyz Republic and Ghana (World Bank). Small countries are Trinidad and Tobago, Andorra, Cyprus, Hong Kong, Estonia and Singapore (World Bank). OPEC countries are Algeria, Iran, Iraq, Nigeria, Saudi Arabia and Venezuela (OPEC). Sources of the classification of counties are presented in each parenthesis

Figure 2.3: Income Distribution of Lower Class: Snapshots
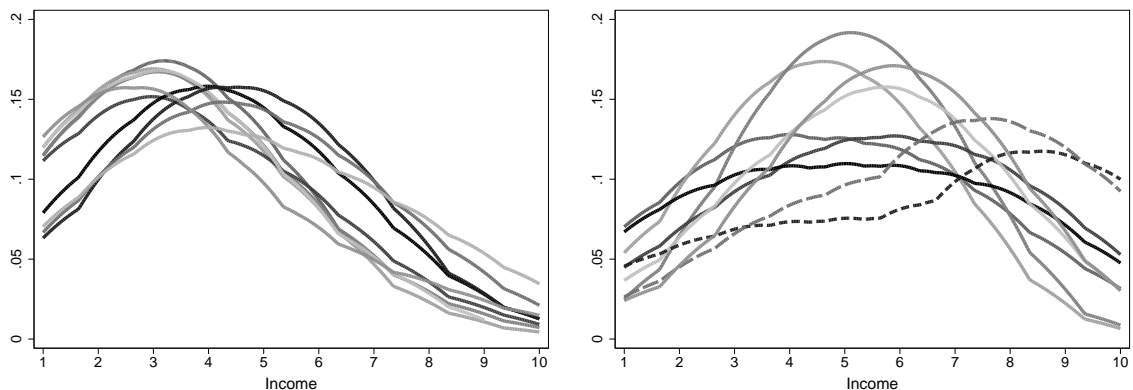
Note: The plot on the left side is for 10 countries (Azerbaijan 1997, Jordan 2001, Armenia 1997, Dominican Republic 1996, Slovak Republic 1998, Israel 2001, Italy 2005, Philippines 2001, Czech Republic 1998 and Croatia 1996) while the plot on the right for 9 countries (Russian Federation 1995, Slovenia 2005, El Salvador 1999, Belarus 1996, Latvia 1996, Thailand 2007 and Malaysia 2006). A long-dash line is for Lithuania 1997 and dash line is for the United Kingdom 1998. Plots are weighted by N=1,000.

bution of income for each dummy variable. The income variable is the standardized scale of household income, ranging from 1 (the lowest) to 10 (the highest) for each country-year. Lower class is defined by those who identify themselves as belonging to middle-lower, working, or lower classes. Economic insecurity is defined by those who answer a question pertaining to favorable aspects of a new job with "a safe job with no risk." The social class model expects that lower class income has a stable, right-skewed distribution while the risk model does not determine a specific shape of distribution. For distributions for each country-year survey, see Figures in Appendix.

Figure 2.3 presents income density plots of lower class identifiers in country-year surveys, which do not allow a longitudinal comparison of distributions. In the left side of the figure, we find strong evidence for the social class model; lower income earners are more likely to develop lower class identification. In the right side of the figure, however, the link between lower income and lower class identification becomes suspicious. In 8 out of 19 country-year surveys included in the figure, we cannot visually determine the right-skewness of income distribution for lower class identifiers.

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Figure 2.4: Lower Class Income Distributions
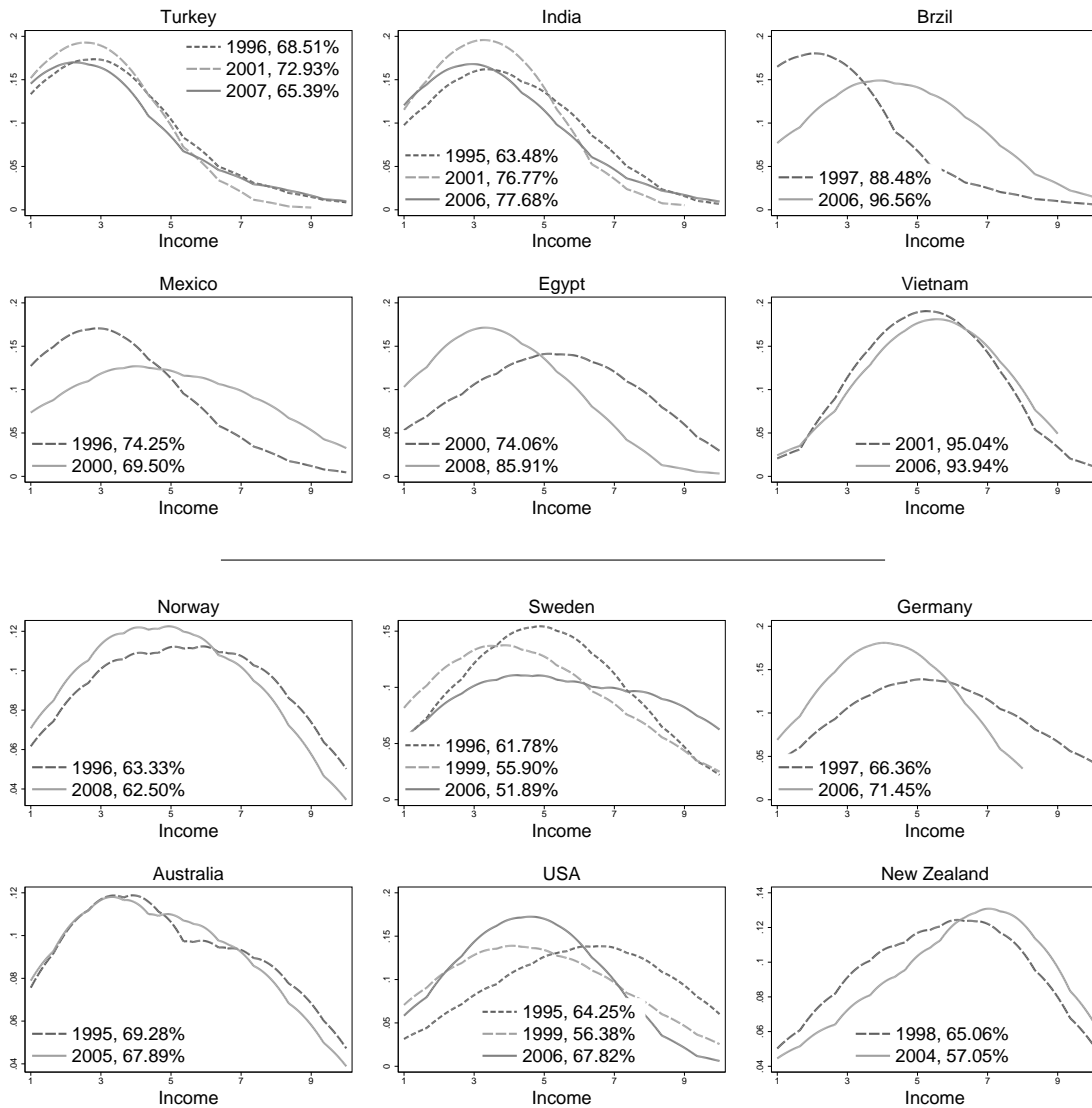
While the lower class identifiers' income is more or less normally distributed across most cases in the figure, even some countries show left-skewed distributions (Lithuania 1997 and the United Kingdom 1998).

Among surveys that span more than a year for developing countries, a similar pattern arises. Some countries do have a stable link between lower income and lower class identification. Peru, Turkey, India, Bosnia and Herzegovina, and Poland fall into this category. For other countries, however, it is difficult to determine that

Figure 2.5: Economic Insecurity Income Distribution: Snapshots
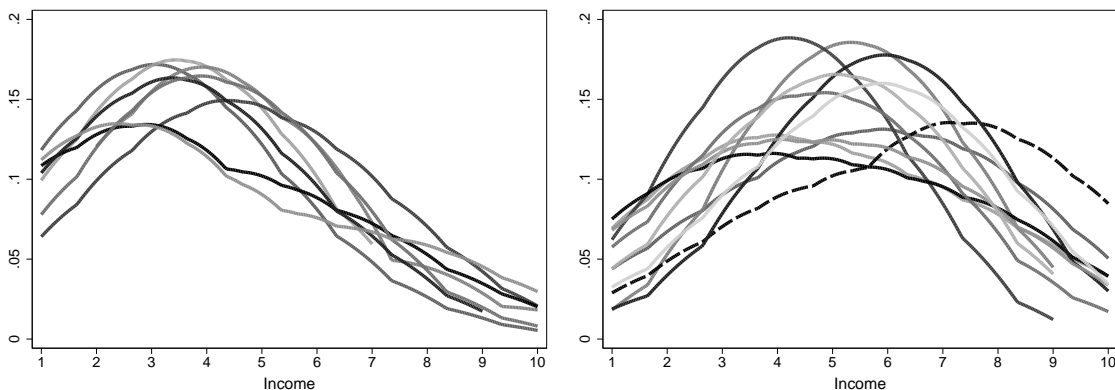
Note: The plot on the left side is for 10 countries (Armenia 1997, Azerbaijan 1997, Colombia 1998, Czech Republic 1998, Dominican Republic 1996, Egypt 1996, Israel 2001, Italy 2005, Poland 2005 and Slovak Republic 1998) while the plot on the right for 11 countries (Belarus 1996, Croatia 1996, El Salvador 1999, Kyrgyz Republic 2003, Latvia1996, Lithuania 1997, Malaysia 2006, Philippines 2001, Russian Federation 1995, Slovenia 2005 and Thailand 2007). The long-dash plot is for Lithuania 1997. Plots are weighted by N=1,000.

income distributions of lower class identifiers are stable and strong across countries. As we can see in Figure 2.4, we can visually identify the fluctuations of distributions over time in Brazil, Mexico and Egypt. The same pattern also arises for developed countries too. While income distributions of lower class identifiers are stable and positively skewed in some countries—such as Finland, Japan and Australia—they do fluctuate in many other countries. Some countries even show left-skewed distributions (New Zealand, the United States, and the United Kingdom).

We can also make a similar conclusion for the risk model. As we can see in Figure 2.5, the income distribution of economic insecurity identifiers does have a surprisingly similar pattern to that of lower class identifiers. For country-year surveys in WVS, which do not allow the longitudinal comparison of distributions, some surveys have right-skewed distributions while allowing some interesting fluctuations in others. Thus, economic insecurity tends to concentrate around lower income earners in some countries while spreading out across income levels in others. Furthermore, the distributions are even left-skewed in some country-years, such as Belarus 1996, China

Figure 2.6: Percentage of Lower Class and Risk Identifiers
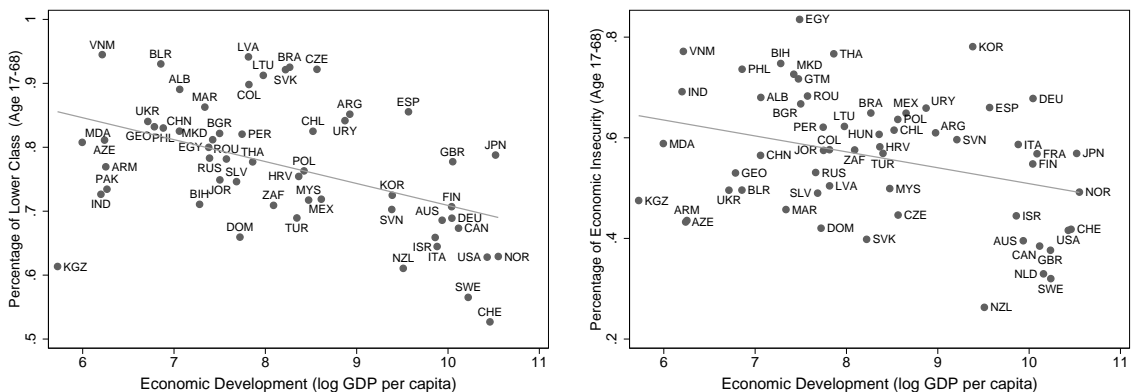
Note: Each country-year surveys' percentage of each identifier is first calculated and the mean values for each country is taken for each country.

2001, Lithuania 1997, New Zealand 1998 and 2004, Sweden 2006, Switzerland 2007, and the United States 1995. As the fluid risk model assumes, economic insecurity does not seem to discriminate against a certain income group.

By examining the income distributions of both lower class and insecurity identifiers, we arrive at several interesting conclusions. First, the income distribution of type of economic hardship seems to fluctuate. Contrary to conventional wisdom, lower income earners are likely to identify themselves as lower class only in certain countries, and over a certain period of time. In general, the risk model seems to have the upper hand over the class model. Second, the proportion of insecurity identifiers is generally lower than those with lower class identification. On average, approximately 57% of respondents consider job security as an important aspect of their new jobs while 77% identify themselves as lower class. Lastly, concerning the difference between developed and developing countries, the proportion of lower class identifiers is substantially lower in advanced countries, whereas the proportion of insecurity identifiers is not. In the scatter plot on the left side of Figure 2.6, we can see that the percentage of lower class identifiers is clustered into two groups of countries, in which developed countries have a relatively low level of lower class identifiers compared to

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developing countries. We do not see a similar pattern on the right side of the figure. The level of economic development reduces the proportion of lower class identifiers while having no ostensible effect on the reduction of risk identifiers.

2.3 Integrated Model: Theory and Hypotheses

In the previous section, I separately examine the distributions of two types of economic hardship—both lower class identification and economic insecurity—over the range of income across country-years. At a glance, the patterns of distributions seem to favor the risk model, but we cannot dismiss the class model all at once for several reasons. First, it is intuitive that these two concepts of economic difficulties are not inherently distinct. It might be reasonable to assume that even though lower class identifiers are not necessarily lower income earners, they might have insecure jobs. Although the proportion of risk category is significantly low compared to the lower class category across countries, we can see surprisingly similar patterns of income distribution between lower class and insecurity identifiers by comparing Figure 2.3 with Figure 2.5. Second, as the class model assumes, at a certain point in time in some countries, lower class identifiers are actually clustered over lower level of income. Lastly, and most importantly, although the link between lower income and lower class identification is not strong in many cases, the argument that economic disadvantage is an important determinant of individual demand for social welfare is still intact.

Given the potential overlaps and deviations between two models, we can establish an integrated model in order to critically assess each argument proposed by each model regarding the influences of economic hardship on individuals' demand for welfare states. Since two models are constructed for range of income, we can easily incorporate them into a single framework. Figure 2.7 gives us a hypothetical integration of two models. The integrated model divides individuals into four categories

Figure 2.7: Integrated Model
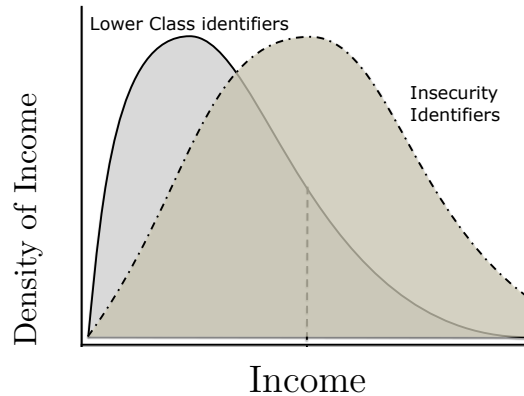
according to how two aspects of economic hardship overlap on level of income. Some individuals not only identify themselves as lower class, but also feel insecure about their jobs (Insecure lower-class). When the two models deviate, individuals can take only one of the two concepts of economic hardship (either secure lower-class or insecure upper-class). Lastly, there are some individuals who do not belong to either group.

We can establish two interesting hypotheses from this integration. First, we can expect that economic demand for welfare states become stronger as two different concepts of economic hardship overlap. In other words, insecure lower class identifiers would develop stronger positive interests in social welfare policies than others. If economic need is a powerful source of favorable attitudes toward social redistributive policies, as both models agree with each other, and if two concepts of economic hardship is not identical, as we just examined in the previous section, then we can expect that two concepts of economic hardship would have synergistic effects in encouraging individuals to have a favorable stance on social welfare policies.

Hypothesis 1. When lower class identification overlaps with economic insecurity, the influences of economic need on favorable attitudes toward welfare states become stronger.

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Second, we can further expect that those individuals who are experiencing only one of the two concepts of economic hardship can also develop positive preferences toward welfare states. In other words, both secure lower-class and insecure upper-class will develop favorable attitudes toward welfare states. As individuals in these categories are not troubled as much as those in the overlapping area, the effect of economic hardship in generating positive attitudes toward welfare states would be relatively weak compared to insecure lower-class identifiers. Thus, the second hypothesis follows:

Hypothesis 2. Individuals who are experiencing only one of the two concepts of economic hardship would also develop favorable attitudes toward welfare states, although the magnitude would be weaker than those who are troubled by both types of economic hardship.

Each model has a different idea about how the role of income affects individual demand for welfare states. In line with conventional wisdom, the social class model assumes that a lower level of income is another important aspect of economic disadvantage (see e.g. Rehm, Hacker and Schlesinger 2012). Thus, the level of income would negatively condition the effects of economic hardship on individual attitudes toward social redistributive policies. In other words, we can expect the strongest materialistic interests in welfare states when individuals are under all sorts of economic hardship under consideration. As the level of income increases, the effect of economic hardship—both lower class and insecurity—would decrease.

Hypothesis 3. Income would negatively condition the effect of economic hardship on individual attitudes toward welfare states.

The social risk model has a different explanation. In general, high income earners are less likely to develop a favorable stance on social welfare policies. As emphasized by revisionist scholars, however, there is a possibility that high income earners would

also develop materialistic preferences for public welfare when they feel the economy treats them poorly. At the same time, as high income earners would face a higher level of economic risk (see e.g. Cusack, Iversen and Rehm 2006), it is likely that income level would positively condition the effects of economic hardship on attitudes toward welfare states. Furthermore, within the progressive income taxation system across countries, in which high income earners take heavier tax burdens for the social redistribution of income, the effect of economic hardship on welfare state preferences can be stronger for high income earners as the situation works in the compensation mentality.

Hypothesis 4. Income would positively condition the effect of economic hardship on individuals' attitudes toward welfare states.

As briefly discussed above, demand for social welfare has an important political dimension. In a market, demand refers to not only how much a buyer wants a product or service, but also a buyers ability to pay the price. In other words, demand for social welfare can be understood not only by an individuals preferences or attitudes toward welfare states, but also an individual's political capabilities to push governments for it. This reasoning leads us to the question of how economic hardship under consideration is associated with an individuals political capabilities. For that matter, socio-economic status is a widely recognized factor that has a positive influence on individual political activism (Verba, Schlozman and Brady 1995). In general, individuals with economic resources are more likely to have interests and participate in politics than those without.

Hypothesis 5. In general, economic hardships would have negative influences on political activism. Among individuals under economic hardship, however, political activism becomes stronger when two types of economic hardship overlap on a higher level of income.

Figure 2.8: Percentage of Each Type of Economic Hardship: Variations
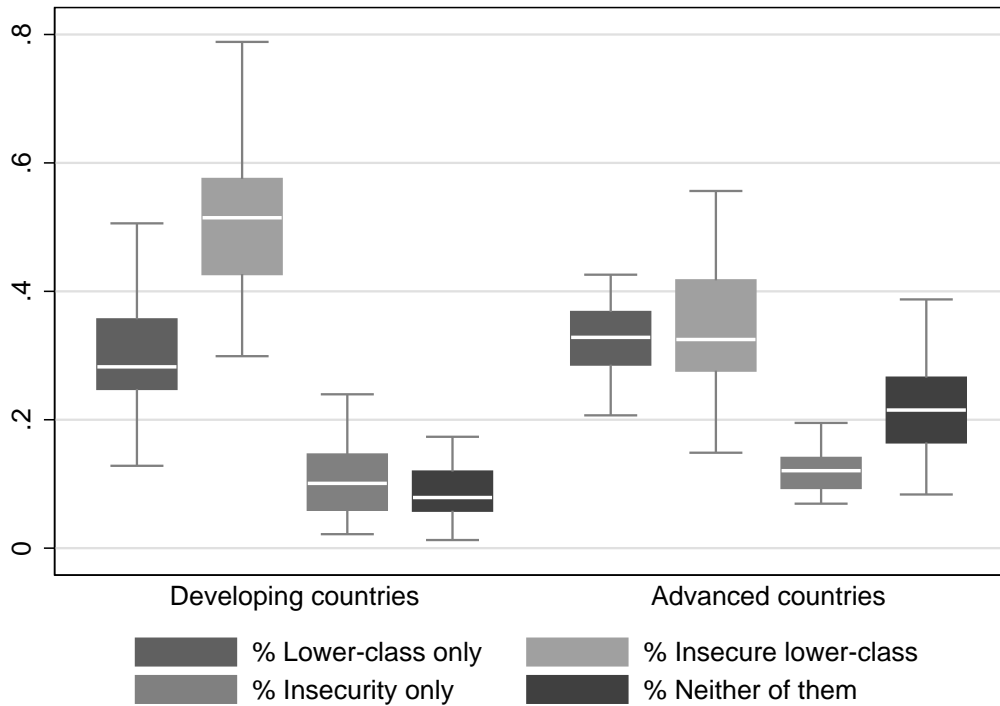
Note: Advanced countries include Australia, Canada, Finland, Germany, Italy, Japan, New Zealand, Norway, Sweden, Switzerland and United States various years. 44 developing countries are included following country-selection criteria discussed above.

We can apply this simple logic in understating the political aspect of welfare state demand. Simply put, we can expect stronger political activism from individuals with a higher level of socio-economic status. Thus, in general, we can expect that individuals with any type of economic hardship under consideration are less likely to be politically active. Among individuals who are identified by the integrated model, the logic further expects that those who belong to the overlapping areas would have the lowest level of political activism. With the same logic, we can also expect that the level of income can positively condition the effect of economic hardship on political activism.

Before testing these hypotheses, we need to check how much these combinations of economic hardship vary. In Figure 2.8, I graph box plots for the proportion of four types of combinations for country years. We can see that there are enough variations for each cluster of people across country-years. The figure makes two points clear. First, there are noticeable differences between developed and developing countries. The percentage of insecure lower-class is much higher in developing countries (about 50%) than in developed counties (about 30%). Furthermore, the percentage of the residual category (secure upper-class) are much lower in developing countries (about 9%) than in developed countries (about 22%). Second, there is a significant portion of individuals who experience only one of the two economic hardships under consideration (secure lower-class and insecure non-lower-class): about 45% for developing countries and about 40% for developed countries.

2.4 Data & Measures

I test the proposed hypotheses through a comparative opinion study by utilizing two extensive cross-national and longitudinal surveys: the World Value Surveys (WVS) and European Value Surveys (EVS). Based on the sample selection criteria discussed above, the final data set includes 198 country-year surveys that are conducted in 67 countries sporadically from 1981 to 2008 in both surveys (see Appendix for the list of country year surveys). In order to increase the sample size, I also scrutinize other cross-national surveys—such as various versions of Barometer surveys or the International Social Survey Programme (ISSP)—and national election surveys. The task, however, is extremely challenging as most surveys do not share questions on some key variables. While the question pertaining to social class identification is common across surveys, most surveys do not share a question about economic insecurity. Given the fact that additional surveys should share questions about both

dependent and control variables, the expansion of the sample size covered by both surveys appears to be significantly limited.

2.4.1 Dependent Variables

The first dependent variable measures individual attitudes toward social welfare policies for hypotheses 1 through 4. Among the possible list of variables provided by both data sets, two measures stand out: attitudes toward egalitarian income distribution and government responsibility. For the former, respondents are asked to place themselves on a 1 to 10 scale, where 1 means "income should be made more equal" and 10 means "we need larger income differences as incentives." Thus, the closer one's response is to 1, the more the respondent is skewed toward an egalitarian distribution of income. I re-code this variable so that higher values represent positive attitudes toward egalitarianism. For the latter, respondents are also asked to place themselves on a 1 to 10 scale, where 1 means "people should take more responsibility to provide for themselves" and 10 means "the government should take more responsibility to ensure that everyone is provided for." Thus, I have two separate measures of individual attitudes toward welfare states: both egalitarianism and government responsibility.

The second dependent variable measures individual political activism for hypothesis 5. Both surveys share a battery of questions about individual engagement in various types of political actions. Respondents are asked whether they have done, might do, or would never do a particular list of political actions: signing a petition, joining in boycotts, attending lawful demonstrations, joining unofficial strikes, and occupying buildings or factories. While excluding two extreme cases of political action, both public and individual violence, I construct an index variable for level of political activism. To do this, I first generate dummy variables for each type of political action, and then multiply each dummy variable by 1 for petition, 2 for boycotts,

3 for lawful demonstration, and 4 for strikes or occupation. The main reason for simple weighting is that when we simply add up these dummy variables, we cannot treat different types of political actions equally. After all, signing a petition is not equivalent to unlawful occupation or strikes. After a summation of these weighted variables, the index variable for political action varies from 1 to 10.

2.4.2   Explanatory Variables

While measures of both lower class and economic insecurity identification follow the basic coding scheme discussed above, they deserve some explanations. In the WVS, lower class is a dummy variable for those who identify themselves as either middle-lower, working, or lower class. As the same question on subjective social class is mostly missing in the EVS, I utilize the question on objective social class as answered by interviewers according to respondent occupation. Here, lower class is a dummy variable for those who are assessed to be manual workers: skilled, semi-skilled, unskilled and unemployed, etc.[3] As the variables in each data set are not derived from the exact same question as for the lower class variable, some might be suspicious about the reliability of this measure. However, the measure of lower class can alleviate this concern in two ways: First, in both survey programs, the lower class dummy is for those who do not belong to upper, upper-middle, and middle class. Second, when the two questions are asked by both surveys in Sweden 1999, the correlation between objective and subjective social class is .993.

In section 2.2, economic insecurity is a dummy variable for those who answer a question about the favorable aspects of a new job with "a safe job with no risk." The same question was not asked in the EVS. Instead, in both surveys, respondents are given a list of job aspects and asked to choose the ones they consider important.

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[3]As it is difficult to consider the unemployed as lower class, I replace the value of lower class when respondents identify themselves as unemployed in a question for employment status.

Among a series of variables that represent respective aspects of a job, I make a dummy variable for the 'job security' category for measuring identification of economic insecurity. Lastly, as a measure of household income, I use the same variable utilized in section 2.2 as both surveys have the same question wording. As the standardized scale of income, individuals are asked to place themselves on a scale of income that varies from 1 (the lowest) to 10 (the highest). As the same question was not included in the 4th wave of the EVS (2008-2010), I exclude the most recent wave of the EVS from the analysis.

2.4.3 Control Variables

I include a series of control variables: age, education, gender, marital status, employment status, union membership, political ideology, and two macro-level indicators—both advanced countries and democracy score. Following the definition of working age population supplied by the World Bank, respondents either younger than 15 or older than 64 are excluded. For marital status, I include a dummy variable for either married or living together as married categories. Employment status is also coded as a dummy variable for full-time, part-time, and self-employed. I further control for the effect of both political ideology and union membership. For the former, I utilize the individual's self-placement on a left-right ideological scale. In the survey, respondents are asked: "In political matters, people talk of the left and the right. How would you place your views on this scale, generally speaking?" Responses run from 1 (the left) to 10 (the right). For the latter, I construct a dummy variable for those who say that they belong to a labor union.

Alongside these individual-level controls, I also control for two contextual variables. First, as discussed in section 2.2, there are some noticeable differences between developed and developing countries concerning the proportion of each type economic hardship combination. In order to control these contextual effects, I include a dummy

variable for 19 advanced countries.[4] Second, I also control for another important contextual factor: democracy. Since democratic institutions provide an equal opportunity for political participation, it is likely that the mechanisms for the development of social welfare demand work differently in democratic and non-democratic countries. In controlling the regime effect, I utilize the Polity IV data set that provides regime scores, by subtracting the autocracy score from the democracy score, which vary from -10 to 10 (Marshall and Jaggers 2010). I include a dummy variable for countries where the polity score is equal to or greater than 6. Variables for measuring both the economic and political development of each country are included in the model and are greatly suspected to be highly correlated, however, the correlation between them is .34 at the country-year level.

2.5   Method

For a data analysis of the hypotheses, I utilize a multilevel modeling approach. With cross-national and longitudinal opinion surveys at hand, respondents are naturally and exclusively clustered into each country-year, and further within each country. Without considering the multilevel structure of the data set, any empirical study based on statistical analysis would suffer from violations of basic regression assumptions (Gelman and Hill 2007; Snijders and Bosker 2011). In particular, as the independent residuals assumption is violated, a statistical inference without considering the hierarchical structure of an error term gives us incorrect standard errors, which in turn leads us to incorrect conclusions. Furthermore, by incorporating a multilevel structure of the data set into the analysis, I consider the fact that individuals are embedded in a distinct national system of social protection (Esping-Andersen 1990;

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[4]The list of 19 countries include Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, and the United States.

Hall and Soskice 2001; Hollingsworth and Boyer 1997; Pierson 1994; Zysman 1994).

For individual i in country-year j in country k the baseline multilevel regression equation is defined as such:

$$\text{Attitudes}_{ijk} = \gamma_{000} + \gamma_{001}Lower\,Class_{ijk} + \gamma_{002}Economic\,Insecurity_{ijk} + \gamma_{003}Income_{ijk}$$
$$+ \gamma_{004}Age_{ijk} + \gamma_{005}Education_{ijk} + \gamma_{006}Female_{ijk} + \gamma_{007}Married_{ijk}$$
$$+ \gamma_{008}Union\,membership_{ijk} + \gamma_{009}Political\,Ideology_{ijk}$$
$$+ \gamma_{300}Advanced_k + \gamma_{020}Democracy_{jk} + \delta_{00k} + \delta_{0jk} + \delta_{ijk}$$

With the multi-level structure of error term at the country-level (δ_{00k}), country-year-level (δ_{0jk}) and individual-level (δ_{ijk}), the estimation directly incorporates the contextual influences in testing the proposed hypotheses. From the baseline model, we can identify each camp's argument regarding the influence of economic hardship on individual attitudes for social welfare policies. To directly test the hypothesis derived from the integrated model, I replace measures of economic hardship with $k-1$ dummy variables for each category of people: insecure lower-class, secure lower-class, insecure non-lower-class, and outsiders. Here, those who do not experience any type of economic hardship are omitted as a reference point. In this way, we can directly test both hypotheses 1 & 2 without affecting the models we have.

For testing hypotheses 3 & 4, I include interaction terms between combinational measures of economic hardship variables and the level of income. With the multiplicative interaction terms in the model, I calculate the marginal effects of different combinations of economic hardship by taking the partial derivative of the dependent variables with respect to key explanatory variables (see e.g. Brambor, Clark and Golder 2006). Then, the estimated effects of an economic hardship depend on both the baseline coefficients and the product of interaction coefficients with income variable. By calculating standard errors for point estimates for these marginal effects, we

can have confidence intervals for statistical inference (see e.g. Golder 2003).

2.6 The Results

Results are presented from Table 2.1 to Table 2.3. Table 2.1 gives us the results of the baseline multilevel analysis. Interestingly, we can identify strong evidence for both models. All else equal, both lower class and economic insecurity have strong positive influences on individuals' favorable attitudes toward welfare states. In considering different combinations of economic hardship identified by the integrated model, Table 2.2 gives us strong evidence for both hypothesis 1 and 2. Regarding competing expectations about the role of income in explaining the relationship between economic hardship and welfare state demand, the results in Table 2.3 are consistent with hypothesis 4: the level of income positively conditions the effect of economic hardship on favorable attitudes toward social welfare policies. Lastly, the analysis provides strong evidence for hypothesis 5: economic hardship has negative influences on political activism in general and the level of income mitigates the negative influences of economic hardship. I explain each point in detail below.

2.6.1 Economic Foundation of Social Welfare Attitudes

The results of the baseline analysis regarding materialistic preferences toward welfare states are reported in the first two columns of Table 2.1. As the social class model expects, the effect of lower class identification on two attitudes toward welfare states is positive and statistically significant at the 0.01 level. Interestingly, there is also strong evidence for the expectation of the social risk model. While controlling for the effect of lower class identification, economic insecurity also shows positive and statistically significant influences on individual attitudes toward egalitarian income distribution and a government's active role in providing social welfare. In sum, when

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Table 2.1: Social Welfare Attitudes and Political Activism: Class vs. Risk I

	Egalitarianism	Government Responsibility	Political Activism
Lower class	0.207***	0.102***	−0.031**
	(0.021)	(0.020)	(0.013)
Subjective Insecurity	0.089***	0.223***	−0.152***
	(0.024)	(0.023)	(0.015)
Income	−0.115***	−0.089***	0.020***
	(0.004)	(0.004)	(0.003)
Age	0.002**	−0.000	0.009***
	(0.001)	(0.001)	(0.000)
Education	−0.095***	−0.056***	0.139***
	(0.004)	(0.004)	(0.003)
Female	0.061***	0.103***	−0.192***
	(0.017)	(0.017)	(0.011)
Married	−0.052***	−0.065***	−0.109***
	(0.019)	(0.018)	(0.012)
Employed	−0.141***	−0.116***	0.099***
	(0.019)	(0.018)	(0.012)
Union membership	0.072	0.050	0.684***
	(0.047)	(0.042)	(0.027)
Political ideology	−0.142***	−0.113***	−0.077***
	(0.004)	(0.004)	(0.002)
Advanced countries	0.616***	−0.982***	0.911***
	(0.231)	(0.195)	(0.130)
Democracy	0.331	−0.061	0.071
	(0.213)	(0.214)	(0.111)
Constant	6.409***	7.418***	0.420***
	(0.197)	(0.195)	(0.108)
N	113,672	120,520	122,352

*p < .1, **p < .05, ***p < .01.

holding the other side's argument constant, each camp receives strong evidence for their argument.

Testing one side's argument while holding the other's constant, however, is not right for testing the proposed hypotheses established from the integrated model. The point of concern should be how combinations of different measures of economic hardship affect an individual's demand for social welfare. From the results of the baseline model, presented in Table 2.1, we can calculate the effects of different combinations of economic hardship. However, it might take additional effort and time to calculate

Table 2.2: Social Welfare Attitudes and Political Activism: Class vs. Risk II

	Egalitarianism	Government Responsibility	Political Activism
Lower-class and Insecurity	0.295***	0.325***	−0.183***
	(0.031)	(0.030)	(0.020)
Lower-class only	0.205***	0.125***	−0.031*
	(0.027)	(0.026)	(0.017)
Insecurity only	0.086***	0.246***	−0.153***
	(0.030)	(0.028)	(0.018)
N	113,672	120,520	122,352

*p < .1, **p < .05, ***p < .01. Results for control variables omitted.

standard errors in order to have confidence intervals for statistical inference. An easier way to get around it is to use k−1 dummy variables for different combinations of economic hardship. In this way, I can directly derive standard errors for the coefficients of each combination of economic hardship without affecting the model. On top of that, as the analysis for hypotheses 3 through 5 contain interaction terms between combinations of economic hardship and income, it is analytically convenient to take the k−1 dummy variable strategy.

The first two columns of Table 2.2 display the results for the re-analysis of the baseline model with k−1 dummy variables for each combination of economic hardship. Results for control variables are omitted as they are identical with those presented in Table 2.1. As the point of interest is on the effect of economic hardship, those who do not have both lower class and insecurity identification become the reference group. As hypothesis 1 expects, when two types of economic hardship are combined, the effects of economic hardship on attitudes toward welfare states become stronger. As also expected by hypothesis 2, even having only one of the economic hardships— either lower class or economic insecurity, encourages individuals to develop positive attitudes toward welfare states. The effects are positive and statistically significant at the 0.01 level while the magnitude is lower compared to those with both types of economic hardship.

Table 2.3: Conditional effect of Income on Economic Hardship

	Egalitarianism	Government Responsibility	Political Activism
Lower-class and Insecurity	0.077	0.109*	−0.314***
	(0.058)	(0.056)	(0.037)
Lower-class only	0.027	0.083	−0.148***
	(0.055)	(0.054)	(0.035)
Insecurity only	−0.020	0.234***	−0.195***
	(0.057)	(0.055)	(0.036)
Income	−0.137***	−0.101***	0.008*
	(0.007)	(0.007)	(0.004)
L-class and Insecurity × income	0.044***	0.046***	0.027***
	(0.010)	(0.010)	(0.006)
L-class only × income	0.034***	0.006	0.023***
	(0.010)	(0.010)	(0.006)
Insecurity only × income	0.019**	0.001	0.007
	(0.009)	(0.009)	(0.006)
Constant	6.526***	7.462***	0.484***
	(0.199)	(0.197)	(0.110)
N	113,672	120,520	122,352

*$p < .1$, **$p < .05$, ***$p < .01$. Results for other control variables omitted.

In order to test for competing hypotheses about the conditional impact of income on the economic hardship for welfare state attitudes, Table 2.3 includes interaction terms of income with k−1 dummy variables for each combination of economic hardship. Results for other control variables are omitted since there is no significant change in direction and significant levels. Against hypothesis 3, there is strong evidence for hypothesis 4 which expects income to have a positive conditional effect on the effects of economic hardship on attitudes toward welfare states. In the first column, we can see that the interaction terms are positive and statistically significant at the 0.01 level on attitudes toward egalitarian income distribution. In the second column, interaction terms do not reach any statistical significance. Overall, we cannot identify a negative conditional effect of income as was expected by hypothesis 3. For a correct interpretation of the multiplicative interaction term, I take the partial derivative of the estimated models with respect to each combination of economic hardship respectively. The results are presented in Figure 2.9. As we can see in the first two rows of

Figure 2.9: Conditional Effect of Income on Economic Hardship

(a) Egalitarianism

(b) Government Responsibility

(c) Political Activism
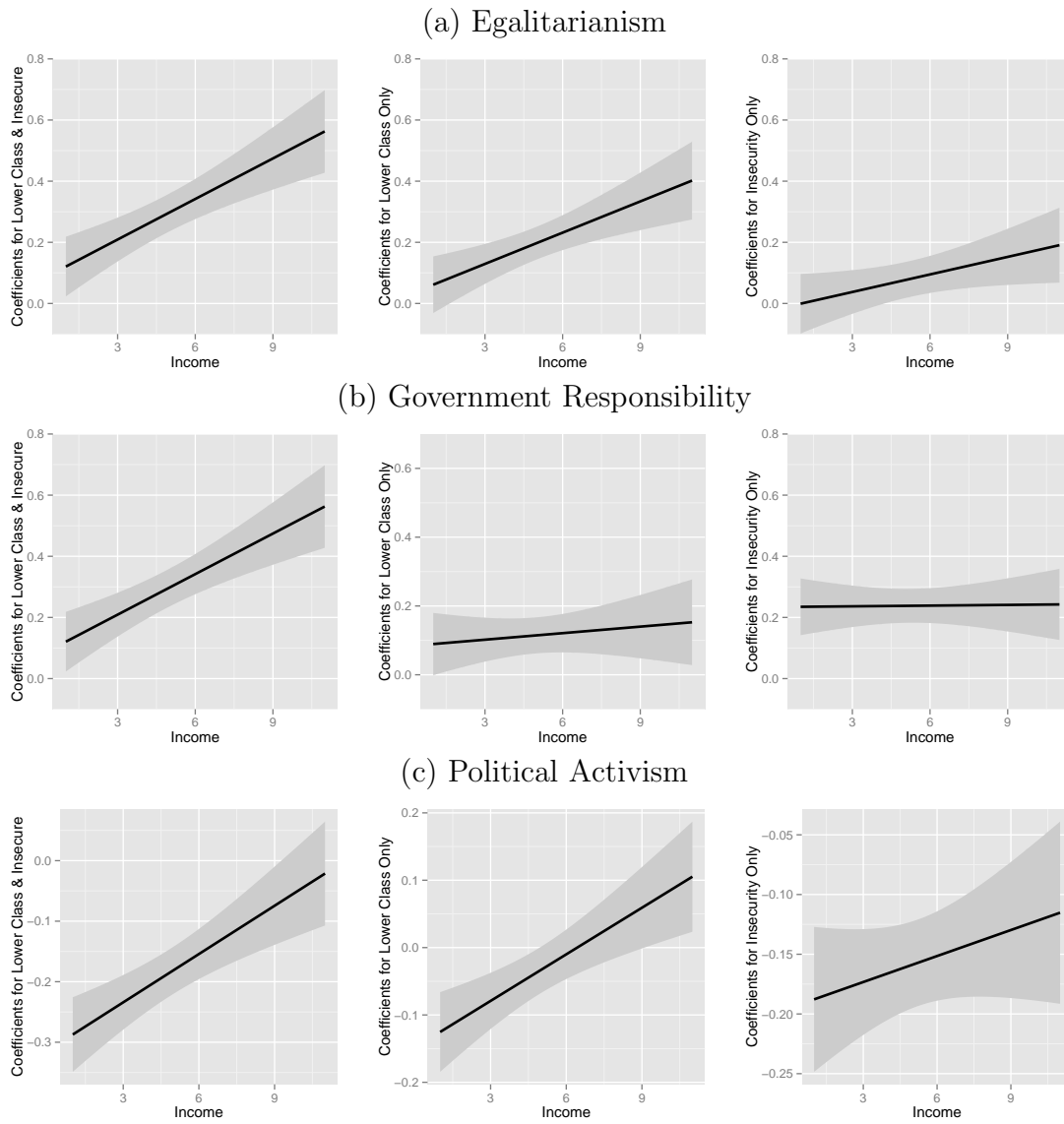
the graph, income positively conditions the effect of economic hardship on attitudes toward welfare states. The positive conditional effect of income is most prominent for the insecure lower-class category as well as for all categories in the egalitarian income equation. In the government responsibility model, the slope is slight positive for the secure lower-class category, and almost zero for the insecure non-lower-class category.

2.6.2 Political Foundation of Social Welfare Demand

The analysis also provides strong evidence for hypothesis 5. In Table 2.1, the results for the baseline multilevel analysis provide strong evidence for conventional wisdom: economic disadvantage represses political activism. While controlling for the level of income, economic hardship, defined either by lower class or insecurity, dampens individual participation in political actions. As we identified in the analysis of the materialistic bases of social welfare attitudes, we can also see that the combination of the two economic hardships has the strongest negative impact on political activism in the last column of Table 2.3. Thus, in general, those who have economic hardship—either lower class identification or economic insecurity—tend not to participate in political actions compared to those who do not. Furthermore, the negative impact of economic resources for political action becomes stronger when different types of economic hardship overlap, all else equal.

With the same logic, hypothesis 5 further expects that level of income positively conditions the effect of economic hardship on political activism. In other words, a lower level of income would be another important aspect of economic hardship that depresses political activism. In Table 2.3, we can see that the two interaction terms are positive and statistically significant, which means that as income increases political activism would also increase from the baseline coefficients of each category of economic hardship. We can clearly identify this point in the last row of Figure 2.9. As the baseline coefficients of each category of economic hardship indicates in Table 2.3, the marginal effects of economic hardship are negative when the level of income is zero. As income increases, however, we see that the negative influence of economic hardship on political activism begins to decrease.

Examination of the results for control variables gives us some interesting insights. First, some factors have consistently negative influences on attitudes toward welfare

states and positive influences on political activism: income, age, education, and employment status. This opens up the possibility to take the model developed here one-step further as most of these variables can be understood as important aspects of socio-economic status. Second, the gender variable (female) has opposite influences. Compared to men, women are more likely to have favorable stance on welfare states while having a lower level of political activism. Third, two variables stand out as they have consistently negative and statistically significant influences on both attitudes toward welfare states and political activism: marital status and political ideology. Finally, the remaining variables also show some interesting results. Union membership does not reach any statistical significance for social welfare attitudes while having a positive and significant impact on political activism. As for contextual variables, we can see that individuals in advanced countries have ambivalent attitudes toward social welfare while being politically active compared to those in developing countries. It is also interesting that democracy does not reach any statistical significance.

2.7 Discussion

In this chapter, I develop and test an integrated model for two theoretical model perspectives concerning individual demand for social welfare. In particular, the analysis focuses on how economic hardship is related to individual attitudes toward welfare states as well as their political activism. The analysis provides several interesting conclusions. First, economic hardship is an important determinant of favorable attitude toward social welfare. In particular, the definition of economic hardship is not confined to social class, which has been conventionally assumed to be an important stimulus for the growth of welfare states. Economic insecurity also takes an important role in promoting an individual's favorable stance on social welfare. Second, contrary

to the widely held belief that a lower level of income is a definition of economic hardship, income works rather as a resource through which economic hardship generates favorable attitudes toward welfare states. Lastly, the analysis also reveals that economic hardship works negatively in invigorating political activism among individuals. Interestingly, however, it shows that a higher income neutralizes the negative influences of economic hardship in dampening political activism.

These conclusions have some implications for existing theories of welfare states. Class politics have long been a major focal point in the literature on welfare states. The idea of public welfare is primarily to redistribute income for the socially disadvantaged. As the analysis above shows, however, it is problematic to assume that a welfare state is invariably a reflection of lower class interests. I do not deny the important role of social class in understanding individual demand for social welfare. However, from the analysis, we can say that economic insecurity is an important aspect of social welfare demand as much as social class. At the same time, level of income does not work as the conventional wisdom assumes: income largely works to strengthen the effect of economic hardship in generating demand for social welfare either economically or politically.

Furthermore, it is now conventional wisdom that ever since the late twentieth century the political significance of class politics has dramatically declined, especially among industrial countries (see e.g. Clark, Lipset and Rempel 1993; Inglehart 1997; Kitschelt 1988). Figure 2.10 gives us a clear image of this pattern. As an important measure of labor strength, union density measures the ratio of union membership to the total number of employees. Across different types of welfare state regimes as defined by Esping-Andersen (1990), there is a clear declining pattern of union strength during the period under consideration. In particular, the pattern is prominent in both Anglo-Saxon and European Continental countries starting in the late 1970s. Although Nordic countries are still sustaining relatively higher levels of union density,

Figure 2.10: Union Strength for Selected Advanced Economies
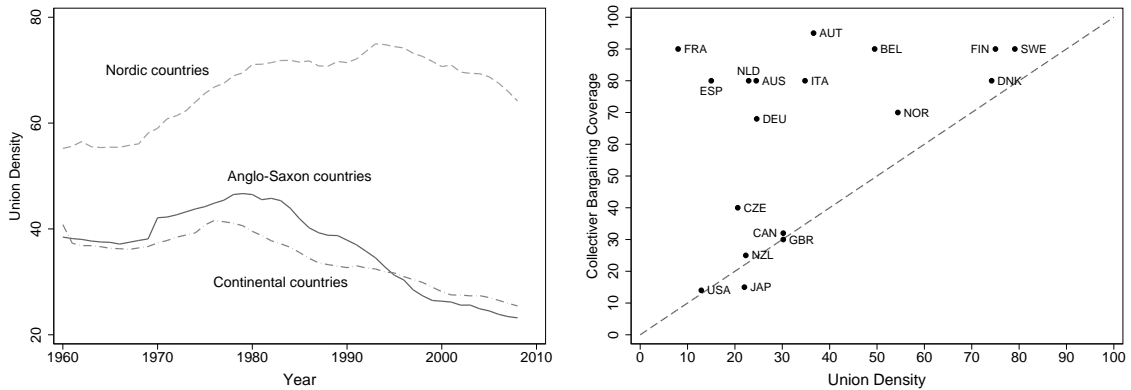
Note: a) Line plots on the left are unweighted averages for clusters of welfare state regimes by each year, defined by (Esping-Andersen 1990). Included countries are Nordic regime (Denmark, Finland, Norway, and Sweden), Anglo-Saxon regime (Australia, Canada, Ireland, New Zealand, the United Kingdom, and the United States), and European Continental regime (Austria, Belgium, France, Italy, Germany, Switzerland, and the Netherlands). b) On the right side, I replicate the scatter plot of OECD Employment Outlook for 18 countries in 2000 (OECD 2004, p, 146).
Source: OECD Database on Trade Unions & OECD Employment Outlook

we can clearly see the declining pattern of labor strength in these countries since the mid-1990s. Given the fact that the decline of union membership is very strongly concentrated in the private sector while the public sector maintains high levels of density rates in most countries (see e.g. Visser 2006), the decline of labor strength may look more dramatic than the plot shows.

Some might argue that union coverage, or collective bargaining coverage, as another important measure of labor strength (expressed by the ratio of paid workers who are covered by collective bargaining benefits) remains relatively constant across countries. In other words, welfare states continue to serve the interests of the working class, or the lower-classes in general, because the union still retains significant clout in controlling labor forces. As we can see in the right cell in Figure 2.10, most European countries are still maintaining high levels of union coverage rates regardless of the size of union memberships in 2000. Although I acknowledge that the institutional settings of welfare states continue to reflect the interests of workers and lower classes,

I argue that it disguises certain much more important dynamics of social class today. In order to argue that the established systems of social welfare continue to serve the interests of lower classes, it is necessary to prove that social disadvantage is closely connected with lower classes. The relationship, however, is empirically weak as the analysis in section 2.2 shows. In many cases, as most revisionist theories imply, the widely accepted link between economic disadvantage and vulnerable social class is not especially robust and elusive.

The analysis of this chapter, however, does not suggest that welfare states have nothing to do with the politics of social class in the period under consideration. Rather, it shows that the established system of social welfare begins to contradict the conventional understanding of the fundamental basis of welfare states. In this sense, Esping-Andersen (1990)—a core and influential scholar in the endogenous camp— argues, "The 'real' crisis of contemporary welfare regimes lies in the disjuncture between the existing institutional construction and exogenous changes (p. 5)." As the social foundation of the established social welfare institutions becomes unstable, a re-formulation of the traditional understanding of welfare states is needed. Here, scholars in the exogenous camp provide an attractive and alternative framework to analyze the dynamics of welfare states under the influences of globalization. At the individual-level focus, this chapter shows that without considering economic insecurity, any attempts to understand public demand for welfare states ought to be biased in a serious way.

CHAPTER III

FDI, Market Competition, and Welfare States

In the literature on political economy, the debate on the consequences of economic globalization on welfare states mostly comes from a question regarding the relationship between markets and politics. Following orthodox economic theory, the retrenchment argument puts more weight on the former. According to this view, the age of big government is over and welfare states are doomed to collapse. In reality, however, welfare states have not been retrenched, at least so far, and we still live with big government today. Welfare states not only survive harsh economic environments, but also grow as globalization intensifies (see e.g. Cameron 1978; Rodrik 1998). In providing rationales for this phenomenon, most scholars of welfare states argue that politics still overrides the market in an age of globalization. In line with the strong tradition of comparative historical studies of welfare states, scholars tend to emphasize the importance of domestic political mechanisms that fend off the external pressure for social welfare retrenchment. Welfare states have their own economic, political, and institutional built-in mechanisms to survive and grow, even under unfavorable conditions (Wilensky 1975; Korpi 1989; Esping-Andersen 1990; Pierson 2000; Soskice 1999).

Beginning in the late 1970s, some scholars began to acknowledge that these two seemingly opposite forces—markets versus politics—can meaningfully work together when shaping welfare states in the global market (Cameron 1978; Blais 1986; Garrett 1998; Katzenstein 1985; Rodrik 1997, 1998). In more open economies, the domestic market embraces greater risks resulting from turbulence in global markets. In this situation, governments expand the size of public economy in order to mitigate

external shocks and legitimize the move toward liberal economic policies. Welfare states take on a compensation, or insulation, function as a reaction to the economic insecurity that is pervasive in an age of globalization. Thus, the theorem is called the "compensation hypothesis."

The idea about the positive link between globalization and welfare states, however, is nothing new. According to Ruggie (1982), the restoration of the international economic order after World War II was based on this linkage—what he calls the international regime of "embedded liberalism." When revitalizing international trade after the war, industrial countries compromised the international monetary system to control the cross-border mobility of capital so that governments can effectively intervene in domestic market processes. As governments actively pursued free trade after the war, welfare states were intentionally designed to alleviate anxieties coming from the internationalization of markets. Welfare states have been a compensation mechanism for globalization losers. In this sense, the compensation mechanism is often called the "new embedded liberalism hypothesis."

What is new about the compensation hypothesis is its argument that the old mechanism of the post-war period is still working even today. It is interesting because conventional wisdom dictates that governments cannot function that way. There has been great suspicion about government macro-economic management capability since the late 1980s, not only for scholars who expect the retrenchment of welfare states, but also for those who argue for the viability of domestic politics in sustaining welfare states. The dramatic increase in capital mobility has been considered one of the major culprits of this situation (see e.g. Mundell 1963). When capital mobility has difficulties crossing national borders, governments can fight against an economic recession by spending more. With a higher level of international capital mobility, however, the expansive fiscal policy is not only ineffective in stabilizing the situation due to capital flights, but its detraction of capital is actually harmful for the economy. Thus, the

compensation argument is surprisingly interesting as it argues for an active role of government in providing social welfare, largely assumed to have negative influences on the economy.

Despite its theoretical breakthrough, the compensation hypothesis awaits further explanation in several important ways. First, the empirical studies of the hypothesis provide mixed results. While some find evidence of compensation, others provide evidence supporting retrenchment arguments. Second, and more importantly, most empirical studies concerning the impact of globalization on welfare states focus on the international trade of goods and services in understanding retrenchment pressures from economic globalization. Although the focus on trade is benign in understanding the topic under consideration, we need to admit that the arguments that *trade* benefits welfare states are incorrectly used against arguments claiming that *capital mobility* works against welfare states. Lastly, the existing studies of the compensation hypothesis are relatively silent about how national governments secure additional revenues to compensate the demand for welfare states. Both theoretical and empirical elaborations appear necessary.

Given these concerns, I elaborate on the compensation hypothesis by focusing on global production capital, or FDI. The positive effects of globalization on welfare states will still hold for FDI. As a type of global investment capital that comes with managerial purposes for foreign enterprises, FDI in most cases is made by multinational corporations (MNCs). In other words, the inflows of FDI refer to the advances of a strong market actor to the host economy. Under the influence of MNCs, market competition will increase while making labor demand unstable, and thus spreading out economic insecurity in a host country. As a result, the inflows of FDI will increase the chance of economic dislocations and thus the demand for social welfare also increases. At the same time, the frequent ebbs and flows of a powerful market actor will have a similar insecurity-generating effect. In sum, both FDI and its mobility

work for welfare states through this compensation mechanism. In providing empirical evidence for these hypotheses, the analysis carefully considers various criticisms of the compensation hypothesis.

3.1 Globalization-Welfare State Nexus

The compensation hypothesis refers to the harmonious relationship between economic globalization and welfare states. As more open economies embrace greater risks emanating from the world market, governments take initiatives to mitigate these risks by expanding the size of the public economy in general, or social welfare spending in particular. Welfare states work to insulate the shocks of globalization by compensating losers, and thus to legitimize the routes to economic liberalization (see e.g. Katzenstein 1985). After Cameron's (1978) seminal work, empirical studies have shown a positive relationship between trade openness and government spending in advanced economies (Hicks and Swank 1992; Huber, Ragin and Stephens 1993). Furthermore, the same relationship still holds in an extended sample of countries beyond affluent democracies (Rodrik 1998).

The compensation mechanism, however, is by no means a consensus among scholars. At the moment, there are twofold major counter-evidences. First, some scholars demonstrate that economic globalization negatively affects government efforts for social welfare provisions (Brady and Lee 2014; Burgoon 2001; Garrett and Mitchell 2001; Rodrik 1997; Schmitt and Starke 2011; Swank 2002). This evidence is in line with retrenchment arguments claiming that economic globalization undercuts a government's fiscal capability to provide social welfare. Second, there is evidence that the relationship between globalization and welfare states could be spurious. On the one hand, the relationship could be historically contingent, which means that the positive relationship between globalization and welfare states is mostly driven by a

small set of countries in Northern Europe (Garrett and Mitchell 2001). On the other hand, Iversen and Cusack (2000) argue that it is not economic globalization, but the process of de-industrialization that makes the compensation mechanism work.

Concerning this counter-evidence, however, there is considerable room to elaborate on the compensation mechanism in both theoretical and empirical ways. First of all, the negative relationship between globalization and welfare states is far from consistent as recent studies on affluent democracies do re-affirm the positive link between them (see e.g. Hays 2009; Hwang and Lee 2014). Furthermore, empirical studies of extended samples of countries consistently find a positive influence of globalization on welfare efforts (Adserà and Boix 2002; Jensen and Skaaning 2014; Rodrik 1998). Empirical regularity regarding developing countries is also in contest (Avelino, Brown and Hunter 2005; Kaufman and Segura-Ubiergo 2001; Rudra 2002; Tenorio 2014). Second, despite the empirical criticisms of the mechanism, accumulated evidence suggests that if we correctly measure the risk of economic globalization, globalization does increase economic insecurity in host economies and thus makes the compensation mechanism work (see e.g. Kim 2007; Rodrik 1997).

3.1.1 New Wine in Old Wineskins

A more compelling reason to elaborate on the compensation mechanism comes from the fact that most arguments of the globalization-welfare state nexus operate with a narrow definition of economic globalization. As shown in Table 3.1, which summarizes the literature on social welfare spending, we can recognize that scholars primarily define globalization as the international trade of goods and services. While no one would disagree that trade is a significant aspect of international economic exchanges, when it comes to the period under consideration, the period that we call the age of globalization since the late twentieth century, we know that economic globalization is simply more than that. According to Bhagwati (2004), for instance,

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Table 3.1: Economic Globalization in the Literature

Sample	Author(s)	Globalization	FDI
Advanced	Cameron (1978)	**Trade**[A]	-
	Blais (1986)	Tariff level	-
	Garrett (1998)	**Trade**, C-Mobility[B]	-
	Iversen and Cusack (2000)	(Δ)**Trade**, (Δ) F-open[C]	-
	Garrett and Mitchell (2001)	**Trade**, L-import,[D]F-open, CID[E]	Openness[F]
	Burgoon (2001)	**Trade**, L-import, P-flows[G]	Openness
	Hays (2009)	log(Import),[H]log(Export)	-
	Cao, Prakash and Ward (2007)	(Δ)Import,[I] ΔFPI inflows	ΔFDI inflows
	Hwang and Lee (2014)	(Δ)Import, ΔFPI inflows	ΔFDI inflows
Developing	Avelino, Brown and Hunter (2005)	**Trade**	-
	Rudra (2002)	**Trade**	-
	Wibbels (2006)	(Δ)**Trade**, (Δ)Capital account[K]	-
	Tenorio (2014)	**Trade**	Inflows
All countries	Quinn (1997)	F-open	-
	Rodrik (1998)	**Trade**	-
	Adserà and Boix (2002)	**Trade**, Export concentration[J]	-
	Jensen and Skaaning (2014)	**Trade**	-

Note: The literature about the size of public economy or social welfare spending is included.
[A] Trade refers to trade openness as the ratio of import and export to GDP.
[B] Government restriction on financial flows (Garrett 1998).
[C] F-open is international financial openness (Quinn 1997).
[D] L-import is low-wage import measured by the ratio of import from non-OECD countries to GDP.
[E] Covered interest rate differentials (see e.g. Swank 1998).
[F] FDI openness measures the ratio of inflows and outflows to GDP.
[G] (Portfolio flows, assets and liabilities of international bonds, and equities)/GDP (p. 528).
[H] Natural log of imports measured in constant US dollar at 1995 price.
[I] The ratio of import to GDP.
[J] Gini-Hirshman index of export concentration.
[K] Capital account liberalization index (Brune et al. 2001).

globalization can be defined not only by the integration of commodity markets, but also by financial integration through MNCs or flows of portfolio capital, international labor mobility, or the diffusion of technology.

More importantly, this narrow focus could be problematic in understanding the domestic consequences of economic globalization especially when trade flows are heavily affected by the flows of international production capital (see e.g. Aizenman and Noy 2006). In particular, by heavily emphasizing trade, scholars implicitly assume

that production factors are confined into each national territory while market competition is held in both domestic and international markets through "made in country" products. In other words, by primarily focusing on trade, scholars embrace a general assumption of a traditional theory of trade that production factors are cross-nationally immobile. Besides the mobility of labor, the focus also assumes the transnational immobility of capital. If we intend to understand the topic—the relationship between globalization and welfare states—in the postwar period, the focus can be justified with the knowledge that international capital mobility was largely controlled under the Bretton Woods international monetary regime.

The situation, however, has changed dramatically since the late 1980s. While commodity markets are still an important battleground for firms around the world, the production activities have become less and less confined to each national territory. Along with the rapid advances of information technology, transportation and financial liberalization around the word, the globalization of production undercuts the traditional assumption that production factors are exclusively confined to each national territory. In particular, MNCs are highly effective in making production capital available across borders through FDI. Beginning in the late 1980s, firms engage in global market competition by utilizing production factors that are both domestically and internationally available. In order to understand the risks coming from economic globalization, we need a new wineskin to for our new wine.

Overall, scholars begin to realize the fact that economic globalization today is simply more than international trade. While the primary focus is still on trade, some scholars emphasize a subset of trade, import, while others focus on dimensions of globalization such as capital flows, FDI, and FPI (see Table 3.1). In doing so, scholars mainly argue that we need a better measure of the level of external risk or foreign competition. I agree that we need a better measure of globalization, but I argue that FDI deserves special attention in order for us to properly understand the

globalization-welfare state nexus for two points. First, we can have a more realistic image of globalization with FDI. In particular, as MNCs penetrate domestic production processes through FDI, domestic workers directly face the impact of globalization at their work. Second, the focus on FDI is also better than other financial aspects of globalization, for example FPI, which have relatively less direct influences on workers' job security.

3.2   Globalization of Production and Social Welfare Spending

How does FDI affect welfare states? I argue that FDI works *for* welfare states by stimulating the demand for social welfare. In other words, I argue that the logic of the new embedded liberalism hypothesis still holds for FDI when thinking of the relationship between economic globalization and welfare states. In particular, FDI works as an important conveyor of economic insecurity, through which demand for social welfare grows. The argument is established based on two well-known observations in the literature on MNCs. First, FDI is mostly made by MNCs. Theoretically, individual foreigners can launch FDI without having established firms abroad. In reality, however, it is rare and is becoming even rarer. "Nearly all new direct investments involve a foreign corporate parent (Caves 1971, p. 2)."

Second, MNCs are not homogeneous actors in their investment motives and especially their potential to project economic insecurity on to host market. Compared with other forms of financial flow, FDI is famous for its stability and thus for its potential contribution to economic growth for destination countries (Goldstein and Razin 2005; Spero and Hart 2009). By definition, FDI is an investment with *lasting* interests for foreign enterprises. However, the literature on MNCs indicates that the stability of FDI varies depending on MNC's investment motives and the industries into which the investment is made (see e.g. Jensen 2008).

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From these observations, we can make two arguments about how FDI affects welfare states. First, FDI refers to the advancement of strong market competitors into host markets. Put differently, local businesses face strong market competition as a result of FDI. These foreign enterprises with established businesses abroad, accumulated knowledge and technologies on production, and flexibility in re-allocating their assets efficiently and internationally, gain a strong competitive advantage over local enterprises (Dunning 2000). As Vernon (1971) succinctly remarks, "multinational enterprises exude an aura of strength and flexibility." Under intensified market competition through FDI, labor should face an increased level of economic insecurity. Through FDI, MNCs make demand for labor more elastic to shock, all else being equal (Scheve and Slaughter 2004). As economic insecurity increases, I expect that demand for social welfare increases.

Second, from the second observation, we can further expect that FDI can also works for welfare state through its mobility. The insecurity-generating effect of FDI could have two different aspects. First, as is widely recognized, MNCs can directly affect their employee's job security by re-locating their businesses. With the possibility that MNCs can re-arrange their business around the globe, job insecurity could be significantly strong for its workers. Relocation episodes that usually cause massive layoffs are abundant. Finally, the mobility of FDI can also increase workers' economic insecurity indirectly. To the extent that FDI mobility refers to the frequent ebbs and flows of powerful market actors, it will negatively affect the stability of labor demand in general while increasing insecurity for the labor force.

3.2.1 MNC as a Powerful Market Competitor

The argument that FDI is positively associated with social welfare spending is based on the assumption that MNCs are powerful market competitors to local business. Within traditional theories on trade, the assumption does attract much atten-

tion. When production activities function mostly on domestic capital and aim to compete with foreign products in domestic as well as foreign markets, it is most likely domestic firms that have the best knowledge on how to produce products that are internationally competitive. With the globalization of production activities , however, the situation will change dramatically as those companies that cross national borders begin to overwhelm local businesses. In the literature of MNCs, there has been a vast accumulation of knowledge as to why local companies expand their value-adding activities abroad. Although I do not intend to explore all theories of MNCs, I briefly summarize the literature relying on John H. Dunning's (2000) "eclectic paradigm" in order to explain why FDI refers to the advancement of powerful market competitors.

In the literature, scholars have vastly diverse ideas concerning the determinants of MNCs, making the summary of these ideas quite challenging. At this point, it is fortunate that John H. Dunning (2000) provides the "eclectic paradigm" within which the wide-ranging theories of MNCs are incorporated into a single analytic framework. In Table 3.2, the existing theories of MNCs are summarized according to the three necessary conditions that should be satisfied for local firms to become international enterprises. These are ownership, locational and internationalization advantages. This is why the eclectic paradigm is also called by OLI paradigm. Dunning names these advantages the sub-paradigms of his umbrella framework and each category of advantages contains a large body of theories and ideas.

The first necessary condition for a firm to cross national borders and expand its value-adding activities abroad, is that it should possess firm-specific assets for that purpose—what Dunning calls the ownership advantage. This has many different names: "proprietary assets," "intangible assets," "firm-specific assets," and "monopolistic advantages" (see e.g. Caves 1996, p. 3). At the same time, it also has many forms: the advantage can stem from the established monopoly power by establishing an entry barrier for new comers (Caves 1971, 1996); from the possession

Table 3.2: The Eclectic (OLI) Paradigm: Advantages of MNCs

Advantages	Author(s)
Ownership	**Intangible assets**: Caves (1971, 1996)
	Efficiency: Hymer (1970), Teece (1985), Vernon (1966)
	Multinationality: Dunning (2000)
Locational	**Efficient exploration of O-advantages**: Hirsch (1976), Dunning (1980, 1998)
	Distance: Vernon (1966)
	Spatial cluster: Audretsch (1998)
	Rules and institutions: Jensen (2008)
	Tax Incentives: Tanzi (1995)
Internalization	**Cost reduction**: Anderson and Gatignon (1986), Caves (1996)
	Risk allocation: Albuquerque (2003), Eisenhardt (1989)

Note: see, Dunning (2000).

of efficiency-increasing technologies, resources, and capabilities (Teece 1985; Vernon 1966); or from the multi-nationality itself which helps MNCs to produce and organize these assets internationally (Dunning 2000). Despite the various explanations on ownership-specific advantages of MNCs, the clear consensus among scholars dictates that without possessing any of these assets, local firms have no incentives to expand their business abroad. Thus, when FDI comes into the host market it means that local companies in the same industry face new competitors who are capable of establishing barriers for newcomers, producing goods in more efficient ways, and allocating resources across countries efficiently and flexibly.

Second, firms should take the locational advantages of a host country seriously in order to be internationalized. Given the ownership-specific advantages of MNCs, the locational features of a host country determine the *destination* of FDI. In other words, MNCs create FDI in a place where they can reduce the cost of production through their own specific assets (see, Dunning 1980, 1998; Hirsch 1976). Before firms make a decision about where to put their production activities beyond their home country, they should consider whether a host country's locational advantage is beneficial to their business. Put differently, even if a firm possesses the best knowledge

and experience in producing a certain good, it will not cross national borders unless it is attracted by the locational advantages of a host country. Of course, the locational advantage of a host country can take different forms: the size of the market, the existence of specific resources and labor forces, the geographical or psychological distance (Vernon 1966), the spatial cluster of businesses (Audretsch 1998), rules and government institutions (Jensen 2008), preferential tax incentives provided by local governments (Tanzi 1995), etc. In a nutshell, when firms choose a certain place for their direct investment, they strategically choose a place where they can efficiently engage in market competition by combining their ownership-related advantages with the host country' location-related features.

Lastly, firms further require internalization advantages in order to become MNCs. Before a firm expands its business beyond the origin country, both ownership and locational advantages remain only as a barrier for a firm to become an international enterprise. In order for MNCs to launch FDI in a certain country, they should evaluate their investment favorably with respect to other methods for approaching that foreign market. In other words, given the advantages set by both firm-specific assets and the locational features of a host country, firms should prefer to expand their value-adding activities rather than licensing their assets or exporting final goods. Various motives of FDI have been identified; cost reduction (Anderson and Gatignon 1986), risk allocation (Albuquerque 2003; Eisenhardt 1989), experiences and learning, market share, economies of scale, and knowledge acquisition. Without these motives, firms do not cross national borders to become MNCs. Thus, when FDI arrives in the host market, it comes with MNCs that have dedicated motives to effectively exploit both their ownership-specific assets and the locational features of the host market.

No component of the OLI paradigm can independently explain the emergence of MNCs. As Dunning (1998) emphasizes, the paradigm works like a three-legged stool: "each leg is supportive of the other, and the stool is only functional if the three legs

are evenly balanced (p. 45)." Having established assets which are specific to each firm, MNCs have capabilities and motives to exploit the locational advantages of a host country while strategically protecting their ownership-related strength. From the OLI paradigm which specifies the inter-locking, necessary conditions for a firm to become MNCs at the firm-level, we can draw the logical conclusion that FDI refers to the advancement of powerful market competitors in host countries.

3.2.2 FDI, Market Competition, and Insecurity

Without foreign production capital in place, we arrive at a completely different conclusion. In a simple model, that does not allow the movement of FDI across countries, domestic firms have the exclusive advantages over foreign firms in utilizing domestic resources for global market competition. As is often depicted in traditional theories of trade, international economic interactions occur only through goods and services that are produced by local enterprises. In this model, the stability of demand for domestic labor becomes a function of domestic firm's competitiveness in the world market. In other words, as domestic labors exclusively work for domestic firms, the stability of jobs largely depends on how well domestic firms weather the external competitive pressures.

In allowing for global production capital in each economy, we can change the picture of market competition. Domestic firms still take most of the control over the allocation of domestic resources. The home-field advantage of domestic firms, however, is now directly challenged by the competitive advantages of foreign firms on the domestic scene. As discussed in the previous section, FDI introduces powerful market competitors, MNCs, which have the willingness and capability to take advantage of the host countries' comparative advantages with their own firm-specific assets and experiences. Now, market competition is not only held over final goods through international trade, but also held over domestic resources among production capitals.

From this simple model, we can derive several interesting hypotheses. In a baseline model without foreign production capitals in motion, domestic firms compete with foreign firms over both imported goods at the domestic market and foreign goods at foreign markets. Thus, in each domestic market, import intensifies competition while export mitigates it. We can apply the same logic to the extended model, which allows foreign production capital. As domestic firms engage in competition with foreign capitals—not only in domestic markets, but also in foreign markets—FDI inflows should have the opposite effect with FDI outflows. In each economy, inflows of production capital intensify competition while its outflows mitigate the pressure.

Then, how does market competition jeopardize workers' job security? In general, under intensified competition efficiency becomes the priority among firms. As demand for labor is derived from how well employers perform against competitors, increased competition works to destabilize the demand for labor. In a technical term, increased competition makes demand for labor more elastic (see e.g. Aizenman 1994; Fabbri, Haskel and Slaughter 2003; Feenstra 1998; Rodrik 1997; Scheve and Slaughter 2004). In this sense, both import and FDI inflows will intensify competition and thus generate economic insecurity for the local labor force. In case of FDI inflows, however, the effect is more direct and dramatic. First, FDI generates a portion of the workforce that directly faces the risk of economic dislocation resulting from the MNCs' potential relocation capability. Second, given MNC's competitive advantages over local firms, the emphasis on efficiency becomes even more intensified. As MNCs set the tone for competition, the elasticity of labor demand will spread out within the domestic market. Thus, to the extent that FDI generates economic insecurity while increasing demand for social welfare, FDI will work for the growth of welfare states.

Hypothesis 1. Inflows of FDI will be positively associated with welfare states while outflows of FDI will have the opposite effect.

As discussed above, we can further relax the model by allowing different types of FDI according to mobility. Although FDI is largely considered to be a stable form of global capital, some FDI is more footloose than others. In other words, some MNCs are more footloose than others. If this is the case, then we can theorize that footloose MNCs are more powerful in generating economic insecurity in host economies. First, this picture fits well with the common understanding on how MNCs affect economic security through re-location episodes. Cases like this are abundant. For example, in 2009, when Dell, a US-based computer company, relocated its computer assembly line from Ireland to Poland, about 1,900 workers instantly lost their jobs.[1]

Second, compared to domestic enterprises, MNCs are relatively less constrained by domestic rules of industrial relations. Of course, by entering into a domestic market, MNCs become domestic economic actors that have to abide by the laws, if any, or convention in regulating the relationship between employers and employees. If MNCs came with varying degrees of mobility, however, it would be reasonable to assume that a more mobile MNC would be less obligated to these rules. Lastly, the mobility of FDI also works against the stability of labor demand. As a powerful market actor, an MNC will set the tone for industrial relations in the labor markets of host economies. The frequent ebbs and flows of such an actor will repress the labor demand of domestic firms and increase the chances of economic dislocation. Thus the second hypothesis follows as such:

Hypothesis 2. The mobility of FDI will be positively associated with welfare states.

Some might argue that the proposed hypotheses are not compatible with conventional wisdom about how foreign production capital affects the labor market in host economies. Inflow of foreign capital is often considered to be beneficial to economic growth, and thus demand for labor in general (see e.g. Pandya 2008). This interpre-

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[1]http://www.rte.ie/news/2009/0108/112419-dell/

tation of conventional wisdom with respect to globalization-welfare state arguments, however, overlooks the important fact that labor demand is a *derived* demand. As numerous factors, such as changes in demand on end products or price shocks to raw materials, affect the level of labor demand, the fact that a certain country creates more jobs does not necessarily increase demand for labor in a society as a whole. Furthermore, FDI's job creation effects could be minimal given the small proportion of labor forces to the entire workforce in host economies. Under the competitive pressures of MNCs, which have the capabilities to project labor-saving technologies on the workforce, however, inflows of FDI would work against demand for labor in general.

Some might also argue that MNCs become a *domestic* economic actor through FDI, which binds them to the local statutory or customary rules which regulates industrial relations. Again, conventional wisdom suggests that FDI is one of the most stable forms of global capital. Furthermore, MNCs tend to have hands-off policies when it comes to labor-contract issues within the local market (Caves 1996). This argument, however, does not necessarily go against the proposed hypothesis. As discussed, all types of FDI are not equally stable. Some are more footloose than others. In a sense, we can incorporate this wisdom into hypothesis 2. The more immobile FDI is, the more it would behave like a domestic economic actor. Put differently, the insecurity-generating effect of FDI would only work in the short-run. Either way, the argument that FDI is a source of economic insecurity still remains.

3.2.3 Economic Insecurity and the Growth of Welfare States

After establishing the causal mechanisms by which FDI works for welfare states at the macro level, there are some interesting and important questions that deserve special attention. How can we understand this societal-level mechanism with respect to what we know about how economic hardship affects individual demand for welfare

states? In other words, by what mechanisms is economic insecurity resulting from global production capital processed in each polity while encouraging welfare states to grow? Are there enough incentives for politicians to embrace the new demand for social welfare, even if we have an extended sample countries including non-democracies? Can we assume that individuals who are experiencing economic insecurity will actually push governments for their own benefit?

By design, the compensation hypothesis is established based on the experiences of affluent democracies. In arguing that governments compensate globalization losers in return for their support for trade liberalization, it is assumed that politicians are obligated to embrace what people want and that citizens find a way to pressure governments to get what they want through the electoral mechanism. For advanced countries, this is a reasonable assumption because they have a stable democracy when they enter into the period under consideration. By expanding the scope of the study to include developing countries, however, we can no longer rely on this assumption. In this case, democracy becomes an important determinant in activating the compensation mechanism for welfare states (Adserà and Boix 2002, see e.g.). At the same time, within developing countries, economic anxieties resulting from economic globalization are difficult to represent in a polity (see e.g. Rudra 2002).

Based on the individual-level mechanisms laid out in Chapter 2, however, I can explain how economic insecurity generated by FDI would lead to the expansion of social welfare at the societal level. Given the existing demand for social welfare, FDI expands the scope of demand by generating economic insecurity. Of course, I do not believe that this extended scope will automatically lead to the growth of social welfare spending. Rather, I argue that those who are experiencing economic insecurity, either directly or indirectly, through FDI are more likely to be above average income earners. In the literature on FDI, it is a well-established fact that MNCs pay higher wages for their employees compared to their local counterparts, which still holds true even after

controlling for the level of skills (see e.g. Blomström and Kokko 1998). As MNCs set the overall tone for market competition in a host country, the economic anxiety is indirectly shared by individuals with a similar income level, at least within the same industry. Note that according to the analysis in Chapter 2, economic demand for welfare states of higher income earners comes with strong political activism. In other words, when FDI expands the scope of welfare state demand in a society, it does activate demand that is politically and economically relevant for the growth of welfare states.

3.3   Data & Measures

To test the hypotheses stated above, I construct a panel data set of 93 countries from 1970 to 2007. The scope of the study is determined by several criteria. First, heavily indebted poor countries (HIPC), defined by the World Bank, are excluded.[2] Second, countries with a membership in the Organization of the Petroleum Exporting Countries (OPEC) are also excluded. The main reason to eliminate these cases is to have a sample of countries with which it would be meaningful to test the proposed hypotheses in terms of a government's fiscal capabilities to finance public services; this might be severely constrained for the former and loosened for the latter. Lastly, I further exclude small states (less than 1.5 million population) and some isolated states (e.g. Pacific islands). For the list of countries included, see Appendix Table 5.

3.3.1   Dependent Variables

The dependent variable measures the final consumption expenditure of a general government as a percentage of GDP for a given year. In the literature, there is no consensus among scholars about how to measure governments' social welfare efforts.

[2]see, http://data.worldbank.org/income-level/HPC

Some rely on the size of government relative to national income, for example, either government revenue or expenditure as a percentage of GDP (see e.g. Cameron 1978; Rodrik 1998). For others, the welfare efforts are measured by the ratio of social welfare spending to government revenues or the total population, etc. (see e.g. Kaufman and Segura-Ubiergo 2001; Rudra 2002). Thus, as Starke (2006) correctly remarks, it might be true that "Ultimately, the choice of the dependent variable for the study of retrenchment reflects the researchers' underlying understanding of what constitutes the welfare state (p. 112)."

Both theoretically and empirically, however, the choice of the dependent variable, the ratio of government expenditure to GDP, can be justified. First, the foundation of my dissertation is in line with the compensation hypothesis which argues that a government takes initiatives to expand the size of the public economy in order to address economic anxieties resulting from economic globalization. Some might argue that there are some types of government consumption which might be difficult to consider a "welfare effort." This is a crucial criticism. However, the core premise of the hypothesis is that jobs created in the public sector are more stable than their counterparts in the private sector. Thus, the bigger the size of the public economy is as a result of government expenditure, the more opportunities the local labor force would have.

On the other hand, I do consider the fact that the size of the public economy can grow not only for social welfare, but also for warfare. Of course, government military spending can also work to provide secure jobs for local laborers. However, if the expansion of military spending is closely related to actual warfare, it is difficult to determine whether the spending increase is technically for social welfare provisions. In case of inter-state conflicts, approximately 30% of country-year observations are engaged in high levels of military disputes, both hostility level 4 and 5, as defined by Correlates of War Project's (COW) Militarized Interstate Dispute (MID) data

set (Ghosn, Palmer and Bremer 2004).[3] Rather than controlling for the effect of conflict on government spending, I choose to subtract military spending from the general government expenditures.[4] In a similar vein, Quinn's (1997) measure of welfare efforts uses government spending net of defense expenditure (as a percentage of national income).[5] Thus, the dependent variable measures the general governments' expenditure, minus military spending, as a percentage of GDP.

At the same time, given the large scope of study when including both developed and developing countries, the choice of the dependent variable is justified by the challenge of data availability. The difficulties in data availability for developing countries are notorious. In particular, when it comes to the detailed information about government outlays, it is extremely difficult to secure a data set that runs both cross-nationally and longitudinally. The IMF's Government Finance Statistic Yearbooks (GFSY) might be the only source for a such a data set. However, as I will explain later, the IMF data set contains a serious break in its time series around 1998, which severely limits the longitudinal data analysis. Against the potential criticisms for using overall level of government expenditures, however, chapter 5 will use the IMF data set at the risk of losing observations after 1998 while addressing other important concerns for including developing countries in the sample.

3.3.2 Explanatory Variables

FDI flows. The first key independent variable is a standard measure of FDI inflows. For this variable, I rely on a data set provided by the United Nations Confer-

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[3]I use the COW MID 3.1 data set, which covers participant level MID incidents from 1816 to 2001. Hostility level 4 refers to episodes in which countries take actions such as 'blockade,' 'occupation of territory,' 'seizure,' 'attack,' or 'use of CBR weapons' while hostility level 5 refers to cases with either 'begin interstate war' or 'join interstate war.'

[4]Controlling for the effect of warfare for governments' welfare efforts could be tricky as governments could begin to augment their military spending before the observable conflict begins.

[5]Although he further excludes education spending, I include it because of its influences on public employment

ence on Trade and Development (UNCTAD).[6] FDI is defined as an investment made by foreign residents with lasting interests in the enterprise, in which foreign investors have a significant degree of influence on the management of a business.[7] By definition, significant managerial control refers to a purchase of more than 10% of the total value of corporate stock. As a balance of payment measure, FDI inflows measure the net investment made by non-residents to each country in a given year.[8] With the same definition of FDI, the outflows measure net investment made by residents to foreign countries in each country-year.

FDI mobility. As for hypothesis 2, I generate a proxy measure of FDI mobility. It measures how much the inflow of FDI affects the inward stock of it. As the mobility of FDI has been largely overlooked in the literature, there is no widely accepted concept or measurement strategy to rely on. Conceptually, as the mobility of FDI can vary across industrial sectors, we can use the amount of FDI for each industry as a proxy measure for its mobility. For example, FDI inflows in the service sector will be more mobile than that that in manufacturing ones. Furthermore, FDI inflows in light industries will be more mobile than that in heavy industries. With the scope of data including both developed and developing countries, however, there is a serious challenge in data availability, especially for developing countries.

In overcoming this challenge, I follow Lensink and Morrissey's (2006) strategy to measure the instability FDI from its actual flow. In order to examine the effect of FDI volatility on economic growth, they measure FDI volatility as a standard deviation of errors from an autoregressive model of FDI inflows on its lagged values (up to t-3 years) and a time trend. Although this measurement strategy has great bearing on measuring the mobility of FDI, it could be seriously misleading in operationalizing FDI mobility. First, when setting up the baseline model, there is no *a priori* reason

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[6]see UNCTADstate website. http://unctadstat.unctad.org/EN/Index.html

[7]See p.35, http://unctad.org/en/pages/PublicationArchive.aspx?publicationid=393

[8]Note that the net investment of FDI does not refer to FDI inflows minus FDI outflows. The former is made by non-residents and the latter by residents.

Figure 3.1: Time Series of FDI Inflows in Selected Countries
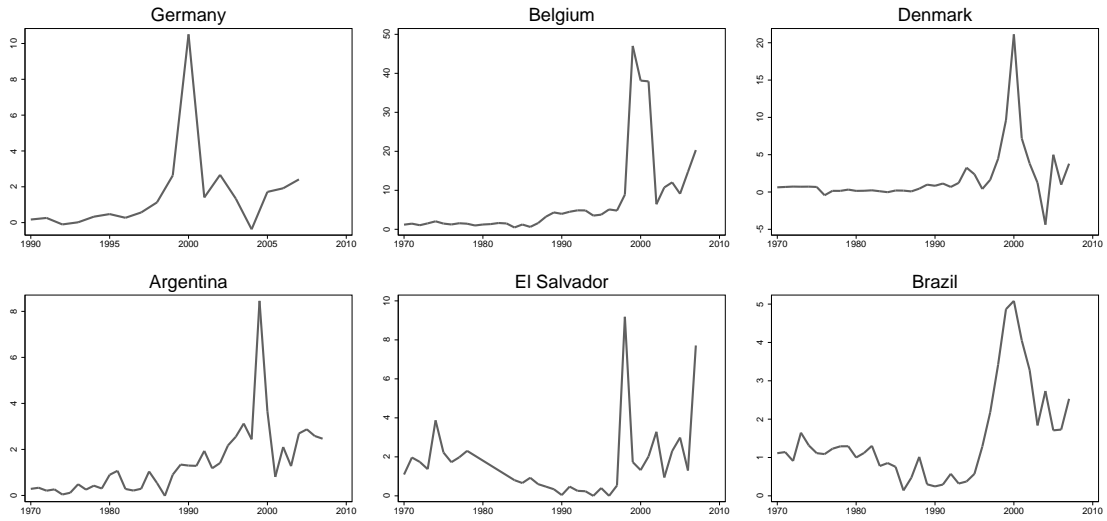
to choose a certain model over others. For example, when specifying the model we are less confident if we have to fit the time series around a simple time trend or a non-linear trend. Furthermore, when an autoregressive model is considered, we are also less confident about the number of lags the baseline estimation model should include. Second, as Figure 3.1 shows, most countries experience a surge of FDI inflows followed by a sudden decline at the end of the twentieth century. On top of the specification criteria for setting up a baseline model, the standard deviation measure should consider these erratic movements of FDI flows seriously. While this was not an issue for Lensink and Morrissey (2006) as their analysis ends in 1997, this is a particularly important point of concern for this chapter's analysis goes way beyond the late twentieth century.

$$FDI\,stock_t = a + b_1\,FDI\,inflows_{t-1} + b_2\,Time\,trend_t$$

In order to overcome these methodological issues, I utilize another important measure of FDI: the stock of FDI, as provided by UCTAD. While FDI flows refer to the amount of new FDI made each year, FDI stock is the accumulated values of

foreign assets contained in a host country at a given point in time. For instance, if FDI is made in a host country at a given time t and stays there for the next five years, FDI flow captures it only at time t, while FDI stock measures it across five years. With an assumption that mobile FDI will generally stay in a host country for a short period of time, at least compared to immobile FDI, we can operationalize FDI mobility by measuring how much FDI's inflow is conducive to the growth of its stock. As the equation stated above, with a regression model for FDI stock on the lagged values of FDI inflow and a simple time trend for each country, I take each country's regression coefficients of FDI inflow times negative unity ($-b1$) as a proxy measure of FDI mobility. As higher values of the proxy measure refer to a weaker influence of inflows on stocks (their accumulation over time), the hypothesis for FDI mobility expects that the measures would have positive influences on the dependent variable.

3.3.3 Control Variables

Globalization indicators. In addition to the two important measures of FDI inflows, I also include a series of other globalization indicators. First, I include the widely-used measure of economic globalization, trade openness, as the ratio of import and export to GDP. In order to consider the effects of the sub-categories of trade openness, I also include both import and export as a percentage of GDP. Furthermore, I control for capital account openness provided by Chinn and Ito (2006). From the IMF's Annual Report on *Exchange Arrangements and Exchange Restrictions*, the Chinn-Ito index measures the degree of financial transaction liberalization, calculated across different categories on external account restrictions. I use a standardized measure of capital account openness that varies from 0 to 1, in which higher values refer to more liberal capital account restrictions.

Economic factors. I also control for relevant economic indicators when explaining variations of government consumption expenditure. First, the market size is

measured with the logged value of GDP (constant 2005 U.S. dollars). Second, level of economic development is measured by GDP per capita (constant 2005 U.S dollars). While the size of the economy will have negative influences on the government spending-GDP ratio, the level of economic development will have the opposite influence according to arguments of the economic development thesis (see e.g. Wilensky 1975). Third, I also control for economic growth while expecting it to have a negative influence on the dependent variables.[9] A vibrant economy will spontaneously address socio-economic anxieties that generate demand for public welfare programs. Lastly, I also include unemployment rates to capture the upward pressure for income transfer.

Contextual factors I also include five additional contextual variables as follows. First, as widely recognized in the literature, the dependency ratio expressed as the proportion of individuals over age 65 to the total number of working age population is expected to put upward pressure on government welfare efforts. Second, as advocated by the political development thesis, political development is considered to have significant positive influence on the governmental provision of public goods (see e.g. Meltzer and Richard 1981). From the Polity IV data set (Marshall and Jaggers 2010), I include a regime score that is calculated by subtracting autocracy scores from democracy scores. The variable is expected to have a positive influence on the government expenditure measure.

Third, I also control for the influence of the urbanization process. As theorized by the economic development thesis, the modernization or industrialization process is expected to push governments for welfare states from below (see e.g. Deutsch 1961). The percentage of urban population out of total number of population is included. Fourth, it is further theorized in the literature that the de-industrialization process can project positive influences on welfare state development. According to Iversen and Cusack (2000), the compensation mechanism could be spurious in that the proposed

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[9]I exclude observations where economic growth rates are less than -15.

effects of economic globalization can be explained by a domestic de-industrialization process in rich democracies. In order to control for this effect in an extended sample of countries, I include a service sector value added as a percentage of GDP for each country-year. Lastly, I also include a dummy variable for advanced countries.[10] For summary statistics and unexplained data sources, see Table 3 in Appendix.

3.4 Method

In analyzing a panel data set, there are three well-know methodological issues: panel heteroskedasticity, temporal and contemporaneous correlations. The error variances of government spending can vary across panels. At the same time, it is highly likely that the previous year's level of government spending strongly determines the following year's spending level (see e.g. Huber and Stephens 2001). Lastly, government expenditure can be geographically clustered in that a government's spending is closely related to that of neighboring countries (see e.g. Hays 2009).

Following the suggestion provided by Beck and Katz (1995), I manage these challenges by relying on a pooled regression analysis with panel-corrected standard errors (PCSE) and a panel specific auto-correlation (AR1) error term. Furthermore, I also estimate the following equation with both year and regional fixed effects.

$$
\begin{aligned}
\text{Expenditure}_{it} = {} & a + b_1 \, FDI \, inflows_{it-1} + b_2 \, FDI \, outflows_{it-1} + b_3 \, Trade \, openness_{it-1} \\
& + b_4 \, GDP_{it-1} + b_5 \, GDP \, capita_{it-1} + b_6 \, Growth_{it-1} + b_7 \, Democracy_{it-1} \\
& + b_8 \, Urbanization_{it-1} + b_9 \, Deindustrialization_{it-1} + b_{10} \, Aged_{it-1} \\
& + b_{11} \, Capital \, openness_{it-1} + b_{12} \, Unemployment_{it-1} \\
& + b_{13} \, Developed \, countries_{it}
\end{aligned}
$$

[10]Advanced economies are the 18 countries that have been a primary focus of studies of welfare states in the literature. The list of countries included is as follows: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Sweden, Switzerland, United Kingdom and United States

Controlling for these fixed effects is particularly important in order to address an important criticism of the compensation hypothesis. According to Garrett and Mitchell (2001), the harmonious relationship between globalization and welfare states could be spurious. Although there could a long term positive relationship between the two, there is evidence against the short term positive influence of globalization on welfare states. They show that once both country- and year-fixed effects were included in their sample of advanced countries, the positive influence of globalization on welfare states disappears. In addressing the concern over the extended sample under study, I first control for the year-fixed effects. Having an unbalanced panel data set with missing observations, however, there are limitations for controlling country-fixed effects. Instead, I include regional dummy variables for Central-South America, Asia, Africa, and Eastern-Southern Europe. When regional dummies are included, I omit the dummy variable for advanced countries to avoid the potential multicollinearity issue. Lastly, in order to address the potential endogeneity problem, I lag all explanatory variables by one time period.

3.5 The Results

Table 3.3 summarizes the estimated results for hypothesis 1. The result for the baseline specification is presented in Model 1. In the next column, the same model is estimated while replacing the aggregate measure of trade openness with its subcategories, both import and export dependency ratio. In Model 3, instead of including both inflows and outflows of FDI, the net FDI inflows—FDI inflows minus FDI outflows—are included. Model 4 adds regional indicator variables to the baseline specification. Lastly, Model 5 includes a year-fixed effect alongside regional dummy variables. Results for fixed effects are suppressed.

The results provide strong evidence for hypothesis 1: FDI inflows work for welfare

Table 3.3: Foreign Direct Investment and Government Spending I

	Model 1	Model 2	Model 3	Model 4	Model 5
FDI inflow	0.08***	0.07**		0.08***	0.08***
	(0.02)	(0.02)		(0.02)	(0.02)
FDI outflow	-0.07***	-0.07***		-0.08***	-0.07***
	(0.02)	(0.02)		(0.02)	(0.02)
Net FDI inflow			0.07**		
			(0.02)		
Trade	0.02**			0.02*	0.02**
	(0.01)			(0.01)	(0.01)
Import		0.06**	0.06**		
		(0.02)	(0.02)		
Export		-0.02	-0.02		
		(0.02)	(0.02)		
Growth	-0.01	-0.02	-0.02	-0.01	-0.00
	(0.02)	(0.02)	(0.02)	(0.02)	(0.02)
Log(GDP)	-0.31*	-0.17	-0.18	0.05	0.12
	(0.15)	(0.18)	(0.18)	(0.16)	(0.17)
GDP per capita	1.15*	1.18*	1.18*	0.76	0.85
	(0.50)	(0.48)	(0.48)	(0.49)	(0.52)
Democracy	-0.09*	-0.10**	-0.10**	-0.01	-0.00
	(0.04)	(0.03)	(0.03)	(0.03)	(0.03)
Urban population ratio	-0.03	-0.03	-0.03	-0.00	-0.00
	(0.02)	(0.02)	(0.02)	(0.02)	(0.02)
De-industrialization	0.01	-0.02	-0.02	-0.04	-0.03
	(0.02)	(0.02)	(0.02)	(0.02)	(0.03)
Dependency ratio	0.24***	0.24***	0.24***	0.09	0.09
	(0.04)	(0.04)	(0.04)	(0.06)	(0.06)
Chinn-Ito index	-1.70**	-1.74**	-1.74**	-0.13	-0.03
	(0.54)	(0.53)	(0.53)	(0.40)	(0.40)
Unemployment rate	0.02	0.03	0.03	0.04	0.03
	(0.03)	(0.03)	(0.03)	(0.03)	(0.03)
Advanced economies	2.97***	3.40***	3.37***		
	(0.79)	(0.80)	(0.81)		
Constant	8.80**	6.57	6.73	9.01**	5.34
	(2.88)	(3.45)	(3.52)	(2.93)	(3.56)
Year dummies	No	No	No	No	Yes
Region dummies	No	No	No	Yes	Yes
Observations	1074	1074	1074	1074	1074
N of Countries	80	80	80	80	80

* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

states while FDI outflows work against it. Across various model specifications, FDI inflows have consistently positive and statistically significant (at .001 level) influences, while FDI outflows have the exact opposite influences on government consumption expenditure. One unit increase in FDI inflows-GDP ratio in the previous year is expected to have a .08 unit increase in government consumption-GDP ratio, with all else being equal. As FDI outflows have the exact opposite effects, it is possible that the positive effect of FDI inflows can be canceled out by the negative effect of FDI outflows. However, the result in Model 3 with the net FDI inflows shows that even after considering the effects of FDI outflows made by residents to foreign countries, we can still expect a greater government expenditure to result from the net FDI inflows. The evidence for hypothesis 1 is also consistent with both regional and year fixed effects in the last two column of the table.

While having FDI in focus, the traditional compensation hypothesis on trade is still empirically robust. In the baseline model, trade openness has positive and statistically significant influences on the size of the public economy. However, as we can see in both Model 2 and Model 3, the positive influence of trade openness is mostly about import, not export. The coefficients for export do have negative tendencies but fail to reach statistical significance. From this result, the analysis clearly shows that in a traditional sense, it is not the aggregate measure of trade or export, but the import of foreign goods and services that is closely related to the economic anxieties coming from economic globalization (see e.g. Hays 2009). Interestingly, as soon as regional fixed effects are controlled for, trade openness variable loses statistical significance at the conventional level in Model 4. The argument that the trade compensation mechanism is rather long-term structural and historically contextual does receive modest evidence (see e.g. Garrett and Mitchell 2001). At the same time, however, we can also see in Model 5, when year fixed effects are additionally controlled for, trade does have positive and statistically significant influences on welfare states as

Table 3.4: Foreign Direct Investment and Government Spending II

	Model 6	Model 7	Model 8
Mobility of FDI	0.80**	0.82***	0.86***
	(0.31)	(0.31)	(0.32)
Trade	0.05***		-16.83
	(0.01)		(15.99)
Import		0.10	16.92
		(0.07)	(15.98)
Export		0.02	16.86
		(0.06)	(16.02)
Growth	-0.07	-0.14	-0.10
	(0.16)	(0.21)	(0.22)
Log(GDP)	0.45	0.56	0.58
	(0.31)	(0.36)	(0.36)
GDP per capita	0.01	0.02	-0.21
	(0.64)	(0.66)	(0.72)
Democracy	-0.09	-0.09	-0.08
	(0.11)	(0.11)	(0.11)
Urban population ratio	-0.06	-0.06	-0.06
	(0.05)	(0.05)	(0.05)
De-industrialization	0.12	0.12*	0.12*
	(0.07)	(0.07)	(0.07)
Dependency ratio	0.34***	0.33***	0.34***
	(0.10)	(0.11)	(0.11)
Capital account openness	-3.92**	-3.99**	-4.02**
	(1.64)	(1.61)	(1.67)
Unemployment rate	0.16***	0.14**	0.11*
	(0.05)	(0.05)	(0.06)
Developed countries	2.68**	2.62**	2.76**
	(1.22)	(1.23)	(1.29)
Constant	-7.12	-9.85	-8.95
	(7.03)	(8.10)	(7.93)
Observations	85	85	85
R-square	0.59	0.60	0.60

* $p<0.10$, ** $p<0.05$, *** $p<0.01$

the compensation hypothesis argues.

As discussed above, the mobility of FDI is separately calculated for each country by a regression model of FDI stock on both FDI inflows and a simple time trend. By multiplying negative 1 with the regression coefficients of FDI inflows, the proxy

measure of FDI mobility takes on a higher value as inflows have less influence on their accumulation over time in each country. After taking mean values for other control variables, I rely on an ordinary least square regression analysis (OLS) with robust standard error for testing hypothesis 2. The results presented in Table 3.4 provide strong evidence for hypothesis 2. The more mobile FDI inflow is, the bigger government a host country has. Furthermore, trade openness still has positive and statistically significant influences on government consumption in this cross-sectional analysis.

The analysis of two hypotheses also delivers some insights for control variables. Most of the economic indicators—economic growth, level of economic development, market size, and even unemployment rates—fail to reach any statistical analysis in Table 3.3. The results are consistent with that of the cross-sectional analysis in Table 3.4, excluding unemployment rates. Among several of the contextual factors included, it is surprising that the coefficients for democracy take negative signs and mostly fail to reach statistical significance at the conventional level. We cannot conclude, however, that democracy does not have any influence on welfare states. It is highly likely that a dummy variable for advanced countries, which has positive and statistically significant coefficients, competes with the democracy variable for the dependent variable. After all, countries that are categorized as advanced economies take most of the highest values of the democracy variable.

There is no compelling evidence that either urbanization or de-industrialization work for the growth of welfare states. In Table 3.3, both variables fail to reach any statistical significance at the conventional level. It is only in cross-sectional analysis in Table 3.4 that de-industrialization begins to take positive and statistical significance in Model 7 (at .1 level), and in a fully specified model (at .1 level). The most interesting finding comes with the qualitative measure of capital mobility. Although consideration of fixed effects takes away the statistical significance, capital mobility

has negative and statistically significant influences on welfare states in both tables. As the theory of welfare state retrenchment argues, financial deregulation reduces the level of government consumption expenditure. Lastly, while being similarly vulnerable to both regional and temporal fixed effects, the age dependency ratio has a positive and statistically significant influence on welfare states in both Tables.

3.6 Discussion

In the literature of welfare states, the international trade of goods and services has long been the major focal point of most studies when understanding the domestic consequences of market internalization. The second stage of economic globalization began in the late 1980s due to the rapid development of informational technology, the end of the Cold War and the advancement of new markets, the re-entry of China into the competitive global market, financial turmoil in developing countries, and financial liberalization. While these factors are significant, the general scholarly focus on trade for understanding welfare state development in the current global market is somewhat misleading. In this chapter, I narrowed down my focus to global production capital alongside trade and elaborated on the compensation hypothesis. Empirical analysis provides strong evidence that both FDI inflows and mobility increases the size of the public economy in order to insulate domestic markets from the risk associated with globalization.

The results are somewhat surprising given the widely accepted sentiment concerning the role of foreign investment in boosting the host economy. As most countries have struggled to sustain economic growth for the last couple of decades, FDI is largely considered to be beneficial in revitalizing an economy while creating more jobs, providing extra cash in the case of trade deficit, and delivering cutting-edge technology to target industries. On the other hand, production investment outflows

made by residents are largely considered as having the opposite effects. The analysis of this chapter, however, provides a completely contradictory story. FDI inflows intensify market competition through which demand for labor becomes unstable, while outflows of it contribute to the competitiveness of a local enterprise in turn stabilizing local demand for labor. As a compensation mechanism, welfare states grow with FDI inflows; global production capital works *for* welfare states.

CHAPTER IV

FDI Competition and Funding for Welfare States

Conventional wisdom suggests that economic globalization undercuts the ability of governments to provide social welfare programs. International capital mobility in particular is widely recognized as the main culprit in this situation. As capital mobility has dramatically increased due to the rapid advances of information technology and financial liberalization since the late twentieth century, it is more likely that capital owners will relocate their businesses to countries in which they can pursue the rate of return in the most profitable way. In this situation, national governments are structurally engaged in a race for global capital, through which the funding base for welfare states is negatively affected (Andrews 1994; Cerny 1997; McKenzie and Lee 1991; Tanzi 1995). The need for "Efficiency" overtakes that of social stability or equality as governments are eager to establish investment-friendly environments. In this vein, this ways of thinking is often called the "efficiency hypothesis," or the theorem of the "race to the bottom."

According to the hypothesis, the paradigmatic Keynesian welfare state that had flourished in the postwar period across industrial countries was dramatically transformed into, what Cerny (1997) calls, "the competition state" as such:

> The crisis of the welfare states lay in their decreasing capacity to insulate national economies from the global economy, and the combination of stagnation and inflation which resulted when they tried. The world since then has seen the emergence of a quite different beast, *the competition state.* Rather than attempt to take certain economic activities out of the market, to 'decommodify' them as the welfare state was organized to do, the competition state has pursued increased marketization in order to make economic activities located within the national territory, or which other-

wise contribute to national wealth, more competitive in international and transnational terms (p. 259, italics added).

Furthermore, the structural incentives to participate in a competitive race for global capital are intensified by the fact that since the late twentieth century, governments around the world have generally failed to sustain the level of economic growth (See Figure 1.1). Some of the macro-economic challenges that governments continue to face today—such as chronic unemployment, accumulated public debts or increased inequality—make the competition for global capital even more appropriate.

The conclusion of this hypothesis—that the competitive race for global capital will lead to the retrenchment of welfare states—is "too simple and considerably overdrawn (Garrett 1995, p. 682)." First, as discussed in the previous chapter, empirical evidence for the retrenchment implied in the hypothesis is rather weak. Not only is the existing evidence for the effect of globalization on welfare states mixed, but different aspects of globalization also have conflicting influences on the size of a public economy. Second, there has been no convincing evidence for the argument that globalization undercuts the revenue-generating capabilities of governments in securing welfare states (Swank 1998; Swank and Steinmo 2002). If governments are able to secure revenues while providing an investment-friendly environment, it is highly likely that we will not observe the expected negative influences of globalization on welfare states.

More importantly, the efficiency hypothesis assumes that governments are searching for any type of international capital; I argue that this is truly a strong assumption to make. If capital is completely mobile, without triggering any cost in crossing national borders, it might be true that the global market projects insurmountable pressure on governments to lower levels of government spending. Macro-economic policies should be carefully managed in order to attract foreign capital and not to trigger unnecessary capital outflows. However, there is no evidence for such a complete level

of capital mobility. Rather, evidence suggests that global capitals are generally clustered into certain regions or countries (see e.g. Audretsch 1998), that there is a strong home country bias (see e.g. Uppal 1992), and above all that there are different types of capitals with varying degrees of mobility (see e.g. Anderson and Gatignon 1986; Goldstein and Razin 2005). Thus, it is reasonable to assume that there are certain types of global capital, upon which national governments will actively engage in a competitive race to provide a market-friendly environment for capital.

Among others, FDI has been the central target of global competition in recent decades. First of all, FDI is highly a preferred form of investment due to its stability, and thus its potential contributions to economic growth. As defined in the previous chapter, FDI brings *lasting interests* in managing enterprises in the host country; as MNCs own a considerable portion of corporate stocks for managerial purposes, FDI tends to have higher levels of *ex post* immobility after an investment is made. This is especially the true when we compare FDI with other forms of global capital, such as portfolio investment. Second, the fact that FDI is a type of production capital made mostly by MNCs makes it even more attractive for governments as it will contribute to economic growth, the creation of jobs, and even technological spillover. Although other forms of global capital, such as bank loans or FPI, could also have these economic benefits, the effect is not as great as that of FDI, with MNCs perform as strong business actors and provide jobs for the local workforce.

In this chapter, I argue that competition for FDI has consequences for the supply side function of welfare states as expected by the efficiency hypothesis. It works against the fiscal capabilities of governments to manage the anxieties FDI generates. First, when attempting to attract FDI, governments compete with each other by providing investment friendly packages of tax policies. Second, the competition is not only concerned with attracting additional FDI, but also securing domestic production capital in their markets. Consequently, as the efficiency hypothesis depicts, structural

engagement in the race to attract and secure production capitals implies a reduction in capital taxation.

Given the positive influences of FDI on the demand-side function of welfare states as discussed in the previous chapter, we can say that FDI stands at the center of the "dilemma of globalization" between an increased demand for social welfare and a decreased capability to satisfy it (Rodrik 1997). National governments' hands are tied precisely when their active involvement is required. In this situation, governments must address the dilemma in a way that somehow meets these demands for social welfare while operating within their fiscal constraints. Among multiple possible solutions, I argue that a government could choose a strategy that comes with lower political costs: to rely more on indirect taxes that tend to be regressive in making lower income earners to take on higher tax burdens. Thus, ironically, efforts to solve the dilemma directly go against the fundamental principle of welfare spending—income redistribution from the rich to the poor.

4.1 Globalization and Capital Taxation

In the literature of welfare states, evidence has accumulated against the main conclusion of the efficiency hypothesis: Governments could/should not afford expensive social welfare programs in an age of globalization. As discussed in the previous chapter, welfare states are still surviving and even growing under the presumed retrenchment pressure of the global market. The survival of welfare states, however, does not necessarily debunk the efficiency hypothesis all at once. At the bottom, governments can spend more simply by borrowing more. In part, widespread and accumulated public debts across industrial countries in the past several decades support this simple conjecture (see e.g. Streeck and Schäfer 2013). In other words, the fact that governments continue to sustain their level of social spending does not necessarily

Table 4.1: The Summary of Literature on Tax Competition

	Globalization	Dependent variable(s)
Advanced countries		
Garrett (1995)	T[A](−), C[B](..)	Capital taxation/GDP
Rodrik (1997)	T, C[C](..)	T (−) Capital ETR
		T (+) labor ETR
Swank (1998)	T (−) & C[D](+)	Capital profit taxation/GDP
Garrett (1998)	T, C[G]	(..) Corporate top marginal ETR
Garrett and Mitchell (2001)	T L-I[1](−) & C[E](+)	Corporate ETR
		(+) P-R ETR ratio[2]
Gelleny and Mccoy (2001)	T (+), C[C](+)	Corporate ETR
Bretschger and Hettich (2002)	T (−), C[F](−)	Corporate ETR
		(+) Labor/corporate ETR ratio
Swank and Steinmo (2002)	T, C[B]	(−) Statutory corporate tax[3]
		(..) Capital ETR
		(−) Labor ETR
Hays (2003)	C [B, G]	(+, −) ECTR
Bretschger and Hettich (2005)	T, C[G]	(−) Corporate ETR
		(..) Corporate revenue/GDP
Winner (2005)	C[H](−)	AEFR[4] (capital, labor, consumption)
Dreher (2006)	KOF[I] (+ on capital)	AEFR (capital, labor, consumption)
Adam and Kammas (2007)	T (size corrected)	ETR on (−) capital and (+)labor
Devereux, Lockwood and Redoano (2008)	(FDI I + X)/GDP	(−) Statutory & corporate ETR
Clausing (2008)	FDI out/GDP	(−) Statutory corporate tax rates
Plümper, Troeger and Winner (2009)	T, C[B]	(..)AEFR (capital & labor, the ratio)
Bretschger (2010)	Index of openness	(−) Corporate ETR
Kammas (2010)	T	(−) Corporate ETR
All countries		
Quinn (1997)	Δ C[B] (+)	Capital taxation/GDP
Slemrod (2004)	T (..)	Statutory corporate income tax rates
Kenny and Winer (2006)	T	Corporate & (−) indirect taxation
Overesch and Rincke (2009)	FDI in/GDP	(..) Statutory & corporate ETR

Note: The list is based on Adam, Kammas and Lagou (2013).
[A] Trade openness: the ratio of import and export to GDP.
[B] Capital account openness: absence of restriction on cross-border movement of capital.
[C] Capital account restriction dummy variable.
[D] Various measures: financial movement and capital market liberalization and capital flows.
[E] Various measures: Quinn's (1997) index of financial openness, FDI and interest differentials.
[F] Capital account openness considering the effect of country size.
[G] Financial market liberalization index.
[H] Estimated saving-relation correlation.
[I] Index of globalization. See Dreher (2006).
[1] Low wage import: import values as a percentage of GDP.
[2] Progressive/regressive tax ratio: Capital ETR/(consumption ETR + labor ETR)
[3] Statutory marginal corporate tax rates and average ETR rates on capital, labor and consumption.
[4] Average effective tax rates: actual tax revenues on factor income.

mean that there is no race to the bottom.

At this point, the efficiency hypothesis provides an interesting causal mechanism

in explaining the existence of the competitive race for global capital among governments. While economic globalization will decrease the tax burdens for mobile capital, it will increase that for immobile asset holders, i.e. labor (see e.g. Rodrik 1997). This mechanism explains how welfare states survive even if national governments are structurally engaged in a competition that fundamentally harms the funding base for social welfare programs. This causal mechanism, however, has been under serious empirical scrutiny in tax competition literature while generating complicatedly mixed evidence.

Table 4.1 summarizes the literature of tax competition. For each study, results are presented in parentheses. Some do find strong evidence for the argument that capital mobility reduces the level of capital taxation (Bretschger and Hettich 2002, 2005; Rodrik 1997; Swank 2002; Winner 2005). At the same time, there is also evidence for the argument that capital mobility increases the tax burdens of labor (Rodrik 1997; Winner 2005). Taking this evidence together, we might argue that capital mobility decreases the tax burdens of capital while increasing that of labor. However, as can be readily recognized in the table, much stronger evidence has been given to the opposite causal mechanism. Rather than reducing the tax burdens of business, capital mobility either does not have the expected negative influences, or projects positive influences on capital taxation (Garrett 1995, 1998; Gelleny and Mccoy 2001; Swank 1998; Quinn 1997). Or, even if capital mobility reduces statutory taxation rates on capital, it does not affect the effective tax rates for capital while reducing effective tax rates for labor (Swank and Steinmo 2002).

Furthermore, it is also interesting that measures of globalization provide different evidence for tax competition. According to the study of Swank's (1998), capital mobility increases capital taxation while trade openness decreases it. Interestingly, however, the evidence of tax competition is not even consistent with respect to trade openness. While some studies show that trade openness reduces taxation on capital (Bretschger and Hettich 2002, 2005; Garrett 1995; Swank 1998; Garrett and Mitchell

2001), others show that trade works to increase capital taxation (Gelleny and Mccoy 2001) or that trade has no discernible influences on it (Slemrod 2004).

On top of the mixed and complicated evidence for tax competition, a summary of the literature reveals two interesting research practices: First, the focal point of the literature is on capital mobility rather than trade openness. We saw in the previous chapter that the literature of social welfare spending has the exact opposite trend (see, Table 3.1). It reveals the weakness of the debate between the efficiency and compensation hypotheses. In understanding the impact of globalization on welfare states, the former emphasizes the financial aspect of it, while the latter emphasizes the commodity aspect of it. Thus, the argument that capital mobility significantly undercuts a government's capability to fund welfare states has been misguidedly fought against the argument that trade stimulates demand for social welfare. Second, only limited scholarly attention has been given to developing countries. With most analyses focused on advanced economies, we are less confident when discussing how the mechanism will work a sample of countries extended beyond affluent democracies.

4.1.1 Tax Competition: Does It Matter?

What does this mixed evidence tell us about tax competition? In fact, this conflicting evidence itself does put a big question mark on the argument that in an age of capital mobility, decreased capital taxation is balanced by increased labor taxation. If tax burdens for business increase with economic globalization as some studies show, there seems to be insufficient pressure for governments to balance revenue at the expense of labor in the first place. At the same time, as evidence suggests, different aspects of economic globalization seem to address the competitive pressure for tax competition by themselves rendering governmental efforts to balance revenue somewhat pointless. This conclusion, however, is marred by three fundamental challenges widespread in the literature of tax competition.

First, most studies wrongfully assume that the level of market internationalization is analogous to that of pressure for tax competition. As can be clearly seen in Table 4.1, despite various efforts to examine various aspects of economic globalization, scholars mostly focus on the overall *openness* of domestic economy to the world market. While following a standard measure of trade openness, the ratio of import and export to GDP, these studies explore various measures of financial openness, or capital mobility. All measures of capital mobility, however, center on how liberal financial market regulations are or how freely capital can flow across borders. These are good measures for the levels of financial liberalization, but not for the level of pressure for tax competition.

The core of the efficiency hypothesis is not about economic globalization *per se*, but about the competitive pressures that enter national governments into a self-destructive race for global capital. Theoretically, it is possible that a highly globalized economy can have a lower level of pressure for tax competition. In part, Bretschger and Hettich's (2002) analysis illustrate this point. By considering country size effects, their measure of economic openness shows that the United States is more open than the United Kingdom, which is the converse of popular belief. Thus, competitive pressure coming from globalization is greater for the former than the latter. Surprisingly, with this measure they show that economic openness does have the expected consequences proposed by the efficiency hypothesis: in an age of global capital, capital taxation goes down while labor taxation goes up (see also, Adam and Kammas 2007).

Second, and more importantly, in emphasizing the financial aspect of globalization, the literature of tax competition also wrongfully assumes that national governments compete with each other over any type of global capital. In order for this assumption to be sound, capital should be perfectly mobile across national borders so that governments' macro-economic policies trigger the immediate reaction of capital. However, evidence goes against the existence of perfect capital mobility. Capital is

nowhere perfectly mobile: it tends to be geographically clustered (see e.g. Audretsch 1998), have a strong home country bias (see e.g. Uppal 1992) and above all come with different forms that have varying degrees of mobility (see e.g. Anderson and Gatignon 1986; Goldstein and Razin 2005). Furthermore, as for relatively mobile capital, it is hard to believe that governments are competitively eager to attract it at the expense of others, given its negative consequences on domestic economy due to its volatility.

Third, the existing studies of tax competition take a narrow definition of tax competition itself. In most cases, the focus on about whether various measures of globalization decrease *tax burdens* for business or not. Of course, lowering tax rates for businesses is an important strategy for competition, but it is not an exclusive one. While sustaining the rate of capital taxation, for example, governments can attract foreign capital by providing tax exemptions, tax holidays, financial support, or even infrastructure. Scholars address this issue by focusing on effective corporate tax rates, measured by the ratio of tax receipts from corporation to corporate profit. In relying on this measure, however, the argument that governments are financially constrained by tax competition is ignored slightly. In other words, even if globalization decreases effective corporate tax rates, we are not confident in how the reduced tax burdens on businesses are associated with the reduced tax revenue from them. In this sense, Hays (2003) remarks, "Competition leads to convergence in the net return to capital, but very little can be said about how capital mobility affects overall levels of taxation (p. 81)."

4.2   FDI Competition and Its Consequences

Based on these challenges to the literature of tax competition, we might argue that "scholars are looking for the wrong thing or searching in the wrong places Hays (p.79 2003)." In order to understand how economic globalization affects the funding system

of social welfare provisions more correctly, we need to answer three questions. First, if there is competition among nations for global capital, over what type of global capital are national governments enticed to compete with one another? Second, if there is a specific kind of capital each government tries to attract, how can we effectively measure the pressure on governments in the competition? Lastly, what are the consequences of that pressure on capital taxation and overall taxation structure? In this section, I provide specific answers to these questions and set out two hypotheses for empirical analysis.

4.2.1 FDI Competition and Capital Taxation

I argue that FDI stands at the center of tax competition among national governments. In other words, global production capitals would be the type of global capital that structurally encourages governments to participate in the race to the bottom. In part, the fact that in an age of globalization most countries have been struggling to sustain a good economic performance encourages government to obsess over FDI. Given the widely recognized potential benefits of FDI—economic growth, technology spillover, and skill upgrading, etc.—FDI implies an opportunity for governments to boost their economy (Goldstein and Razin 2005). More correctly, it is thought that the potential benefits outweigh the drawbacks, such as environmental concerns, labor standard issues, etc. At the same time, the fact that FDI is a relatively stable form of global capital addresses governmental concern regarding the consequences of global capitals' volatility and profit repatriation.

With its focus on FDI, the efficiency hypothesis can be re-stated to suggest that the more pressure governments have from the competition for FDI, the stronger their incentives to provide a business-friendly policy environment for capital compared to other nations. As a consequence, FDI competition will result in reductions in capital taxation. This hypothesis challenges the dominant view that the general

possibility of capital mobility is what constrains the role of governments in the market. At the fundamental level, most theories in line with the efficiency hypothesis rely on the theorem of the "Unholy Trinity" or "Impossible Trinity" in explaining how capital mobility structurally weakens the role of government in the economy (see e.g. Mundell 1963). When capital mobility is high, autonomous monetary policy should be abandoned to stabilize the foreign exchange rate. Here, capital mobility is not about a certain type of global capital, but about the sheer capacity of capital in general to cross national borders for higher returns. This partly explains why the literature of tax competition has heavily focused on the overall level of the liberalization of financial market, not on a certain type of global capital.

Hypothesis 1. Governments under pressure for FDI competition will experience reductions in capital taxation.

I suggest, however, that the simple possibility of capital mobility is not enough to conceptualize the "pressure" for FDI competition. Rather, the level of competitive pressure for FDI is simultaneously determined by both the capacity of FDI to cross national borders and its actual flows. FDI's capability to cross national borders is a necessary condition, but not a sufficient condition, for FDI competition among governments. It is not sufficient because as a type of production capital, FDI tends to take relatively higher levels of *ex post* immobility compared to other forms of global capital (Jensen 2008). To the extent that FDI is immobile after investment is actually made, at least in the short term, the capacity of FDI to cross national borders could not be a good proxy measure of competition between governments. The same conclusion is also true for the actual flows of FDI as an indicator of FDI competition.

In this sense, the actual inflows could be considered as a reward for a government's participation in the competition. If a country engages with other countries in a

bidding war for FDI by providing financial and fiscal incentives for business, for example, the actual inflows of FDI should work to relieve the competitive pressure to the extent that FDI is immobile *ex post*. Thus, the pressure for FDI competition can be conceptualized as: every effort for attracting global production capital minus the actual inflows of it. Of course, the levels of *ex post* immobility could vary across different types of FDI or industry as discussed in Chapter 3. However, the role of actual flows still hold as FDI is generally stable compared to other forms of global capital and even a volatile FDI is executed with a managerial purpose that makes it stable at least in the short term.

As pressure for FDI competition increases, governments are to provide a more business-friendly environment for foreign investors compared to other countries. For this purpose, they provide various sorts of incentives that would increase the rate of return of foreign capitals. The incentives, however, cannot be limited to foreign investment only. Apparently, governments under FDI competition should seriously consider the fact that domestic production capital can also become globalized. Thus, all sorts of efforts to attract FDI should also be directed to retain domestic production capital within the national territory. Participation in the competition for global production capital is to engage in a bidding war along two front lines. It is in this way that FDI competition negatively affects overall levels of capital taxation in a significant way.

Then, what kinds of options do national governments have to attract and retain production capital? More importantly, how do these options reduce tax revenues levied from corporations? Deceasing the level of corporate income tax rates could be an important way to influence foreign direct investors' decisions on its destination (Altshuler and Grubert 2001; Hines 1999; Mutti 2003). Despite the plausibility of the assumption that multinational firms are greatly enticed by the level of corporate tax rates, however, empirical evidence suggests that tax rates might be a minor

determinant of FDI. (see. e.g. Gelleny and Mccoy 2001; Jensen 2012; Markusen 1995). The literature of MNCs is largely in line with the argument that tax rates are just one of the many factors that affect the location of international business (Dunning 2000).

In other words, government can still attract FDI without reducing tax rates for business. However, the argument does not necessarily go against the negative consequences of FDI competition on capital taxation. As many studies show, there might be weak evidence of competition in which national governments competitively reduce capital tax rates (Basinger and Hallerberg 2004; Hallerberg and Basinger 1998; Hays 2003; Plümper, Troeger and Winner 2009). From here, however, we cannot argue that tax competition does not harm capital taxation. It has been widely recognized in the literature that governments can compete with each other in providing various concessions to businesses in ways other than reducing corporate income tax rates.

As can easily be seen in Table 4.1, most studies explore this fact by utilizing the effective tax rates (ETR) in measuring the actual tax burdens of business, which result from various concessions, such as tax credits, tax holidays, etc. Even with the effective tax rates of capital, however, reductions in the tax burden of capital at the firm-level do not necessarily refer to reductions in tax receipts from capital at the aggregate level. Thus, in understanding the impact of FDI competition on capital taxation, a careful consideration of both various determinants of FDI and government tax revenues is required.

4.2.2 FDI Competition and Regressive Taxation

In the previous chapter, I show that FDI inflows increase demand for the provision of social welfare. In sum, as FDI puts a host economy under the strong influence of MNCs, it increases the market competition which causes economic insecurity for workers increases. Because economic insecurity encourages individual demand more

for welfare states, as discussed in Chapter 2, FDI requires national governments to provide social welfare programs. If the pressure to attract and retain production capitals negatively affects capital taxation, governments face a situation in which important tax revenue shrinks just at the time when more revenues are required for social welfare provisions. This is a perfect example of what Rodrik (1997) calls the "dilemma of globalization," in which increased demand for social welfare faces a decreased capability of government to supply it.

There are two simple solutions for this dilemma. First, national governments can spend more by simply borrowing more. The deficit spending, however, is simply to push the problem into the future while hoping that the future economic growth will allow governments to pay its debts later. Furthermore, given both accumulated public debts and stagnated economic growth, which have been prevalent across industrial countries since the late twentieth century, this solution does not sound promising (see e.g. Streeck and Schäfer 2013). In particular, developing countries have more serious problems with borrowing to finance deficit spending (see e.g. Wibbels 2006).

Second, governments can simply solve this dilemma by cutting outlays as retrenchment theories expect. The inexpensive way, however, is not the easiest way. De-funding public services is always politically expensive. In particular, the politics of welfare state retrenchment is radically different from that of welfare state establishment (see e.g. Pierson 1994; Brooks and Manza 2006*b*). According to Pierson and Castles (2006), the former is about blame avoidance while the latter is about credit claiming. With the established beneficiaries of the existing social welfare programs, the political cost of welfare state retrenchment seems to be high. This logic is not necessarily confined to social welfare spending. Every type of government outlay naturally generates beneficiaries who will be resistant to spending cuts.

This stalemate, however, can be easily solved by securing additional revenues to satisfy the new demand for social welfare. When the level of taxation decreases from

a certain tax base, the simplest measure to sustain the level of expenditure is to increase taxation at other bases. In general, the loss of taxation from mobile capital can be covered by tax revenues from immobile labor (Rodrik 1997). In particular, I hypothesize that under pressure for FDI competition, governments will try to secure additional revenue through regressive taxation (see e.g. Kato 2003; Avi-Yonah 2000).

Hypothesis 2. The pressure for FDI competition will encourage governments to rely more on regressive taxation.

In general, taxes are regressive (progressive) when lower income earners take relatively higher (lower) tax burdens compared to higher income earners. Broadly speaking, personal income tax is progressive while indirect taxes, such as consumption tax, are regressive. Of course, income taxes could also be regressive in a certain way. For example, as the number of income brackets decreases, taxation of income becomes more regressive: in each bracket the lower income earners' tax burden increases compared to high income earners. In general, however, direct taxes are generally considered progressive while indirect taxes are regressive (Winner 2005).

In theory, governments can secure additional revenues by making either direct or indirect taxes regressive. In reality, however, tax reforms for the former quickly become politically intolerable. In many cases, reforms in direct taxes face serious challenges from those with vested interests. When these reforms were enacted in the 1980s in industrial countries, governments mostly increased the top marginal income tax rates while making income tax system look more progressive. At the same time, however, they also significantly reduced the number of income brackets, which is normally considered a way to make a tax system regressive.

Thus, if additional revenues are to be secured through regressive taxation, governments will focus on indirect taxes, such as consumption taxes, excise taxes, sales taxes, or value-added taxes. As indirect taxes are flat-rate, they are notoriously re-

gressive in that lower income earners take on heavier tax burdens than higher income earners. Given that these taxes are mostly invisible as individuals do not directly pay it to the government, we can expect that the political cost of tax reform is relatively low for politicians. At the same time, given the extensive number of taxpayers who are targeted by the reform, governments can effectively secure additional revenues by just slightly increasing the rates of these types of taxes.

As a result, under pressure of FDI competition, the general contours of the taxation structure are expected to be more regressive, in the sense that tax burdens become heavier for lower-income earners. In particular, a government in this position will rely more on taxation from indirect taxes. Interestingly, this causal mechanism goes directly against the basic idea of social welfare provisions for income redistribution. In the first place, welfare states are based on progressive taxation, through which income is redistributed from the rich to the poor for social equality and stability. The theory developed in this section, however, suggests that the dilemma of globalization creates the exact opposite situation. As the dilemma continues, a social welfare system will be sustained at the expense of lower income earners. In an age of globalization, social welfare for economic needs tends to be paid by people in a similar economic condition.

4.3 Data & Measures

For testing the hypotheses stated above, I utilize the Government Finance Statistics Yearbooks (GFSY) provided by the International Monetary Fund (IMF).[1] It is well known that with developing countries in a sample, researchers face a severe challenge in data availability of any kind. In this sense, it is fortunate to have a GFSY data set that provides the most detailed information about government tax receipts

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[1]Data are retrieved by IMF GFS databse CD-ROM (see, http://data.imf.org/?sk=0C6E53F6-938F-4111-B8F0-31306DF7AA59)

with a global perspective. The data set, however, is not totally free from the same challenge. In many cases, countries fail to report information, creating large time series with missing information. More importantly, as briefly explained in the previous chapter, there was a serious break in time series around 1998 by IMF's adoption of a new manual for re-defining concepts and the scope of public economy.[2] Given the IMF's efforts to correctly measure government revenues, this chapter only utilizes the time series covered by the new manual.

4.3.1 Dependent Variables

Capital taxation. As for hypothesis 1, capital taxation measures corporate income taxation as a percentage of total tax revenue. As emphasized above, the measure of capital taxation should consider the fact that governments rely on various policy tools rather than lowering statutory corporate income tax rates. In that sense, the effective corporate tax rate, measured by the ratio of capital taxation to capital income, is innovative. However, tax burdens are not necessarily associated with the taxation of capital. In addressing this challenge, some studies use the ratio of capital taxation to GDP (see e.g. Altshuler and Goodspeed 2014). Intuitively, however, we are not interested in whether the ratio of capital taxation to national gross income increases or not under the pressure of FDI competition. Rather, we are interested in how a government's funding base is affected by it. Thus, I choose total government tax revenue as a denominator. Having taxation on "corporation and other enterprises" as a numerator from the IMF's classification of taxes, the first dependent variable is the ratio of business income taxation to overall taxation.

Regressive taxation. The dependent variable for hypothesis 2 is the ratio of regressive taxation to total tax revenue. Measuring regressive taxation might be tricky given the complicated structure of tax codes. As explained earlier, for example, even

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[2]see, http://www.imf.org/external/pubs/ft/gfs/manual/index.htm

income taxation that is widely recognized as progressive can also be regressive in some senses. For analytic convenience, I narrowly define regressive taxation as flat-rate taxes, under which the same tax rates are applied regardless of individual income level. From the IMF's classification of taxes, I choose to use tax revenues from "taxes on goods and services" as a representative of regressive taxation. As a composite measure of regressive taxation, it includes revenues from "General taxes on goods and service," "Excise taxes," "Taxes on specific services," etc. Thus, the second dependent variable is the ratio of consumption taxation to overall taxation.

4.3.2 Explanatory Variables

FDI Pressure. For testing both hypotheses, it is important to measure the *pressure* of FDI competition properly. In three steps, I construct a proxy measure of this pressure. First, I classify entire sample countries in to, what I call, the competition pool. If national governments compete with each other for global production capital, it is reasonable to assume that the competition is not a war of all against all. In general, it is well known that capital is clustered geographically and biased toward home countries (Audretsch 1998; Uppal 1992). In particular, FDI competition is strong between neighboring countries (Kammas 2010).At the same time, it is also a well-known fact that patterns of FDI flows are not only different across regions, but also different between developed and developing countries (UNCTAD 2000). Thus, according to the level of economic development and regional categories, countries are grouped into six competition pools: western countries and five regional categories for developing countries (For the classification of countries, see Table 6 in Appendix).

In part, the discussion about the competition pools explains why the actual flow of FDI is a poor indicator of FDI competition as I briefly explained above. In the upper figure of Figure 4.1, the scatter plot of FDI inflows over the level of economic development shows this point clearly. If the actual flow of FDI is a good proxy measure

Figure 4.1: Inflows of FDI as a proxy measure for FDI competition
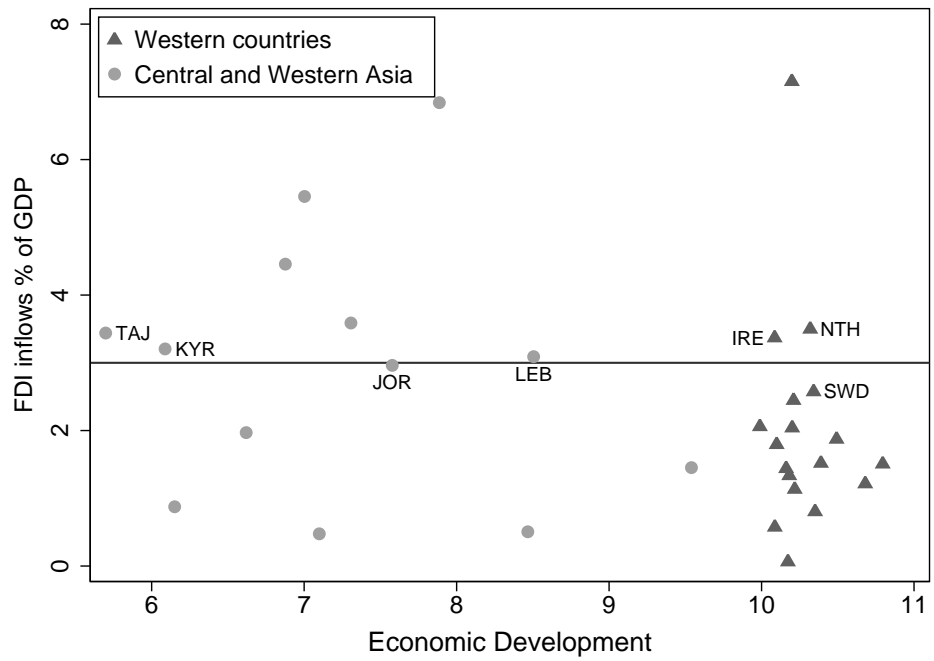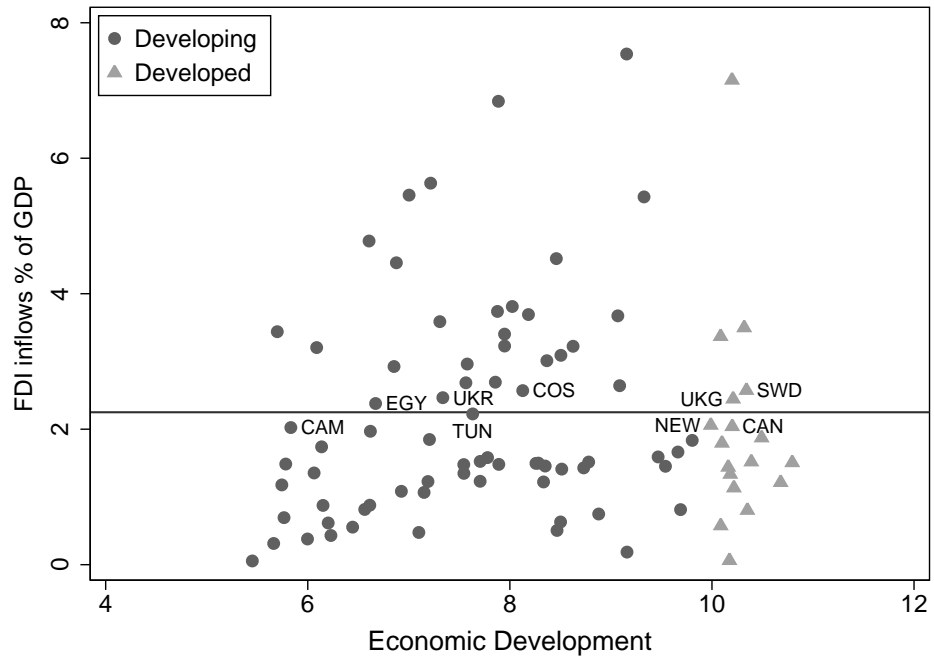
Note: Horizontal lines are added as a reference point. Economic development is the natural log of GDP per capita.

Table 4.2: Determinants of Foreign Direct Investment by Region

	Western	Africa	CW Asia	ES Europe	L America	SE Asia
Trade	0.1***	0.0*	0.0	0.0	0.0	0.0***
	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)
Log(GDP)	-6.3	-5.2**	-22.0**	-18.8**	-6.4***	-4.5*
	(5.5)	(2.1)	(9.2)	(8.1)	(1.5)	(2.6)
GDP pc	1.6	6.0***	5.1	17.2**	9.0***	3.7*
	(4.7)	(1.7)	(5.8)	(7.8)	(2.0)	(2.1)
Growth	0.1*	0.0	0.0	0.0	-0.0	0.0
	(0.1)	(0.0)	(0.0)	(0.0)	(0.0)	(0.0)
Spending	8.0	-2.8	-6.1*	-4.2**	-4.1***	-2.3
	(13.2)	(2.3)	(3.3)	(2.1)	(1.6)	(4.0)
Democracy	-0.2	0.0	0.1	0.1	-0.0	-0.0
	(0.5)	(0.0)	(0.1)	(0.0)	(0.0)	(0.0)
Food export	0.0	-0.0	0.2***	0.1**	0.0**	-0.0
	(0.1)	(0.0)	(0.0)	(0.1)	(0.0)	(0.0)
War	-0.1	-0.1	0.9	-0.6**	-0.5**	0.1
	(0.4)	(0.2)	(0.8)	(0.3)	(0.2)	(0.1)
Constant	166.7	75.0**	439.9**	339.2**	91.3***	98.9*
	(126.3)	(35.3)	(183.8)	(146.7)	(26.5)	(54.4)
Country dummy	Yes	Yes	Yes	Yes	Yes	Yes
Decade dummy	Yes	Yes	Yes	Yes	Yes	Yes
Time trend	Yes	Yes	Yes	Yes	Yes	Yes
Observations	624	227	207	314	485	372
N of Countries	18	10	13	20	14	12

* $p<0.10$, ** $p<0.05$, *** $p<0.01$

of the competitive pressure for FDI, this measure treats Cambodia similarly with the United Kingdom. At the same time, in the lower figure, Jordan shows a similar level of pressure for FDI competition with the Netherlands. With the actual flows as a proxy for FDI competition, it wrongfully assumes that these governments compete with each other all together. With the pool, however, the actual flows are reasonable measures of competitive pressure, as the scatter plots show. As the theory stated above shows, however, FDI flows cannot be considered to be competitive pressure, but as rewards resulting from various efforts to win the race for FDI.

Second, before considering the rewarding effect of FDI inflows for FDI competition,

I estimate the expected levels of FDI for each country-year given a host government's efforts to attract and retain production capitals in the previous year. For this estimation, I expand the model provided by Jensen (2008) that demonstrates how the level of FDI inflow is determined by other standard control variables and government spending (see, p.84-87) and separately estimate it for each competition pool. Results are presented in Table 4.2. As can be readily noticed, there are three important changes made to the original estimation.

(1) In order to get around the estimation issues associated with lagged dependent variable on the right hand side of the equation, the auto-correlation is instead treated within panel-specific error terms (see, e.g. Achen 2000; Keele and Kelly 2006). (2) A decade dummy is included alongside the country dummy variables. As noticed in Figure 3.1, FDI flows seem to be seriously affected by time periods. Although controlling for year-fixed effects might be ideal for this situation, the decade dummy is included due to the severely unbalanced structure of the data set. (3) I additionally control for both food export and inter-state war. While concerns about national resources are partly addressed by excluding countries with OPEC membership, I control for the potential influences of agricultural industry on FDI by including the ratio of food export as a percentage of merchandise export. At the same time, I also control for the potential negative impact of inter-state conflicts on FDI. Based on the Correlates of War Project's (COW) Militarized Interstate Disputes (MID) 3.1 data set, I include a dummy variable if a country is experiencing MID beyond hostility level 3 (Ghosn, Palmer and Bremer 2004).

Lastly, the pressure for FDI competition is measured by subtracting the actual inflows of FDI from the expected levels of FDI. This construction measures the extent to which national governments fail to attract global production capital to the level expected in each competition pool, given both their distinctive combinations of standard determinants of FDI and country specific effects. Higher values refer to higher

pressure of FDI competition as a government receives less FDI compared to what it expects to receive based on the efforts made in the previous year. As stated above, the theory expects that this measure of FDI pressure will have negative influences on capital taxation while having positive influences on regressive taxation.

As mentioned in the previous section, competitive pressure for attracting global production capital could refer to the retention of domestic production capital. However, I do not include a measure of pressure from FDI outflows in the equations for two reasons. First, the measure of FDI competition is a proxy for the level of government incentive to provide business-friendly policies to capital in general. Thus, in theory, the measure constructed from FDI inflows are also about FDI outflows. Second, if we can measure the pressure for mobile production capital in either way, constructing the measure based on FDI inflows is more reasonable as it fits well into the general conception of FDI competition. The market-friendly policies to attract foreign capital could be applied to domestic capital, but technically not the other way around.

4.3.3   Control Variables

Having measures on both dependent and key independent variables, I include a series of control variables to single out the causal mechanisms provided by the hypotheses. Model specification over an extended sample of countries, however, is not an easy task due to the failure of the existing literature to explore beyond affluent democracies. Quinn's (1997) analysis might be an important benchmark given the study's significant contribution to the literature and its extended sample size. Besides the fact that he applies a first difference to his corporate taxation measure, there are only four explanatory variables that cannot reasonably be considered as sound specification.

In order to have a reasonable sets of control variables, I follow and expand Gar-

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rett and Mitchell's (2001) model for capital taxation. Although this model is also simple, the analysis is empirically and theoretically important for the current study. First, the model includes various measures of economic globalization that are consistent with my general focus on both trade and FDI. Second, the analysis shows that economic globalization is not associated with reductions in capital taxation and increased burdens for labor, which is contrary to the conclusions of both hypotheses stated above. Furthermore, according to Garrett and Mitchell's (2001) analysis, once both year- and country- fixed effects are included, we cannot say that globalization does reduce capital tax rates and increase tax burdens for labor. As a sensitivity check for my analysis, I utilize this specification strategy.

Due to the challenges in data availability, however, the exact replication of the model seems implausible for an extended sample of countries. The economic globalization measures included are trade openness, FDI inflows and outflows, and Chinn and Ito's (2006) measure of capital openness. Some of the political variables, such as left portfolios and the Christian Democratic portfolio, are replaced by regime score as provided by Polity IV project (Marshall and Jaggers 2010). Along with economic growth rates, I additionally control for market size (the natural of GDP), the level of economic development (GDP per capita), and Government consumption expressed by the ratio to GDP (Heston, Summers and Aten 2012). Finally, and most importantly, I include indicator variables for both region and year.

4.4 Method

In analyzing the panel data, I rely on the exact estimation techniques applied in Chapter 3: a pooled regression analysis with panel corrected standard errors (PCSE) and a panel specific auto-correlation (AR1) error term. As for the potential endogeneity, all relevant explanatory variables are lagged by one time period. With both

regional- and year-fixed effects, the models are specified as follows:

$$\text{Capital Taxation}_{it} = a + b_1\,FDI\,competition_{it-1} + b_2\,FDI\,inflows_{it-1}$$
$$+ b_3\,FDI\,outflows_{it-1} + b_4\,Trade\,openness_{it-1}$$
$$+ b_5\,log(GDP)_{it-1} + b_6\,GDP\,per\,capita_{it-1} + b_7\,Growth_{it-1}$$
$$+ b_8\,Spending_{it-1} + b_9\,Capital\,mobility_{it-1} + b_{10}\,Aged_{it-1}$$
$$+ b_{11}\,Democracy_{it-1}$$

Before testing both hypotheses, I first examine how FDI competition affects overall levels of tax revenues. From the data provided by the World Bank, I estimate the influences of the pressure for FDI competition over the ratio of tax revenues to GDP. Then, the following analysis utilizes the data provided by IMF GFSY. Concerning the equation for regressive taxation, I also conduct an additional analysis by utilizing a data set provided again by the World Bank. In general, although World the Bank data do not contain detailed information on government revenues, it usually comes with more observations when they do. Sensitivity of the analysis, as a result, is in part under scrutiny across different data sets.

4.5   The Results

In Figure 4.2, the scatter plots show how the measure of competitive pressure for FDI is associated with the level of capital taxation in each competition pool. In general, despite the variation across groups of countries, there is a pattern that shows the negative relationship between pressures for FDI competition and capital taxation. The slops of the fitted linear line is negative and steepest in South and East Asia, followed by Africa, and then almost flat in Western countries. By taking the mean values for both variables, Figure 4.3 shows that compared to actual flows of FDI, the competition measure does show a more significant negative relationship with capital

Figure 4.2: FDI competition and Capital Taxation I
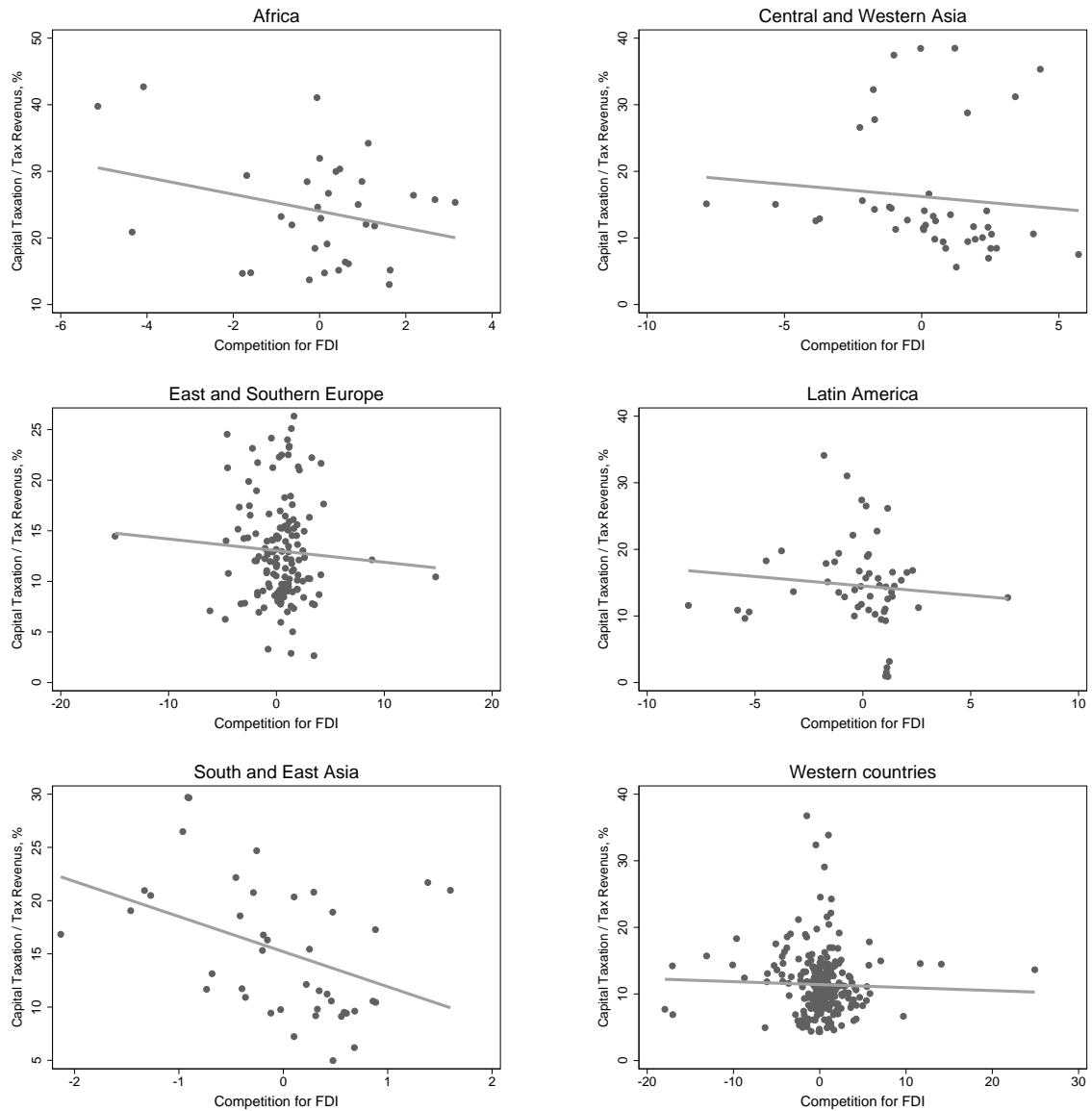
taxation on the right-side figure. Of course, these plots might not be evidence of a causal relationship. However, it is clearly suggestive that countries under greater pressure for FDI competition have difficulties securing revenues from capital.

In Table 4.3, I regress the total tax revenue as a percentage of GDP on the specified explanatory variables discussed above. The results show that higher pressure for FDI competition has positive and statistically significant influences on the overall levels

Figure 4.3: FDI competition and Capital Taxation II
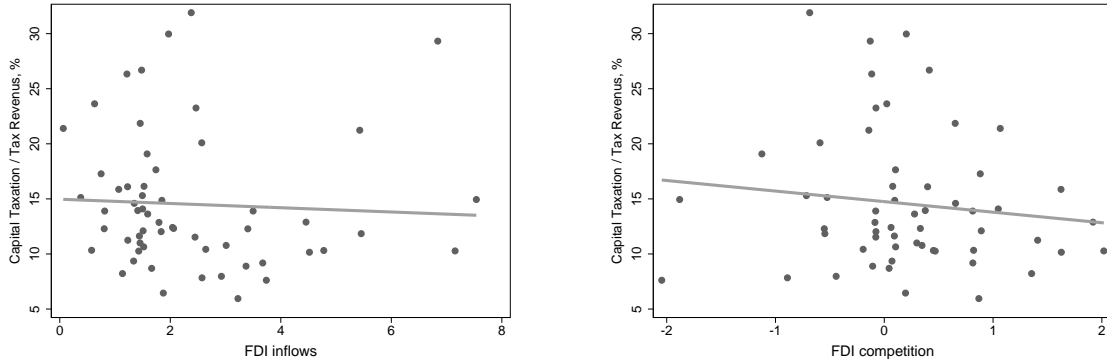
of taxation. Interestingly, with the control of FDI competition, the actual flows of FDI also increase the overall taxation. At the same time, by considering regional- and year-fixed effects, government consumption also increases the general levels of taxation. Concerning other aspects of globalization, trade openness fails to reach any statistical significance across different models. As widely expected by retrenchment arguments, capital mobility does have a negative and statistically significant influence on the overall taxation level in Model 3. With year-fixed effects in Model 4, however, it also fails to reach statistical significance.

Table 4.4 present the results for hypothesis 1—that higher pressure for FDI competition will reduce capital taxation. Strong evidence is given for this mechanism. In Model 5, without FDI flows in the equation, FDI competition shows a negative and statistically significant influence, at .1 level, on capital taxation. When controlling for FDI inflows in Model 6, the effect reaches the conventional statistical significance (.05). Although the failure to include a year-fixed dummy washes out these effects (Model 7), it again shows a negative and statistically significant influence in Model 8. There are three additionally interesting results for the influences of economic globalization on capital taxation. First, trade openness shows a positive and statistically significant, at .01 level, influence on capital taxation. Thus, when focused on trade, there is counter-evidence of tax competition as some studies show (Gelleny and Mccoy

Table 4.3: FDI Competition and Tax Receipt

	Model 1 b/se	Model 2 b/se	Model 3 b/se	Model 4 b/se
Competition for FDI	0.01	0.10***	0.11***	0.11***
	(0.03)	(0.03)	(0.03)	(0.03)
FDI inflow		0.10***	0.12***	0.12***
		(0.03)	(0.03)	(0.02)
FDI outflow		0.00	-0.04*	-0.03
		(0.02)	(0.02)	(0.03)
Trade	0.01	0.00	0.00	0.00
	(0.01)	(0.01)	(0.01)	(0.01)
Log(GDP)	-1.03***	-1.04***	-1.41***	-1.42***
	(0.15)	(0.15)	(0.23)	(0.23)
GDP per capita	3.18***	3.18***	2.65***	2.71***
	(0.28)	(0.27)	(0.40)	(0.40)
Growth	0.06***	0.06***	0.06***	0.06***
	(0.02)	(0.02)	(0.02)	(0.02)
Spending	1.83	1.90	1.64	2.32**
	(1.17)	(1.22)	(1.05)	(0.99)
Capital mobility	-0.91	-0.83	-0.99**	-0.74
	(0.56)	(0.51)	(0.40)	(0.46)
Democracy	-0.04	-0.05	0.02	0.03
	(0.04)	(0.04)	(0.03)	(0.04)
Constant	15.06***	15.60***	32.85***	33.28***
	(2.76)	(3.03)	(4.43)	(4.56)
Region dummy	No	No	Yes	Yes
Year dummy	No	No	No	Yes
Observations	766	754	754	754
N of Countries	79	78	78	78

* $p<0.10$, ** $p<0.05$, *** $p<0.01$

2001). Second, contrary to most theories of tax competition, capital mobility does not reach any statistical significance across different models. Lastly, government consumption in the previous year projects a strong negative influence on capital taxation.

Both Table 4.5 and Table 4.6 present results for hypothesis 2. The pressure for FDI competition will increase the overall levels of regressive taxation. In utilizing two different data sets—both IMF's GFSY for Table 4.5 and World Bank's WDI for Table 4.6, the dependent variable in both tables is the tax revenues from goods and services

Table 4.4: FDI Competition and Capital Taxation

	Model 5 b/se	Model 6 b/se	Model 7 b/se	Model 8 b/se
Competition for FDI	-0.04*	-0.21**	-0.16	-0.24**
	(0.02)	(0.09)	(0.10)	(0.10)
FDI inflow		-0.17**	-0.14	-0.19*
		(0.08)	(0.10)	(0.10)
FDI outflow		-0.03	-0.02	-0.04
		(0.04)	(0.04)	(0.03)
Trade	0.05***	0.06***	0.07***	0.06***
	(0.01)	(0.01)	(0.02)	(0.02)
Log(GDP)	1.33***	1.34***	1.96***	1.72**
	(0.33)	(0.32)	(0.55)	(0.69)
GDP per capita	-2.26***	-2.39***	-1.42	-1.85
	(0.62)	(0.65)	(1.03)	(1.33)
Growth	0.08	0.09*	0.08*	0.06
	(0.05)	(0.05)	(0.05)	(0.05)
Spending	-7.66***	-8.76***	-5.02*	-6.30**
	(1.84)	(2.19)	(2.85)	(2.59)
Capital mobility	0.92	1.37	1.54	1.06
	(1.03)	(1.05)	(1.11)	(1.01)
Democracy	-0.13	-0.13	-0.03	-0.02
	(0.09)	(0.09)	(0.09)	(0.08)
Constant	-2.01	-1.03	-19.98**	-9.10
	(4.80)	(4.89)	(8.03)	(8.38)
Region dummy	No	No	Yes	Yes
Year dummy	No	No	No	Yes
Observations	572	572	572	572
N of Countries	58	58	58	58

* p<0.10, ** p<0.05, *** p<0.01

as a percentage of total tax revenue. As we can see in both tables, the pressure for FDI competition consistently shows a positive and statistically significant influence on regressive taxation. In particular, the results are even more interesting given the fact that effects of other aspects of globalization—trade and capital mobility—seem to be sensitive to the choice not only of model specification, but also of data sets. While trade has positive influences on regressive taxation with the GFSY data set in some models, in Table 4.5 for example, it has consistently negative effects while relying

Table 4.5: FDI Competition and Goods and Service Taxation I

	Model 9	Model 10	Model 11	Model 12
Competition for FDI	0.07	0.60***	0.45**	0.43**
	(0.05)	(0.11)	(0.20)	(0.17)
FDI inflow		0.60***	0.43**	0.39***
		(0.09)	(0.18)	(0.15)
FDI outflow		-0.00	0.01	0.01
		(0.04)	(0.04)	(0.04)
Trade	0.07***	0.02	0.04*	0.02
	(0.02)	(0.02)	(0.02)	(0.02)
Log(GDP)	-0.81	-0.59	-1.36	-1.93*
	(1.14)	(1.01)	(1.21)	(1.16)
GDP per capita	-5.83***	-4.75***	-2.15	-1.44
	(1.36)	(1.04)	(2.08)	(2.08)
Growth	-0.08	-0.04	-0.01	-0.00
	(0.05)	(0.05)	(0.05)	(0.05)
Spending	0.24	6.94**	7.98**	8.78***
	(3.92)	(3.33)	(3.35)	(3.41)
Capital mobility	0.32	-0.81	-0.98	-3.29***
	(1.60)	(1.60)	(1.23)	(1.22)
Democracy	0.06	0.01	-0.24**	-0.31***
	(0.14)	(0.14)	(0.10)	(0.09)
Constant	114.90***	99.95***	84.11***	90.06***
	(20.27)	(19.80)	(20.74)	(19.90)
Region dummy	No	No	Yes	Yes
Decade dummy	No	No	No	Yes
Observations	711	711	711	711
N of Countries	59	59	59	59

* p<0.10, ** p<0.05, *** p<0.01

on the WDI data set. In case of both FDI inflows and competitive pressure for FDI competition, the effects are consistently positive and statistically significant. Another interesting result is that government spending also consistently shows a positive and statistically significant influence on regressive taxation. Thus, if governments spend more, they tend to secure additional revenue from regressive taxation.

Table 4.6: FDI Competition and Goods and Service Taxation II

	Model 13	Model 14	Model 15	Model 16
Competition for FDI	-0.00	0.36***	0.43***	0.44***
	(0.02)	(0.10)	(0.13)	(0.14)
FDI inflow		0.42***	0.49***	0.50***
		(0.09)	(0.10)	(0.11)
FDI outflow		-0.01	0.02	0.02
		(0.05)	(0.05)	(0.05)
Trade	-0.05***	-0.05***	-0.06***	-0.06***
	(0.01)	(0.01)	(0.02)	(0.02)
Log(GDP)	-2.42***	-2.07***	-2.24**	-2.34***
	(0.58)	(0.65)	(0.97)	(0.90)
GDP per capita	-0.11	-0.25	0.73	0.80
	(0.43)	(0.37)	(0.52)	(0.53)
Growth	0.05	0.05	0.03	0.03
	(0.05)	(0.05)	(0.05)	(0.05)
Spending	11.38***	14.40***	10.70***	11.94***
	(2.98)	(3.42)	(2.76)	(2.60)
Capital mobility	2.77	2.59	2.57	2.15
	(1.79)	(1.59)	(1.62)	(1.76)
Democracy	0.02	0.04	0.03	0.01
	(0.13)	(0.11)	(0.18)	(0.19)
Constant	93.91***	84.35***	77.62***	80.08***
	(15.22)	(16.65)	(23.40)	(22.85)
Region dummy	No	No	Yes	Yes
Decade dummy	No	No	No	Yes
Observations	745	733	733	733
N of Countries	78	77	77	77

* $p<0.10$, ** $p<0.05$, *** $p<0.01$

4.6 Discussion

Taken all these results together, we can argue that FDI has strong bearing on social welfare funding. The pressure of FDI competition, alongside the actual flows of it, works to increase the overall levels of tax revenues. Among the sub-categories of taxation, however, government efforts to attract and retain production capital results in decreased capital taxation and increased regressive taxation. Thus, the gap between increased tax revenue and decreased capital taxation is to be filled by the

increase in regressive taxation. Concerning the effects of government consumption spending, there is evidence for an interesting chain-reaction effect. FDI inflows lead to the expansion of social welfare spending as we examined in Chapter 3 while the spending increases do not affect the overall level of taxation (Table 4.3). However, increases in government spending decrease capital taxation while increasing regressive taxation. Thus, in controlling for the level of FDI competition, FDI inflows indirectly affects the manipulation of taxation structure.

CHAPTER V

Routes to Welfare States in the Developing World:
A Double Movement under Global Market

In the previous chapters, I argue that FDI stands at the center of the "globalization dilemma," through which governments face both increased demand for social welfare and decreased capabilities to supply it. More importantly, this analysis has been conducted over an extended sample of countries including both developed and developing countries. As discussed, the scope of the study was intentionally set in order to overcome the failure of the existing literature to include countries that are not affluent democracies. In doing so, however, any attempt to include developing countries directly faces wide-spread skepticism. Discussions of welfare states in developing countries may be irrelevant as government spending in these countries is not equivalent to social welfare spending in affluent democracies. In other words, there is no theoretical and empirical ground upon which to believe that every dollar spent by governments in developing countries are equivalent to that in developed democracies.

In part, the sparse evidence suggests a pessimistic conclusion for the development of welfare states in developing countries. Even if we narrow down our focus on government provisions of social welfare in these countries, the influences of the global market overrides domestic politics for redistribution. Put differently, even if globalization increases economic insecurity in a host country, collective action problems hamper labor's active push for social welfare provisions (Rudra 2002) and national governments have difficulties borrowing in order to spend more for social welfare (Wibbels 2006). In summary, developing countries might be too weak, either politically or financially, to fight back the global market's retrenchment pressure for a small

government. Thus, any attempt to go beyond the affluent countries in understanding the topic under consideration always faces an important criticism: the lessons we learned from advanced countries might not be applicable to developing ones.

The criticism does have some merit. Above all, two important contextual factors that have been cornerstones of both the development and consolidation of welfare states in affluent democracies are missing in developing countries. First, given that countries in the category are by definition still struggling with economic development, governments might have limited resources for establishing the institutionalized system for social protection or to satisfying individual citizens' demands for social welfare. At the same time, the level of demand for social welfare might not be compatible with that of affluent countries. Second, even if developing countries have some resources and public demand for welfare states, the political regime is not mature enough to put great emphasis on the social redistribution of income. In other words, as soon as we pay exclusive attention to developing countries when attempting to understand the development of welfare states in an age of globalization, researchers face a situation in which both the level of economic development and political development begin to vary in a meaningful way alongside economic globalization. Developing countries are experiencing a double movement under the global market.

How can we explain the expansion of social welfare spending within the distinct context of developing countries? More importantly, does the argument that FDI works for welfare states still work if we narrow down our focus to developing countries' social welfare spending? Furthermore, does the argument still hold when seriously considering the complicated relationships of the contextual factors? In answering these questions, this chapter faces the complicated web of interactions of these important contextual factors. In the literature, each contextual factor has been recognized as an important determinant for welfare state development, but in a very isolated fashion. Only a few studies examine how the aspects of what I call the *welfare state*

tripod (modernization, democratization and globalization) interact with each other in determining the course of welfare state development. Based on the potential inter-relationships among them, the article provides a road map to the development of welfare states in developing countries. In doing so, I am interested in how the FDI-welfare state argument[1] fits into the diverse paths toward welfare states in the Third World.

Each school of thought in the welfare state tripod provides its own arguments controlling for the others. Regarding the possible interactions between each leg of the tripod, only two pathways have been identified in the literature. First, the positive linkage of economic globalization on welfare states can be conditional to the existence of democracy (Adserà and Boix 2002). Second, the positive linkage of domestic labor powers on welfare states can be negatively conditioned by economic globalization (Rudra 2002). This chapter sheds some light on the remaining unexplored linkages between each pillar of the welfare state tripod in developing countries. First, political development can positively condition the effect of economic development on the growth of welfare states. Second, both economic development and globalization can also positively condition political development for welfare states. Lastly, controlling for the effect of political development, economic development can possibly condition the effect of globalization on social welfare spending.

This chapter consists of four parts. First, the following section reviews the existing literature on each pillar of the welfare state tripod: economic development, political development, and globalization. To summarize how each pillar leads to the expansion of social welfare spending, I also examine a few pioneering studies that explore

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[1]As the criticism is mostly about the irrelevance of the discussion of welfare state development, this chapter only considers the demand-side function of welfare states, which was the topic of Chapter 3. Concerning the question about how the distinctive contextual factors affect the funding system of social welfare in developing countries is also important as the tax competition literature has been also mostly about advanced countries. I have put this important question in my future research agenda.

the potential connections among them. Second, the theory section identifies some hypotheses that have been largely overlooked in the literature of welfare states with respect to developing countries. Third, the proposed hypotheses are examined under a large-N quantitative analysis of 36 developing countries from 1972 to 1997. Lastly, I explain the results and discuss their implications to the study of welfare states in the Third World.

5.1   Welfare State Tripod

In studying the dynamics of social welfare spending in developing countries under the global market, two important ongoing processes come to the front. First, developing countries are experiencing a process of economic development, in which the ensuing socio-economic transformations, such as urbanization, industrialization, or social mobilization, stimulates the growth of public services. Second, these countries are also experiencing a process of political development, through which various social pressures for welfare states can be effectively represented within a polity. Thus, in order to understand how economic globalization affects welfare states in this world, the double movement should be seriously considered as it provides a radically different environment for welfare states compared to that of affluent democracies.

In the literature, economic development has been a widely accepted determinant of welfare state development. Various theoretical elaborations—the logic of industrialism within the tradition of modernization theory, the logic of capitalism within that of the neo-Marxist tradition, and even so-called Wagner's law—agree that economic development has positive influences on the growth of public economy (see e.g. Deutsch 1961; Inkeles and Smith 1974; Lerner 1958; Myles 1984; Wilensky 1975). The gist of the arguments is that the process generates economic anxieties which have to be managed by governments for social stability and equality. Furthermore, economic

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development and the ensuing social transformations—such as urbanization, industrialization, introduction of modern factory systems or mass media—not only generate a direct need for big government, but also contribute to the formation of modern participatory citizens who are willing to push governments for their own right.

Political development also has a similar effect. According to Meltzer and Richard (1981), the introduction of universal suffrage and majority rule for collective action politically empowers those who are economically deprived. Given the decisive role of median voters for collective decision-making in democracy (Downs 1957), the bigger the difference between the mean and median income voters is, the greater the pressure on the growth of public economy. The argument, however, is different with the economic development argument in that political development is not a direct source of economic anxieties, but a platform on which the existing social cleavages can surface.

In this vein, Bueno de Mesquita et al. (2003) explain how political leaders' calculations for public good provisions can be transformed by political development. With limited resources, political leaders try to maximize their political tenure by providing enough benefits for a group of people, the "winning coalition," whose support is necessary for that purpose. In an autocracy, providing private goods for this group is enough to secure their tenure as the relatively small size of the winning coalition compared to citizens, the "selectorate," makes the defection of members of the winning coalition costly. As the size of the winning coalition expands with political development, however, political leaders have to put more emphasis on providing public goods because defection becomes a cheap affair for the members of the wining coalition. Thus, in a democracy, politicians tend to put greater emphasis on the provision of public goods. Haggard (2005) succinctly summarize the point as such:

> Democracy changes the political landscape in at least two ways that are significant. On the supply side, democracy provides incentives for politicians to compete for support by redistributing income and expanding

Figure 5.1: Growth of Welfare States: Explored Linkages
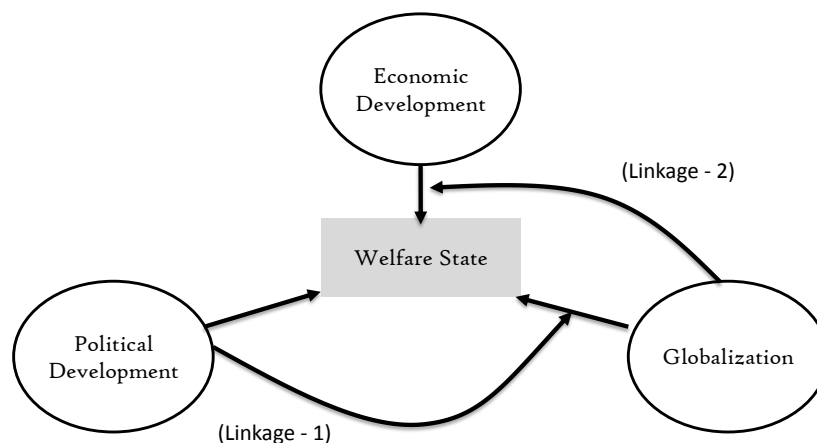
social commitments. On the demand side, democracy creates opportunities for previously excluded groups, including unions, nongovernmental organizations (NGOs), and other social movement (pp. 22-23).

Lastly, economic globalization is also considered an important source of economic anxieties that can potentially project upward pressure on welfare states (see e.g. Katzenstein 1985). As more open economies embrace greater risks coming from the global market, governments take the initiatives to insulate this risk by expanding the size of the public economy. Although the globalization-induced anxieties could intensify the existing domestic anxieties (Cameron 1978), an accumulation of evidence suggests that economic globalization generates new types of economic anxieties that can be distinguishable from those coming from economic development (Garrett 1998; Rodrik 1997, 1998; Scheve and Slaughter 2004)

Overall, each pillar of the welfare state tripod has been examined in a very isolated fashion. In a schematic view presented in Figure 5.1, the straight arrows leading from each pillar of the tripod to welfare states represent the arguments of each scholarly camp. Only a few studies examine the potential linkages between these pillars. First, Adserà and Boix (2002) argue that democracy works as a positive conditional factor

Figure 5.2: Growth of Welfare States: Missing Linkages
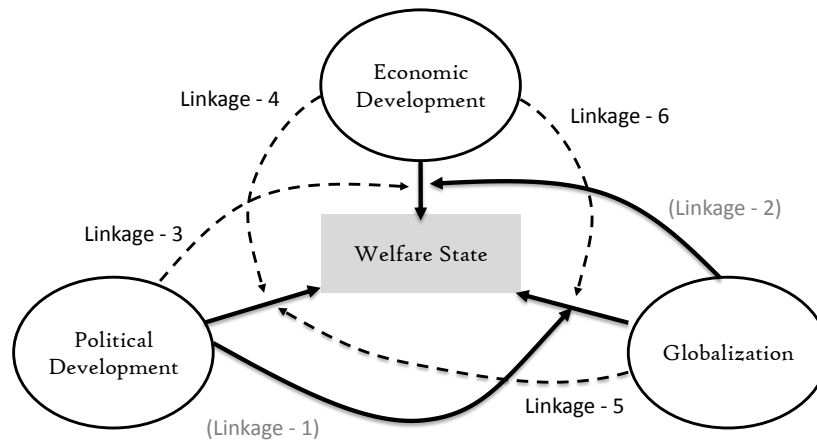
for magnifying the effect of globalization on the size of the government. Compared to non-democracies that have other options to use against the risk of globalization, such as economic isolation or authoritative openness, democratic governments are electorally constrained to embrace economic anxieties coming from the global market (Linkage-1). Second, Rudra (2002) examines how the political power of labor is related to government welfare efforts in developing countries. She concludes that holding democracy constant, globalization weakens the effect of labor's political power on social redistributive spending. To the extent that labor powers represent economic demand for social welfare spending, the argument can be interpreted as how the effect of economic development is conditioned by globalization (Linkage-2). Thus, two hypotheses follows as such:

Hypothesis 1. Political development will positively condition the effect of economic globalization for welfare states.

Hypothesis 2. Economic globalization will negatively condition the effect of economic development for welfare states.

5.2 Missing Linkages: A web of Conditional Relationships

From what we know about the development of welfare states in developing countries, as presented in Figure 5.1, there are some apparent missing linkages for welfare states concerning how these ongoing processes interact with each other. From here, we can complete the picture by connecting arrows from each pillar of the tripod to the remaining straight arrows. Figure 5.2 gives us a complete picture of the potential inter-relationships among them. First, political development can positively condition the effect of economic development on welfare state growth. If anxieties coming from economic development can push welfare states forward, the effect could be stronger when individual citizens have more opportunities to participate in politics and political leaders who have incentives to satisfy their demand (Linkage 3). In other words, the impact of economic development on social welfare spending would be stronger in a democracy.

Hypothesis 3 (Linkage 3)**.** Political development can positively condition the effect of economic development for welfare states.

Second, economic development can magnify the effect of political development on welfare state growth (Linkage 4). If the democratization process transforms political leaders' calculations for their survival by emphasizing public provisions, the effect will be stronger as economic anxieties related to economic development increases. At the same time, the effect of economic development over social welfare spending will be stronger when individuals have political rights to push governments. Third, the same logic can also be applied to the conditional effect of globalization on the political development for welfare states (Linkage 5).

Hypothesis 4 (Linkage 4)**.** Economic development will positively condition the effect of political development on welfare states.

Hypothesis 5 (Linkage 5)**.** Globalization will positively condition the effect of political development on welfare states.

Lastly, the relationship between economic development and globalization for welfare states has not been seriously considered in the literature. Although Rudra (2002) examines how globalization conditions the effect of labor power for social welfare spending, the same effect on economic development-induced anxieties has been unexplored. If economic globalization worsens labor's collective action problems, globalization has a negative conditional effect not only on labor powers, but also on general anxieties coming from economic development for welfare states. At the same time, there is also another linkage that economic development can project conditional effects on economic globalization (Linkage 6). Here, we are less confident about how the causal link between globalization and welfare states can be affected by economic anxieties coming from economic development. On the one hand, while compensating globalization losers, governments can actively take the initiative to embrace anxieties resulting from economic development. On the other hand, developing countries might have financial difficulties to take additional burdens.

Hypothesis 6 (Linkage 6)**.** Holding democracy constant, economic development can, either positively or negatively, condition the effect of economic globalization on welfare state development

In providing an empirical analysis of these complicated routes to the expansion of social welfare spending in developing countries, I am particularly interested in the sensitivity of the argument that FDI will increase government effort toward social welfare provisions. Thus, in operationalizaing economic globalization, I start with the widely accepted measure of it—both trade and financial openness—and further include FDI measures. In order not to make the analysis too complicated, other aspects of globalization are not considered.

5.3 Data & Measures

In order to test these hypotheses, I use a panel data set of 36 developing countries from 1972 to 1997. From Rudra's (2002) data set containing detailed information on social welfare spending in 53 less-developed countries (LDCs), I choose 36 countries to be used as a developing country for understanding the dynamics of welfare state growth discussed above. First, heavily indebted poor countries (HIPC), classified by the World Bank, are excluded[2]. Second, member countries of Organization of the Petroleum Exporting Countries (OPEC) are also excluded. The exclusion of both extremely poor and oil rich countries is primarily to take into consideration a government's financial capability to provide public services in a meaningful way; government capability for social welfare provisions might be extremely constrained for the former while being extremely liberated due to the massive natural resource in the latter. Lastly, by further excluding small countries (less than 1.5 million population), the scope of the study comes down to 36 developing countries with 917 total observations.

When it comes to a data set for developing countries' governmental outlays, especially in categories of social welfare spending, the International Monetary Fund's Government Finance Statistics Yearbooks (GFSY) might be the only data source on which to rely given its cross-national coverage and time-span. Rudra's (2002) data set is also extracted from this database. Concerning the time series included in the original data set, however, it is unfortunate that the times series data were interrupted by the IMF's adoption of a new manual for measuring government outlays (Government Finance Statistics Manual 2001, GFSM2001[3]). In order to consider sub-national level government activities and government agencies, the times series before and after the adoption of GFSM2001 is not compatible. Thus, the time frame of the analysis is

[2]see, http://data.worldbank.org/income-level/HPC
[3]see, https://www.imf.org/external/pubs/ft/gfs/manual/

confined to the observations before the new manual was adopted. Consequently, this chapter includes 36 developing countries from 1972 to 1997. For the list of countries included, see Appendix.

5.3.1 Dependent Variables

Social welfare spending/expenditure. The dependent variable measures the ratio of social welfare spending—social welfare, education and public health spending—to total levels of government expenditure. Earlier empirical studies of welfare states rely on the ratio of government expenditure or revenues to national income (Cameron 1978; Rodrik 1998). Due to the concern that government spending is generally a poor indicator for governmental welfare efforts, most scholars increasingly rely on sub-categories of government spending—such as subsidies to industry, direct income transfer, etc.—alongside total government spending (see e.g. Garrett 1998; Garrett and Mitchell 2001). Concerning developing countries, there is another concern about using national income as a denominator. First, significant changes in national income due to rapid growth or frequent economic crises affect the measure of welfare efforts. Second, the national income denominator can potentially underestimate government efforts to provide social welfare. In order to overcome these challenges, welfare efforts are often measured by social welfare spending as the ratio of government expenditure (see, e.g. Kaufman and Segura-Ubiergo 2001; Rudra 2002).

5.3.2 Explanatory Variables

Political development. The level of political development is measured by a 10-point scale democracy score as provided by the Polity IV database. The score measures each regime's democratic characteristics in three different ways: (1) competitiveness and openness in executive recruitment, (2) constraints on chief executive (3) competitiveness of political competition (see e.g. Marshall and Jaggers 2010).

Without considering the autocracy score, the democracy score clearly captures the argument of the political development thesis concerning how executives are constrained by movement toward democracy. Although constructing a dummy variable for a mature democracy could be an alternative measure to address the concern that not all progress along the 10 point scale is equally important, I keep the original coding to see how movement toward democracy is affected by other important determinants for the expansion of social welfare spending.

Economic development. In addition to the conventional measure of economic development, GDP per capita, I further operationalize it through urbanization, de-industrialization, and potential labor power. From the modernization theory, urbanization is an important social change resulting from economic development, through which cheap labor from rural areas to urban areas works to push governments for the expansion of public services. Second, labor power is considered another important aspect of economic development. Traditionally, the political clout of labor organizations has been considered an important determinant of welfare state growth in advanced economies (see e.g. Korpi 1989). Direct theoretical implications of the power resources theory suggest that if labor can garner strong political clout over the developmental process, we can expect the growth of welfare states in developing countries. Rudra (2002) provides an important measure of the potential labor power (PLP). Based on both the ratio of skilled to the lower-skilled labor and the amount of surplus labor, higher values of PLP refer to stronger political power of labor. Lastly, developing countries' economic development processes can co-exist with de-industrialization. According to Iversen and Cusack (2000), the economic anxieties that are largely considered to result from economic globalization are actually induced by the process of de-industrialization in advanced economies. I measure de-industrialization as service sector's value added as a percentage of GDP.[4]

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[4]see, http://data.worldbank.org/indicator/NV.SRV.TETC.ZS

Economic globalization. In general, there are two measures of economic globalization. First, the most widely accepted measure of economic globalization is trade openness, expressed as the sum of imports and exports divided by GDP. Along with aggregate level openness, I also separately include both imports and exports as a percentage of GDP. At the same time, I also include financial openness. From the data set provided by Rudra (2002), financial openness measures the sum of capital inflows and outflows as a percentage of GDP.[5] Alongside both trade and financial openness, I also include foreign direct investment (FDI) along with both inflows and outflows respectively.

5.3.3 Control Variables

I include two control variables. First, I control for the age dependency ratio, expressed as the population of age 65 and above as a percentage of the total population. It is generally expected that a more age-dependent county will have a more generous social welfare provision. Second, I also control for the stock of external debt expressed as a percentage of Gross National Income (GNI). It is important to include this variable in order to consider fiscal constraints on governments to supply social welfare. It is expected that the external debts will have negative influences on social welfare spending in developing countries.

5.4 Method

For each pathway to the expansion of social welfare spending in developing countries, I analyze 36 developing countries from 1972 to 1997. The same estimation techniques from the previous chapters are utilized for analyzing a panel data set: a pooled regression analysis with panel-corrected standard errors (PCSE), and a panel

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[5]The original data source of financial openness is IMF's *Balance of Payments Statistics*. The capital flows include foreign direct investment, foreign portfolio investment and others, such as trade credits, loans, currency, and deposits.

specific auto-correlation error term. Based on the model specification of Rudra (2002), this study adds the additional variables discussed above to embrace more complex inter-relationships between each pillar of welfare state tripod. In doing so, all explanatory variables are lagged one time period in order to address the potential problem of endogeneity. Although this concern could be addressed with other estimation techniques as Rudra (2002) does, I follow the conventional strategy to make the analysis as simple and intuitive as possible when examining the complicated picture depicted in Figure 2. For each pairing of the tripod (linkage1-5, linkage 2-6 and linkage 3-4), appropriate interaction models are estimated. For example, the relationship between trade openness and democracy is estimated as such:

$$
\begin{aligned}
\text{Welfare Efforts}_{it} = {} & a + b_1\,GDP\,per\,capita_{it-1} + b_2\,Growth_{it-1} + b_3\,Democracy_{it-1} \\
& + b_4\,Trade\,openness_{it-1} + b_5\,Financial\,openness_{it-1} + b_6\,FDI\,inflow_{it-1} \\
& + b_7\,FDI\,outflow_{it-1} + b_8\,Age\,dependency_{it-1} + b_9\,PLP_{it-1} \\
& + b_{10}\,External\,Debt_{it-1} + b_{11}\,Trade\,openness_{it-1} \times Democracy_{it-1}
\end{aligned}
$$

In obtaining parameter estimates for this equation, note that the level of economic development indicator, GDP per capita, is not specified along with other measures of economic development due to the potential multicollinearity problem. For example, the correlation between GDP per capita and urbanization is .84 in the sample. As the labor power indicators are weakly related to other indicators for economic development, the PLP index is included along with other indicators of economic development. The results for interaction models are not presented given the limited space. I instead present the baseline regression results while visualizing how the marginal effects of each pillar of welfare state tripod are conditioned by others.

Table 5.1: Baseline Results with Economic Development Indicators

	Model 1	Model 2	Model 3	Model 4
GDP per capita	0.06***			-0.02
	(0.01)			(0.02)
Urbanization		0.00***		0.00***
		(0.00)		(0.00)
De-industrialization			0.00***	0.00***
			(0.00)	(0.00)
Economic growth	-0.00	-0.00	-0.00	-0.00
	(0.00)	(0.00)	(0.00)	(0.00)
Democracy	0.01***	0.01***	0.01***	0.01***
	(0.00)	(0.00)	(0.00)	(0.00)
Labor power	-0.02***	-0.02***	-0.01***	-0.02***
	(0.00)	(0.01)	(0.00)	(0.00)
Age dependency	0.03***	0.02***	0.04***	0.03***
	(0.00)	(0.00)	(0.00)	(0.00)
External debt	0.00	-0.00	0.00	-0.00
	(0.00)	(0.00)	(0.00)	(0.00)
Trade openness	0.00	0.00	-0.00	-0.00
	(0.00)	(0.00)	(0.00)	(0.00)
Financial openness	0.00***	0.01***	0.00***	0.00***
	(0.00)	(0.00)	(0.00)	(0.00)
Constant	-0.21***	0.05**	-0.06	0.11
	(0.05)	(0.02)	(0.04)	(0.12)
Observations	412	412	395	395
N of Countries	30	30	30	30
R-square	0.84	0.90	0.91	0.86

* p<0.10, ** p<0.05, *** p<0.01

Standard errors are in parentheses.

5.5 The Results

The results provide some interesting insights about the role of each pillar of welfare state tripod and their interactions in developing countries. The baseline estimation results provide strong evidence for each pillar of the tripod. Concerning their inter-relationships, however, we can make more nuanced explanations for the expansion of social welfare spending in developing countries. First, there is strong evidence for hypothesis 1: political development positively conditions the effect of globalization on

social welfare spending (Linkage 1). Second, there is mixed evidence for hypothesis 2: the conditional effects of globalization on economic development for social welfare spending vary across different measures of market internationalization (Linkage 2). Third, there is relatively strong evidence for the mechanisms whereby political development works for welfare states either directly or indirectly (hypotheses 3 to 5). Lastly, the evidence in general suggests negative conditional effects of economic development on globalization for social welfare spending (Linkage 6).

The results from the baseline estimation for each pillar of the tripod are presented in both Table 5.1 and Table 5.2. While table 5.1 considers different indicators of economic development separately across models, Table 5.2 considers sub-categories of each measure of economic globalization by expanding Model 1 of Table 5.1. First, there is strong evidence for the economic development thesis. The level of economic development, urbanization, and de-industrialization has positive and statistically significant influences on social welfare spending in developing countries. Against Rudra's (2002) argument, however, the coefficients of the potential labor power are negative and statistically significant at a .001 level. At the same time, there is also strong evidence for the political development thesis. Across different model specifications, in both tables, democracy stands out as having consistently positive and statistically significant influences on government social welfare efforts. A more democratic country puts greater emphasis on social welfare provisions, all else equal. Concerning arguments about economic globalization, an interesting picture arises. In both tables, trade openness as a widely accepted measure of globalization, fails to reach any statistical significance. Rather, it is the financial openness variable that has positive and statistically significant influences on welfare states in developing countries.

From these baseline estimations, the analysis of the interaction effects among each pillar of the welfare state tripod gives us nuanced evidence for the proposed hypotheses. Among the two identified interactive relationships in the literature, there is strong

Table 5.2: Baseline Results with Economic Globalization Indicators

|	Model 5	Model 6	Model 7
GDP per capita	0.06***	0.05***	0.07***
	(0.01)	(0.01)	(0.01)
Economic growth	-0.00	-0.00*	-0.00
	(0.00)	(0.00)	(0.00)
Democracy	0.01***	0.01***	0.01***
	(0.00)	(0.00)	(0.00)
Labor power	-0.02***	-0.02***	-0.02***
	(0.00)	(0.00)	(0.00)
Age dependency	0.03***	0.03***	0.03***
	(0.00)	(0.00)	(0.00)
External debt	0.00	-0.00	0.00
	(0.00)	(0.00)	(0.00)
Trade openness		0.00	-0.00
		(0.00)	(0.00)
Import	-0.00		-0.00
	(0.00)		(0.00)
Export	0.00		0.00
	(0.00)		(0.00)
Financial openness	0.01***	0.00***	0.00***
	(0.00)	(0.00)	(0.00)
FDI inflows		0.01**	0.01*
		(0.00)	(0.00)
FDI outflows		0.00	-0.00
		(0.01)	(0.01)
Constant	-0.25***	-0.19**	-0.30***
	(0.05)	(0.08)	(0.06)
Observations	413	394	394
N of Countries	30	28	28
R-square	0.84	0.84	0.83

* p<0.10, ** p<0.05, *** p<0.01

Standard errors are in parentheses.

evidence for arguments raised by Adserà and Boix (2002). The effect of economic globalization on welfare states is positively conditioned by the process of political development (Hypothesis 1). In Figure 5.3 A, we can clearly see that the marginal effects of both trade and financial openness on welfare efforts become stronger as democracy scores increase and become statistically significant at 0.5 level. Without
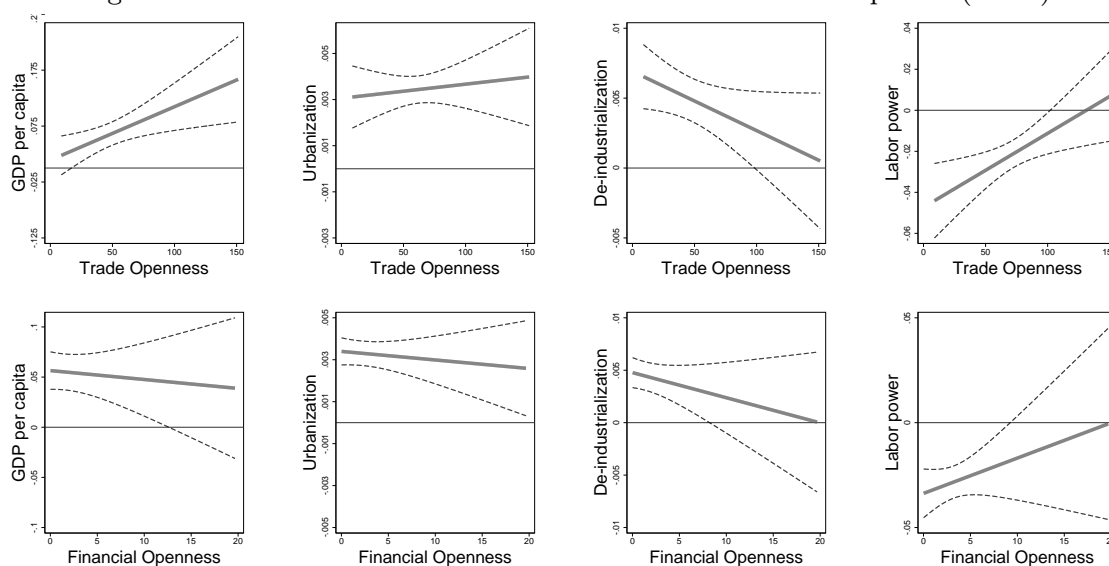
Figure 5.3: Welfare States in Developing Countries: Explored Routes

A Linkage 1: Democracy's conditional effects on globalization (HY 1)
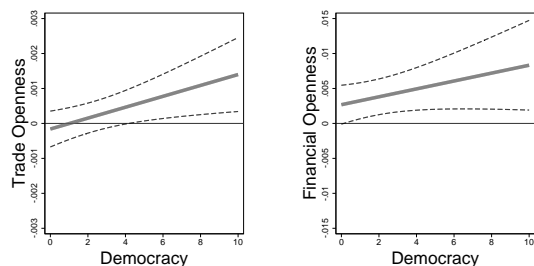
B Linkage 2: Globalization's conditional effects on economic development (HY 2)

democracy, trade openness does not have any influence on social welfare spending. However, beyond a democracy score of 4, trade openness begins to positively influence welfare states and is statistically significant at .05 level. The positive conditional effect of democracy on financial globalization is also evident for composite measures of financial openness. Interestingly, financial openness has positive and statistically significant influences on social welfare spending even without a democratic government in place.

The argument raised by Rudra (2002) that economic globalization negatively conditions the effect of labor power on social welfare provisions in developing countries,

however, is not supported by these results. As can be identified in the sub-figures in the last column in Figure 5.3 B, economic globalization has positive conditional effects on the potential labor power for social welfare spending (Linkage 2). Although both trade and financial openness do not cause the potential labor power to have positive and statistically significant influences on social welfare spending, it at least neutralizes the negative influences of it as both measures increase. Concerning the conditional effects of globalization on other aspects of economic development, there are mixed results. On the one hand, trade openness has positive and statistically significant conditional impacts on both GDP per capita and urbanization. On the other hand, while trade openness has a negative and statistical significant influence on de-industrialization, financial openness has consistently negative and statistically significant conditional effects on GDP per capita, urbanization, and de-industrialization. These results imply that Rudra's (2002) arguments can be more broadly applied to the process of economic development. Individuals who are experiencing anxieties through economic development are disturbed in their collective actions when they are also experiencing other anxieties coming from market globalization.

The hypothesis 3 about the conditional effect of political development on economic development for welfare states is partly supported by the results. In Figure 5.4 A (Linkage 3), we can see that the marginal effects of both urbanization and de-industrialization increase as democracy sores increase. However, we cannot identify the same effect for GDP per capita while having the exact opposite result for potential labor power. As democracy strengthens, the effect of both urbanization and de-industrialization on social welfare spending increases while the effect of labor power decreases. The result is in line with the argument that in advanced countries workers had not been successfully mobilized to empower left-governments even when they possessed the political rights to participate in politics (Przeworski and Sprague 1986). In other words, labor in developing countries has severe collective action problems to

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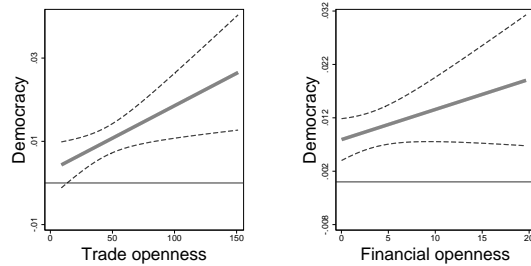Figure 5.4: Welfare States in Developing Countries: Unexplored Routes I

A Linkage 3: Democracy's conditional effects on economic development (HY 3)
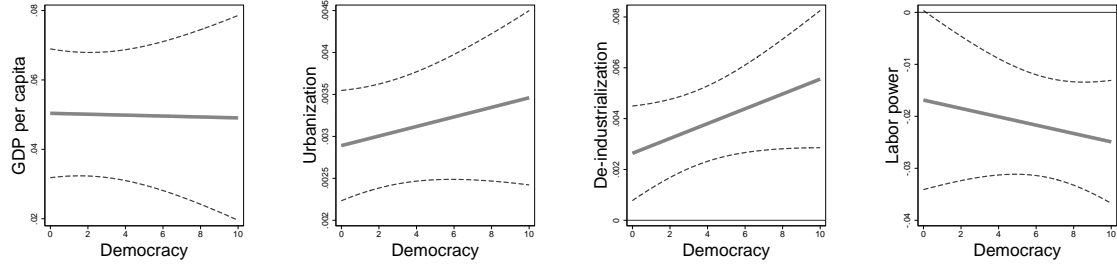
B Linkage 4: Economic Development's conditional effects on Democracy (HY 4)
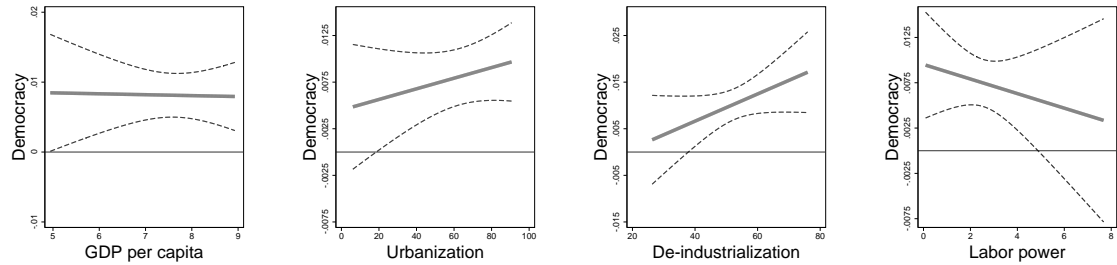
C Linkage 5: Globalization's conditional effects on democracy (HY 5)

push governments for their own right even in democracies. In a sense, the conflicting conditional influences of democracy over different measures of economic development explain why marginal effects of GDP per capital are not affected by the political development process.

The results presented in the remaining section of Figure 5.4 provide strong evidence for both hypothesis 4 and hypothesis 5 about the conditional effects of both economic development and globalization on democracy for welfare states. In Figure 5.4 B, we can see that the marginal effects of democracy increase as both urbaniza-

Figure 5.5: Welfare States in Developing Countries: Unexplored Routes II

Linkage 6: Economic Development's conditional effects on globalization (HY 6)
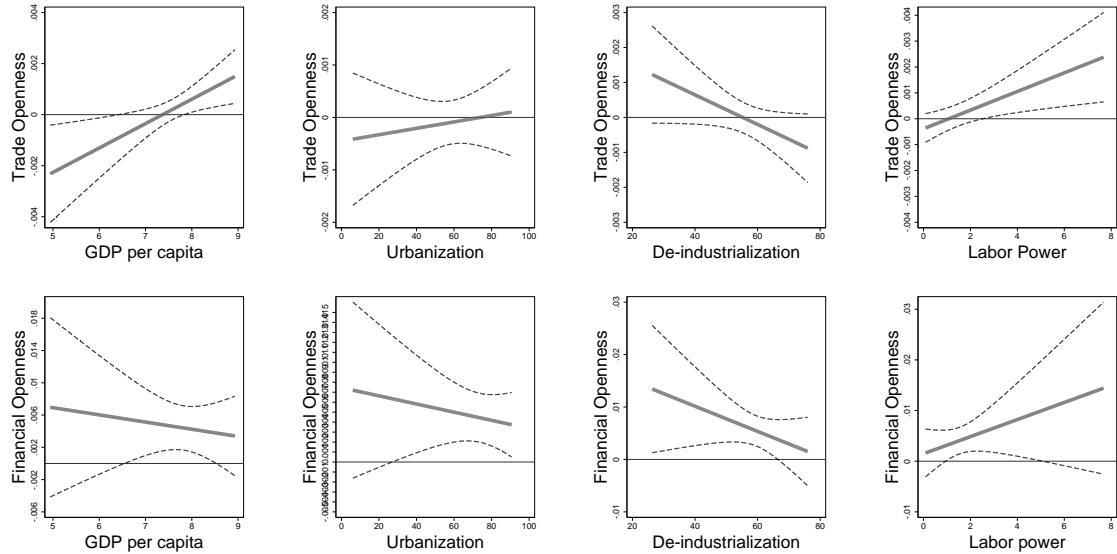
tion and de-industrialization increase. Interestingly again, the potential labor power
dampens the positive influences of democracy for social welfare provisions. In Figure
5.4 C (Linkage 5), there is even stronger and more consistent evidence for the posi-
tive conditional effect of globalization on democracy. As globalization strengthens—as
measured by either trade openness or financial openness—the effect of democracy on
social welfare spending increases.

The evidence for hypothesis 6 is somewhat interesting. In Figure 5.5, GDP per
capita positively conditions the effects of trade openness for social welfare spending.
However, we see that other indicators of economic development—both urbanization
and de-industrialization—do not have statistically meaningful conditional effects on
trade openness. Financial openness, on the other hand, is negatively conditioned
by different measures of economic development as presented in the first three sub-
figures in the bottom row of Figure 5.5. Economic development dampens the positive
influences of financial openness on social welfare spending. Lastly, the effect of both

trade and financial openness increases as the potential labor power becomes stronger.

As for control variables, it is interesting that alongside democracy, age dependency stands out as having positive and statistically significant influences on government welfare efforts across different model specifications in Table 1 and Table 2. However, the other control variables, both external debt and economic growth, do not reach any statistical significance at the conventional level.

5.6   FDI and Welfare States in Developing Countries

Having a complicated web of interactions among pillars of welfare state tripod, there is an important question to ask with respect to the focal point of my dissertation. How does FDI fit into the web for developing countries? Does the argument that FDI works for welfare states still hold in the developing countries? If it is, how does FDI, as an important aspect of globalization, interact with the pillars of the welfare state tripod in explaining the expansion of social welfare spending? I argue that even if we consider a radically different context of the developing world, FDI still works for welfare states while working with other contextual factors either directly and indirectly.

In Table 5.2, Model 6 expands the baseline model (Model 1 in Table 5.1) by adding both FDI inflows and FDI outflows. The results provide strong evidence of my argument that in the sub-sample of developing countries, FDI inflows have positive and statistically significant influences on social welfare spending. Regarding interactions with other two contextual variables, both political and economic development, an interesting picture arises as was presented in Figure 5.6. First, hypothesis 1 still holds for FDI inflows (Figure 5.6 B). As political development furthers, the effects of FDI inflows on social welfare spending increases. Note that although FDI does not work for welfare states without democracy, it does not require a high score in

the democracy variable in order to allow FDI to stimulate social welfare spending in developing countries. This occurs around democracy score of 3, beyond which FDI inflows have positive and statistically significant influences on social welfare spending. At the same time, there is also strong evidence for hypothesis 5 that predicts the positive conditional effect of globalization on democracy with respect to FDI in Figure 5.6 C.

Second, in Figure 5.6 A, we can identify mostly counter-evidence for hypothesis 2 with respect to FDI inflows. There are positive conditional effects of FDI inflows on various indicators of economic development. As FDI inflows increase, the marginal effects of GDP per capita, urbanization and de-industrialization also increases. At the same time, however, it takes negative and statistically significant conditional influences on the potential labor power for social welfare spending. These are radically different results from what we have in Table 5.3 with respect to composite measures of economic globalization. Concerning the role of FDI inflows in linkage 6 about the conditional effect of economic development on globalization for welfare states, both GDP per capita and urbanization do not have any conditional influences on FDI. However, while de-industrialization positively conditions the effect of FDI on welfare states, the potential labor power has the exact opposite influences.

5.7 Discussion

In this chapter, I provided an empirical analysis concerning the expansion of social welfare spending in developing countries. In doing so, I was particularly interested in three important contextual factors, which have been widely recognized but rarely studied together in the literature of welfare states: economic development, political development, and economic globalization. While controlling for other arguments, each school of thought for welfare state development does receive strong empirical

Figure 5.6: FDI and Routes to Welfare States in Developing Countries
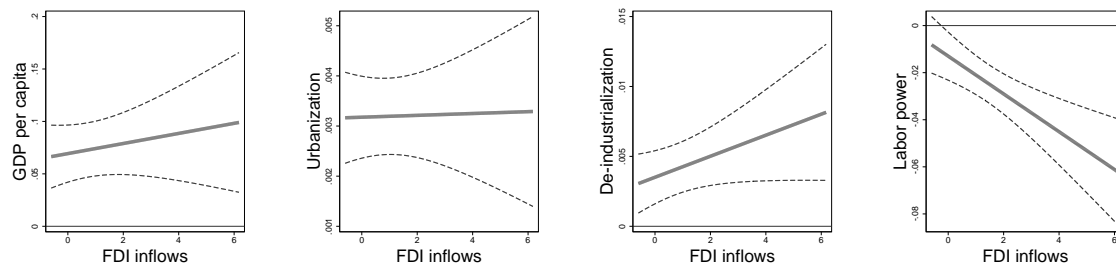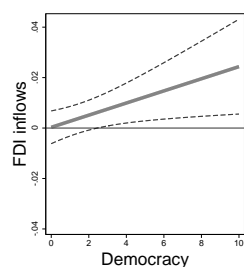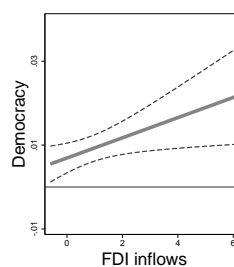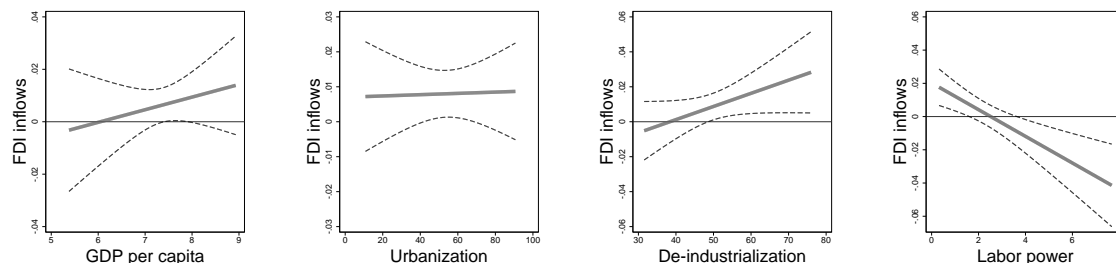
evidence. Democratization, economic development and ensuing social transformation and market internationalization have independent positive influences on a government's social welfare efforts in a strictly defined set of developing countries. Interestingly, globalization works for welfare states not through trade openness, which is a widely recognized measure of economic globalization, but through financial openness.

Regarding the inter-relationships among these contextual factors, we can make several interesting conclusions. First, political development stands out as one of the most important determinants for welfare state development in the developing world.

Not only does it directly increase the amount of welfare efforts, but also it intensifies the effect of economic anxieties, both internal or external, to push governments towards welfare states (Linkage 1 & 3). In other words, if the economic need works for the growth of welfare states, the effect will be stronger in a democratic country, in which political leaders face both open competition for recruitment and constraints on the exercise of executive power, and in which individual citizens enjoy competitive political participation. Demand for social welfare is amplified in a democracy. At the same time, if democracy has an independent effect on the growth of welfare states, the supply-side function is also magnified as demand for social welfare increases (Linkage 4 & 5). Supply of social welfare is also amplified by demand for social welfare in democracy.

Second, when two sources of economic anxieties collide, we cannot say that the collision has a synergistic effect on the growth of welfare states in developing countries. For Linkage 2, trade openness positively conditions economic development while financial openness has the exact opposite conditional effects. A similar pattern also arises for Linkage 6; Economic development intensifies the role of trade through GDP per capita, but dampens that of trade through de-industrialization. At the same time, the effect of financial openness is negatively conditioned by different measures of economic development.

Third, the labor power has a negative and statistically significant influence on governmental welfare efforts, all else being equal. It implies that the collective action problems are severe for labor in developing countries. In a country with more skilled workers than unskilled and less surplus labor, governments tend to spend less out of their total expenditure on social welfare. Interestingly, economic globalization—both trade and financial openness—works to mitigate the negative effects of labor power for welfare spending. This implies that, contrary to the arguments raised by Rudra (2002), Cameron's (1978) arguments can be applied to the set of developing

countries under consideration: economic globalization works to solve the collective action problems of labor to push for welfare states. However, the results also show that FDI inflows dampen the effect of labor power in pushing for social welfare spending.

Last, having an analysis about how FDI inflows fit into the complex system of interactions between each pillar of the welfare state tripod, we can make several arguments about the potential criticisms discussed earlier. Considering a complex web of interactions between these contextual factors, it is true that welfare state dynamics of developing countries are different than that of developed democracies in the period under consideration. However, when economic globalization pushes governments to spend more on social welfare, neither stable democracy nor a developed market seem to be necessary. First, although it is the case that democracy is an important factor to encourage other factors to work for government social welfare efforts, the evidence suggests that even with lower levels of political development, FDI inflows can work for the expansion of social welfare spending in developing countries. Second, the level of economic development does not have systematic influences on how FDI affects welfare states in developing countries. In part, its conditional effects on FDI inflows depend on how we measure economic globalization. Lastly, the push for welfare states in developing countries does not work in such a way that labor is mobilized for collective rights. Rather, when FDI increases, the power of labor on welfare states is negatively affected.

CHAPTER VI

Conclusion

This dissertation has shown that FDI has conflicting influences on welfare states and that it has interesting consequences on the principle of redistribution. On the one hand, FDI has been a major source of the "globalization dilemma," in which national governments experience increased public demand for social welfare and decreased capabilities to supply it. On the demand side, FDI works *for* welfare states as the ensuing economic insecurity increases demand for social welfare. On the supply side, however, FDI works *against* welfare states because governments will experience reductions in capital taxation as a result of the competitive race to attract and retain production capital. As Bretschger and Hettich (2002) correctly remarks, "the so-called 'efficiency' and 'compensation' hypotheses of globalization are not competing, but rather, both appear to apply at the same time (p.695)."

On the other hand, the conflicting influences of FDI on welfare states distort the principle funding system of social welfare provisions: the *redistribution* of income from the rich to the poor. Faced with the dilemma, governments must secure additional revenues to provide social welfare services. The losses in capital taxation should be balanced by other types of taxation. Among others, governments choose a strategy that is fiscally effective and politically less expensive: that is to rely more on indirect taxation, which is notoriously regressive in its character and is mostly borne out by labor. Thus, under the dilemma of FDI, the very efforts to meet the social demand for social welfare have the potential to make a situation in which lower income earners take on higher tax burdens than high income earners in providing additional revenues for those efforts.

Concerning the influences of FDI on the demand-side function of social welfare spending, I spared additional chapters to defend the potential, but important, criticisms of this causal mechanism. In Chapter 3, I argue that FDI works for welfare states by increasing demand for social welfare. *Economic insecurity* is proposed to be a main source of this demand while conventional wisdom, as most scholars of welfare states agree, suggests that economic disadvantage is a strong determinant of such demand. Thus, in Chapter 2, I examined how important economic insecurity is in generating demand for welfare states along with economic disadvantage. An empirical analysis of the synthetic model of both disadvantage and insecurity provides interesting insights.

Economic insecurity is an important determinant of demand for social welfare, as much so as economic disadvantage. Controlling for economic disadvantage, defined either by income level or social class identification, those who are economically insecure are more likely to believe that income should be equality distributed across society and that governments should take more active responsibility to provide for individual needs. We arrive at in the same conclusion even if we allow the potential overlap between economic disadvantage and insecurity. Interestingly, however, level of income strengthens the positive influence of these economic needs on social welfare demand while also encouraging individuals to be politically active. Given the well-known fact that MNCs pay above-average wages and that it is effective to increase economic insecurity in a society, the results suggest that FDI works to generate demand for social welfare, which is economically and politically relevant to push governments to spend more on social welfare.

In Chapter 5, I also defend another important criticism of the mechanism about how FDI affects the demand-side function of social welfare provisions. In explaining variations in social welfare spending in relation to economic globalization, the analysis should consider the radically different contextual factors of developing countries

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seriously. Among others, these countries lack two important foundations upon which the modern welfare stats had been established in affluent democracies in the postwar period: certain levels of both economic and political development. In other words, an analysis of welfare states could not be done in a sample that includes both developed and developing countries. Social spending of the former could not be equivalent to that of the latter. Thus, it might be reasonable to assume that in the developing country sub-sample, we might not arrive at the same conclusion we have in Chapter 3 through every countries.

This criticism does have some empirical evidence in Chapter 5. The three important contextual factors—globalization, modernization and democratization, which vary in a meaningful way in developing countries—have strong and positive influences on social welfare spending. At the same time, considering a complex web of interactions between these contextual factors, it is true that the welfare state dynamics of developing countries are different than those of developed democracies in the period under consideration. However, when economic globalization pushes governments to spend more on social welfare, neither a stable democracy nor a developed market seem to be necessary. In particular, we can make the same conclusion in regards to how FDI affects developing countries' social welfare efforts. Although the level of political development does strengthen the impact of FDI on social welfare spending, it does not require a government that is fully democratic. At the same time, the level of economic development does not have systematic influences on how FDI affects welfare states in developing countries.

My dissertation contributes to the literature on welfare states in several important ways. First, it is the first attempt to place FDI at the center of the analysis explaining social welfare spending with a global perspective. In understanding the relationship between economic globalization and welfare states, most attention has been paid to the international trade of goods and services. While a sparse attention has been

paid to other aspects of globalization, FDI is only treated as something to control in order to single out causal mechanisms under consideration. For the first time, my dissertation theorizes and tests a model explaining how multinational corporations affect government effort for the provision of social welfare. Second, it also provides a balanced explanation of how FDI affects welfare states. In many cases, it is implied that the persistence of welfare states in an age of globalization automatically belies the argument of welfare state retrenchment. Given the focus on trade, however, the argument that trade works *for* welfare states is incorrectly used to combat the argument that capital mobility works *against* welfare states. With a focus on FDI, which has great bearing on both the demand- and supply-side functions of social welfare, my dissertation addresses this analytic misstep.

Lastly, in theorizing and testing hypotheses about how FDI affects both the demand and supply of social welfare, my dissertation bridges the literature of welfare states with two distinctive bodies of literature: the literature of both multinational corporations and tax competition. I do not mean to say that there is no single study that spans this literature; instead, I believe that in the study of welfare states, discussions including both multinational corporations and tax competition have been limited. Given the importance of both market competition through FDI and inter-governmental competition for FDI over the system of social welfare provision, it cannot be emphasized enough that studies of welfare states should consult with this literature more thoroughly in order to deepen our understanding of this topic.

APPENDIX

Table A.1: Chapter 2: List of Countries and Years Included

Country	Year(s)	Country	Year(s)
Albania	1998 2002	Kazakhstan	2003
Argentina	1991 1995 1999 2006	Korea	1990, 1996, 2001, 2005
Armenia	1997	Latvia	1991^E, 1996, 1999^E
Australia	1981, 1995, 2005	Lithuania	1991^E, 1997, 1999^E
Austria	1990^E, 1999^E	Luxembourg	1999
Azerbaijan	1997	Macedonia	1998, 2001
Belarus	1991, 1996, 2000^E	Malaysia	2006
Belgium	1981^E, 1990^E, 1999^E	Mexico	1990, 1996, 2000, 2005
Bosnia	1998, 2001	Moldova	1996, 2002, 2006
Brazil	1991, 1997, 2006	Morocco	2001, 2007
Bulgaria	1991^E, 1997, 1999^E, 2006	Netherlands	1981^E, 1990^E, 1999^E, 2006
Canada	1982^E, 1990^E, 2000, 2006	New Zealand	1998, 2004
Chile	1990, 1996, 2000, 2005	Norway	1982^E, 1990^E, 1996, 2008
China	1990, 1995, 2001, 2007	Pakistan	1997, 2001
Colombia	1997, 1998, 2005	Peru	1996, 2001, 2008
Croatia	1996, 1999 ^{E}	Philippines	1996, 2001
Czech Republic	1990, 1991^E, 1998, 1999^E	Poland	1989, 1990^E, 1997, 1999^E, 2005
Denmark	1981^E, 1990^E, 1999^E	Portugal	1990^E, 1999^E
Dominican Rep.	1996	Romania	1993^E, 1998, 1999^E, 2005
Egypt	2000, 2008	Russia	1990, 1995, 1999^E, 2006
El Salvador	1999	Slovakia	1990, 1991^E, 1998, 1999^E
Finland	1990^E, 1996, 2000^E, 2005	Slovenia	1992^E, 1995, 1999^E, 2005
France	1981^E, 1990^E, 1999^E, 2006	South Africa	1990, 1996, 2001, 2007
Georgia	1996, 2008	Spain	1981^E, $1990^{(E)}$,
Germany	1981^E, 1990^E, 1997, 1999^E, 2006		1995, 1999^E, 2000, 2007
Greece	1999^E	Sweden	1982^E, 1990^E, 1996, $1999^{(E)}$, 2006
Guatemala	2005	Switzerland	1989, 1996, 2007
Hungary	1991^E, 1998, 1999^E	Thailand	2007
India	1990, 1995, 2001, 2006	Turkey	1990, 1996, 2001^E, 2001, 2007
Ireland	1981^E, 1990^E, 1999^E	Ukraine	1996, 1999^E, 2006
Israel	2001	UK	1981^E, 1990^E, 1988, 1999^E, 2006
Italy	1981^E, 1990^E, 1999^E, 2005	US	1982^E, 1990^E, 1995, 1999, 2006
Japan	1990, 1995, 2000, 2005	Uruguay	1996, 2006
Jordan	2001, 2007	Vietnam	2001, 2006

^{E} European Value Surveys. Others are for WVS.

Table A.2: Chapter 2: Summary Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
Egalitarianism	212412	5.109	3.002	1	10
Government responsibility	222077	5.849	3.001	1	10
Political activism	249405	1.136	1.959	0	10
Lower Class	249405	.481	.5	0	1
Subjective insecurity	249405	.508	.5	0	1
Income	217828	4.793	2.47	1	11
Age	249405	38.107	12.962	15	64
Education	187670	4.626	2.244	1	8
Union membership	249405	.522	.5	0	1
Married	249405	.648	.478	0	1
Employed	249405	.593	.491	0	1
Union membership	249405	.077	.267	0	1
Political Ideology	184488	5.526	2.234	1	10
Advanced countries	249405	.295	.456	0	1
Democracy	249405	.797	.402	0	1

Table A.3: Chapter 3: Summary Statistics I, TSCS

Variable	Obs	Mean	Std. Dev.	Min	Max
Govt consumption (WDI)	1553	13.308	5.251	1.64	36.11
FDI inflow (UNCTAD)	2954	1.993	3.556	-15.643	47.031
FDI outflow (UNCTAD)	2830	.74	2.339	-4.257	48.057
Trade (WDI)	2690	63.19	34.672	.309	220
Import (WDI)	2690	33.326	18.405	0	109
Export (WDI)	2690	29.863	17.751	.183	121
Growth (WDI)	2701	3.985	4.857	-15	89
GDP (WDI)	2713	24.83	1.94	20.568	30.248
GDP per capita (WDI)	2712	8.187	1.562	4.977	11.124
Democracy (Polity IV)	2941	2.823	7.319	-10	10
Urbanization (WDI)	2978	54.658	22.651	3.96	97.5
De-industrialization (WDI)	2237	52.367	12.803	15.9	79.9
Dependency ratio (WDI)	2978	12.633	6.698	3.22	32.1
Capital mobility (Chinn and Ito 2006)	2621	.462	.363	0	1
Unemployment rate (WDI)	1534	8.901	5.561	.2	37.3

Table A.4: Chapter 3: Summary Statistics II, CS

Variable	Obs	Mean	Std. Dev.	Min	Max
Government consumption	89	13.4	4.963	2.984	24.862
FDI mobility	93	-1.123	1.269	-5.558	1.93
Trade	92	68.479	31.282	9.389	154.679
Export	92	32.056	15.813	3.601	80.521
Import	92	36.42	16.885	5.778	77.493
Growth	92	3.987	2.483	-6.054	16.365
GDP	91	24.609	1.904	21.164	29.681
GDP per capita	91	8.112	1.499	5.451	10.795
Democracy	93	2.662	5.984	-9	10
Urbanization	93	54.446	21.304	9.1	96.024
De-industrialization	88	50.071	15.991	11.1	74.918
Dependency ratio	93	12.992	6.47	4.466	25.892
Capital Mobility	90	.461	.296	.013	1
Unemployment rate	92	8.895	5.338	1.518	33.767

Table A.5: Chapter 3: List of Countries

Albania, Angola, Argentina, Armenia, Australia, Austria, Azerbaijan, Bangladesh, Belarus, Belgium, Bolivia, Bosnia and Herzegovina, Brazil, Bulgaria, Cambodia, Canada, Chile, China, Colombia, Costa Rica, Croatia, Czech Republic, Czechoslovakia, Democratic Republic of Congo, Denmark, Ecuador, Egypt, El Salvador, Finland, France, Georgia, Germany, Greece, Guatemala, Hungary, India, Indonesia, Ireland, Israel, Italy, Japan, Jordan, Kazakhstan, Kenya, Kyrgyz Republic, Laos, Latvia, Lebanon, Lithuania, Macedonia, Malaysia, Mexico, Moldova, Morocco, Myanmar, Nepal, Netherlands, New Zealand, Niger, Norway, Pakistan, Panama, Paraguay, Peru, Philippines, Poland, Portugal, Romania, Russia, Serbia and Montenegro, Slovak Republic, Slovenia, South Africa, South Korea, Spain, Sri Lanka, Sweden, Switzerland,Syria, Tajikistan, Tanzania, Thailand, Tunisia, Turkey, Turkmenistan, Ukraine, United Kingdom, United States, Uruguay, Uzbekistan, Yemen, Yemen People's Republic, Zimbabwe

Table A.6: Chapter 4: List of Countries by Region

Western countries	Latin America	East and South Asia
Australia	Argentina	Bangladesh
Austria	Bolivia	Cambodia
Belgium	Brazil	China
Canada	Chile	India
Denmark	Colombia	Indonesia
Finland	Costa Rica	Laos
France	Ecuador	Malaysia
Germany	El Salvador	Myanmar
Ireland	Guatemala	Nepal
Italy	Mexico	Pakistan
Japan	Panama	Philippines
Netherlands	Paraguay	South Korea
New Zealand	Peru	Sri Lanka
Norway	Uruguay	Thailand
Portugal		
Spain		
Sweden		
Switzerland		
United Kingdom		
United States		

Central and Western Asia	East and south Europe	Africa
Armenia	Albania	Angola
Azerbaijan	Belarus	Dem. Rep. of Congo
Georgia	Bosnia and Herzegovina	Egypt
Israel	Bulgaria	Kenya
Jordan	Croatia	Morocco
Kazakhstan	Czech Republic	Niger
Kyrgyz Republic	Czechoslovakia	South Africa
Lebanon	Greece	Tanzania
Syria	Hungary	Tunisia
Tajikistan	Latvia	Zimbabwe
Turkey	Lithuania	
Turkmenistan	Macedonia	
Uzbekistan	Moldova	
Yemen	Poland	
Yemen People's Republic	Romania	
	Russia	
	Serbia and Montenegro	
	Slovak Republic	
	Slovenia	
	Ukraine	

Table A.7: Chapter 4: Summary Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
Tax revenue/GDP (WDI)	912	16.32	6.084	.78	39.7
Capital taxation	602	13.426	6.464	.9	42.698
Regressive taxation	797	42.809	13.945	.671	87.146
FDI pressure	2210	.264	2.827	-31.151	24.717
FDI inflow/GDP	2954	1.993	3.556	-15.643	47.031
FDI outflow/GDP	2830	.74	2.339	-4.257	48.057
Capital mobility	2621	.462	.363	0	1
Trade	2690	63.19	34.672	.309	220
GDP	2713	24.83	1.94	20.568	30.248
GDP per capita	2712	8.187	1.562	4.977	11.124
Growth	2701	3.985	4.857	-15	89
Government consumption (PWT)	2735	.251	.279	.009	2.569
Polity IV	2941	2.823	7.319	-10	10
Region	2978	3.822	1.685	1	6
Year	2978	1989.826	10.957	1970	2007

Table A.8: Chapter 5: List of Countries

Argentina, Bangladesh, Bolivia, Brazil, Chile, China, Colombia, Costa Rica, Dominican Republic, Ecuador, Egypt, El Salvador, Greece, Guatemala, India, Indonesia, Israel, Jordan, Kenya, South Korea, Mauritius, Mexico, Morocco, Nepal, Pakistan, Paraguay, Peru, Philippines, South Africa, Sri Lanka, Syrian Arab Republic, Thailand, Tunisia, Turkey, Uruguay, Zimbabwe
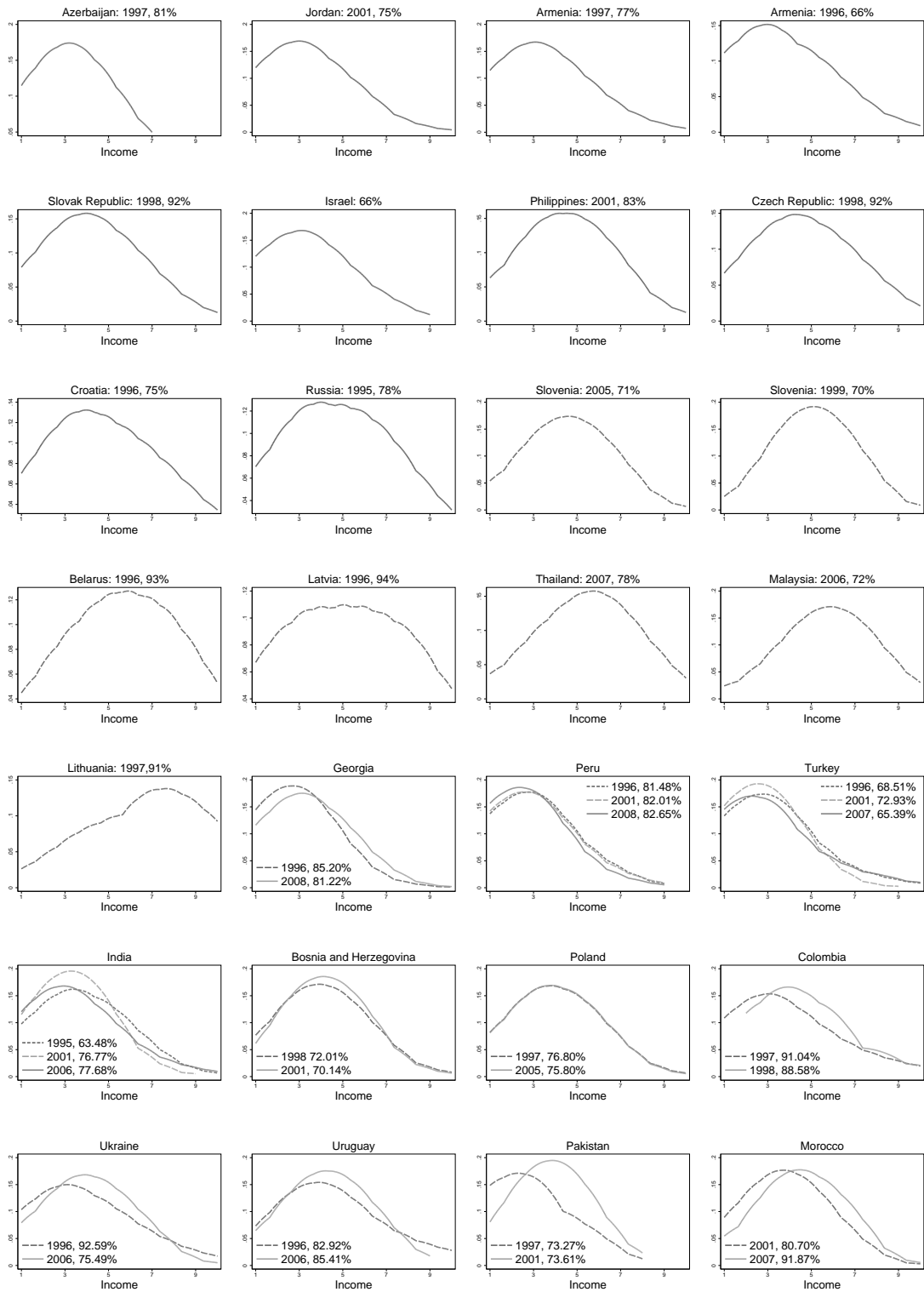
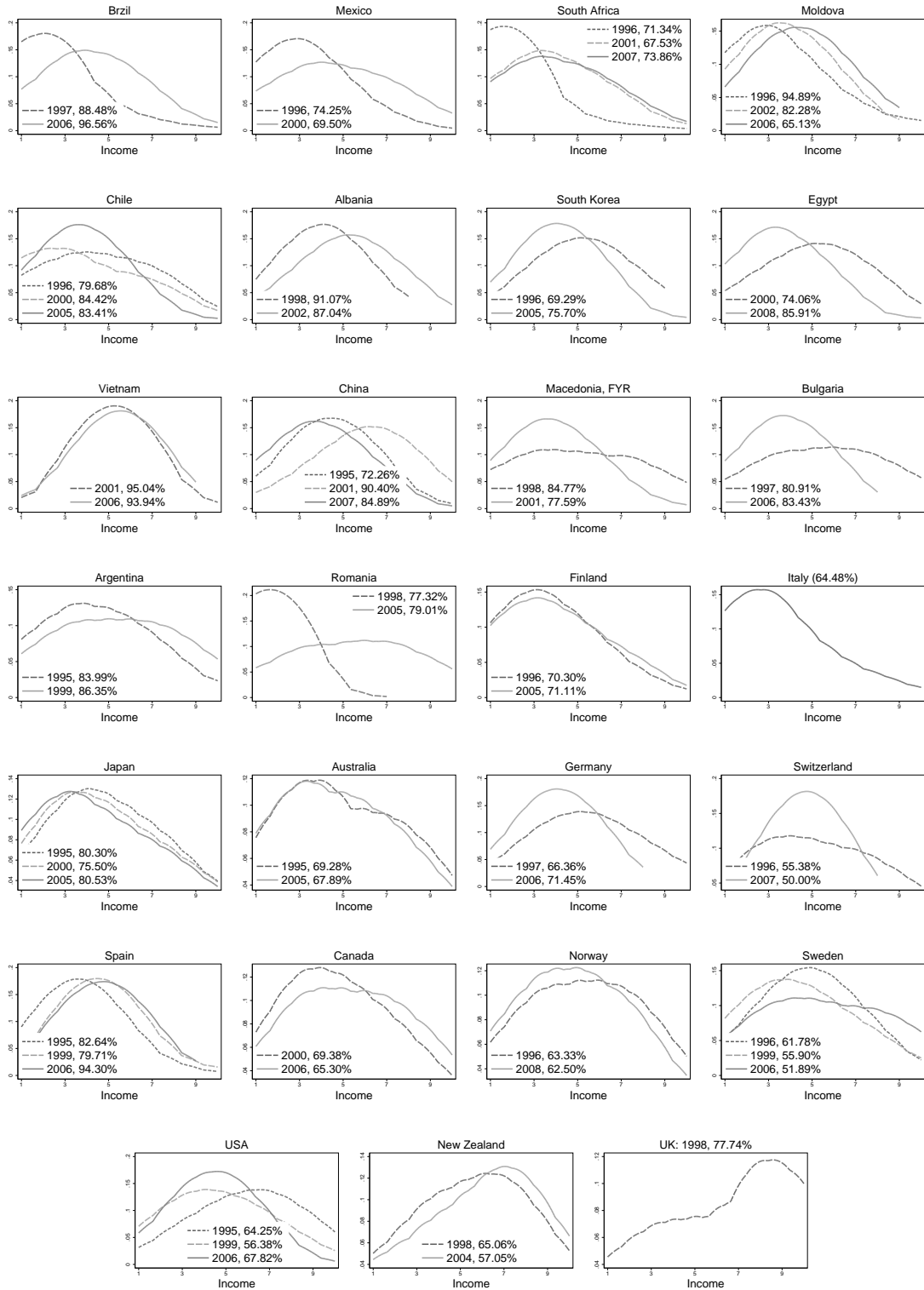Figure A.1: Lower Class Income Distribution

Figure A.1: Continue

Note: Density plots are are weighted by N=1,000 for working age population (17-68).
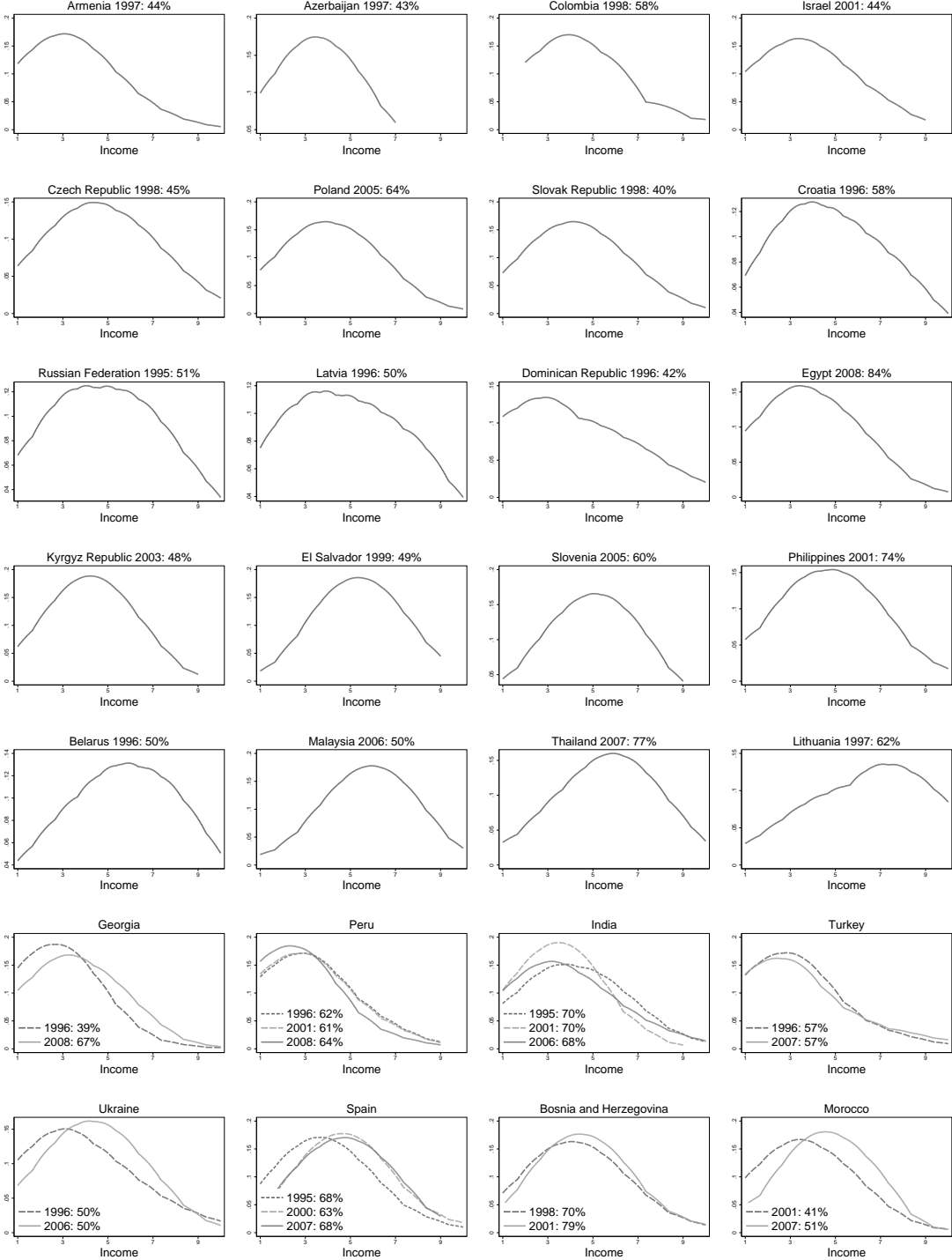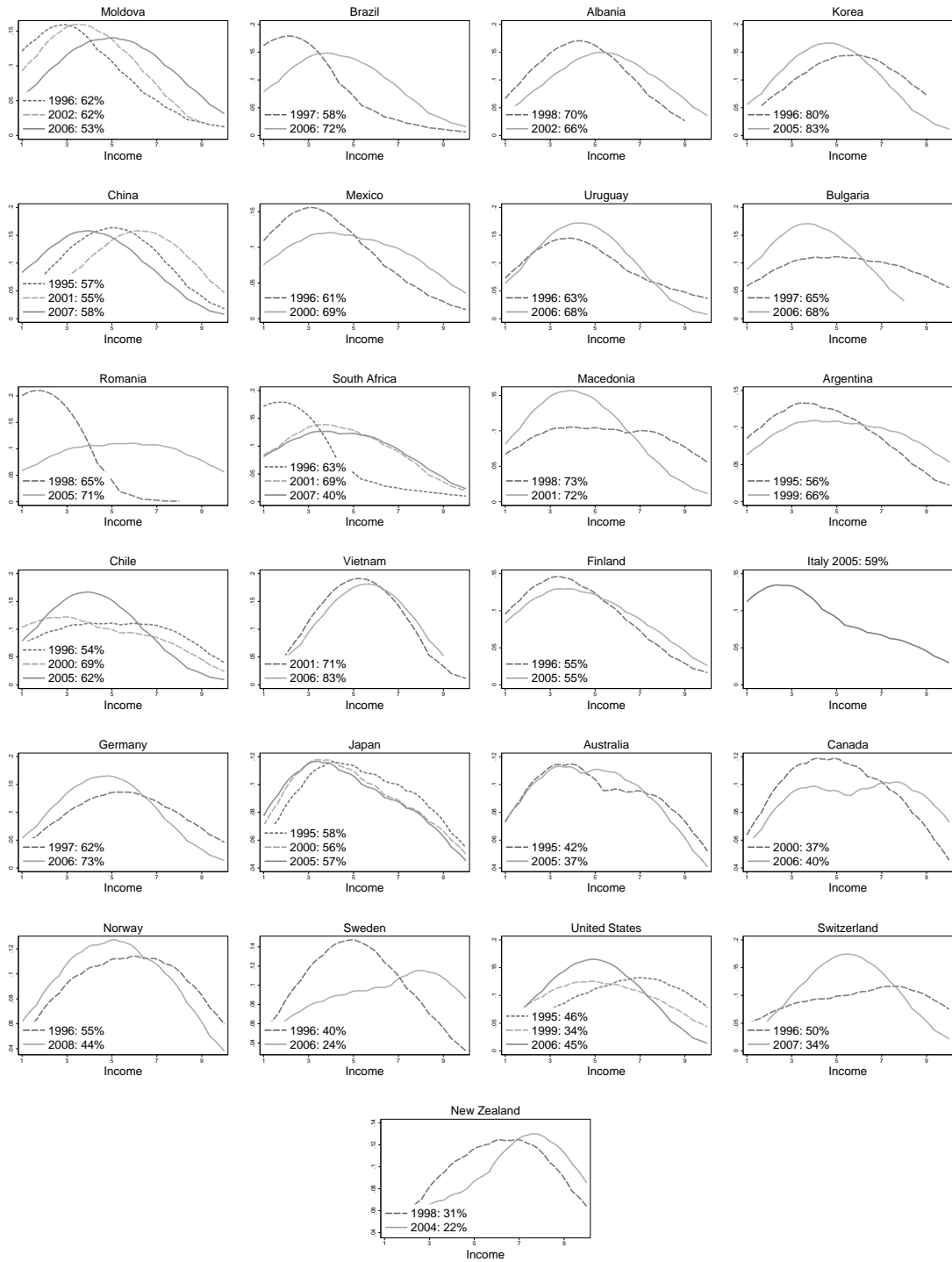Source: WVS

Figure A.2: Economic Insecurity Income Distribution

Figure A.2: Continue

Note: Density plots are are weighted by N=1,000 for working age population (17-68).
Source: WVS

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Table A.9: Chapter 5: Summary statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
Social Welfare Spending/Tax revenue	728	.077	.049	.002	.255
GDP per capita	906	7.254	1.088	4.859	9.802
Economic Growth	904	4.483	4.524	-13.974	25.028
PLP	764	1.843	1.735	.09	18.362
Urbanization	917	47.812	21.535	4.32	91.1
De-industrialization	804	49.621	9.111	20.068	75.999
Trade openness	907	50.14	25.537	5.022	151.197
Financial openness	763	2.958	2.714	.023	19.669
Import/GDP	905	27.577	15.199	3.428	97.155
Export/GDP	905	22.69	11.455	2.895	64.181
FDI inflow/GDP	891	.909	1.152	-.879	10.775
FDI outflow/GDP	865	.086	.228	-.946	1.716
External debt	759	47.073	30.445	1.132	253.214
Age dependency	917	4.646	2.349	2.486	15.787
Democracy	899	4.049	3.895	0	10

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