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Abstract:

Increased economic integration is widely held to restrict national political autonomy in many areas, among them the choice of social expenditures. An extreme view takes the argument one step further, arguing that integration/globalization reduces national governments to passive reactors in a forced "race to the bottom" eviscerating national social welfare systems. The paper analyzes the evidence on the linkage between integration and social expenditure choices, focusing on the case of the EU from 1980-1997, a period including a sharp reduction in mobility barriers through the Single Market Act.

The evidence unambiguously rejects a simple race to the bottom; indeed, average social spending levels, expressed as a share of GDP or in real terms, have risen in most EU members over the last two decades. The evidence does however suggest a more general convergence trend towards an intermediate social expenditure share. Specifically, the variability of social expenditure patterns across the EU member states has markedly declined over the last two decades; while the social expenditure share in 1980 is significantly negatively correlated with the subsequent change in social expenditure shares from 1980 to 1997.

To the extent that the policy decisions underlying this convergence trend reflect concerns about location choices of mobile factors the findings are consistent with the existence of effective tensions between globalization and national political autonomy emphasized in the literature, but suggest that such tensions are resolved through convergence to an intermediate level of social expenditures rather than a race to the bottom.

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Keywords:

Globalization, Race to the Bottom, Convergence, Welfare Systems

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1. Introduction

“The proprietor of stock is properly a citizen of the world, and is not necessarily attached to any particular country. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed a burdensome tax, and would remove his stock to some other country where he could either carry on his business, or enjoy his fortune more at ease.” (Adam Smith)

“Europe can have the social charter. We shall have employment. ... Let Jacques Delors accuse us of creating a paradise for foreign investors; I am happy to plead guilty” (John Mayor)¹

Modern social expenditure systems, shaped during an era of limited capital and labor mobility [Simon (1938), Tanzi (1996)], largely reflect national preferences. Little attention was paid – or needed to be paid – to potential endogenous location choices of firms and workers in response to international differences in tax rates and benefits.

Over the last decades, mobility barriers have fallen, particularly for skilled labor and capital. The increase in potential mobility raises the question whether the large differences in social expenditure shares resulting from these national choices (and the associated differences in tax rates) will trigger labor and capital relocation responses of sufficient magnitude to significantly influence the cost-benefit calculus of social policy setting.

The nature of these constraints, and the potential avenues towards their resolution lies at the heart of an extensive and lively literature spanning the fields of political science, economics and international relations, and are widely perceived to constitute a crucial issue for the political economy of economic integration.²

On one end of the spectrum, the location endogeneity is argued to be sufficiently important to impose prohibitive costs on any upward divergence in expenditure and taxation patterns from the lowest standards. As footloose firms and, increasingly, highly educated professionals choose among locations, the system competition in this view leads to a dismantling of the more generous welfare systems in an inexorable “race to the bottom”.

The validity of the prediction rests on three testable assumptions. First, are location choices of mobile labor and capital indeed responsive to differences in social expenditure patterns and in the associated taxes? Second, if so, does mobile labor and capital choose the systems with the lowest social expenditure patterns? Third, if the answer to the first two questions is affirmative, do governments in fact respond to such pressures, and, if so, responds by changing the social expenditure patterns rather than imposing barriers to movements of mobile factors?

Sizable literatures address each of these questions. The tenor of findings, taken together, suggests that the removal of mobility barriers indeed constrains national sovereignty in setting social expenditures, but that the constraints are sufficiently moderate to rule out extreme scenarios such as the wholesale evisceration of social systems envisaged by the race to the bottom scenario.

Empirical studies of foreign direct investment point to a complex set of considerations influencing location choice, including the state of the social and physical infrastructure, the skill mix and wage level of the local work force as well as political and social stability. While higher corporate tax rates act as a deterrent, they are rarely a decisive unconditional determinant.³ Migration studies similarly identify a host of determinants of relocation choices, including linguistic and cultural factors, in addition to after-tax income. While anecdotes – ranging from Astrid Lindgren's criticism of the Swedish taxation system to the popularity of a Monaco residence for sport stars – reveal that tax concerns do play a role for high-income individuals, there is little evidence to suggest that tax differences, rather than income differences, are a main driving force for large-scale migration, nor that differences in benefits have resulted in large-scale “welfare tourism”.

On a more fundamental level, it is far from evident that the responsiveness of capital to social expenditures and the associated tax rates reflects an undifferentiated “small is beautiful” perspective. Many of the location benefits cited by firms in surveys derive directly from social and other expenditures. This is most

¹ Quoted in Rodrik (1997: 39).

² See in particular Pierson (1994), Cerny (1995), Garrett and Lange (1995), Frieden and Rogowski (1996), Rodrik (1997a), Garrett (1998), Keohane and Milner (1996) and Swank (2002), *inter alia*.

³ The pressures on taxation generated by location competition are explored in the literatures on tax competition and harmonization and will not be further explored here. Recent critical overviews are provided by Wilson (1999) and Sorensen (2001). Wildasin (2000) explores the importance of adjustment costs on factor re-location over both space and time.

trivially true for public education creating the sine qua non for foreign direct investment - a skilled labor force. It also holds indirectly through the link between the risk-insurance provided by social safety nets, societal stability, ongoing support for economic integration, and individual risk-taking.⁴

These arguments suggest that location choices are endogenous to tax rates, but that, particularly from the perspective of mobile capital, the location with the laxest standards and smallest social programs is unlikely to be the most attractive choice. This suggests a *convergence hypothesis* as an alternative to the race to the bottom view, with downward adjustments of localities with particular extensive social expenditures, but upwards adjustment of localities with particularly restrictive systems, both defined conditionally to the development stage and other country-specific determinants. In addition to the *cost convergence*, system competition may furthermore lead to (much harder to test) *quality convergence* as mobile factors may reward localities providing a given level of services in the most cost-efficient manner.

Both the pessimistic view of a race to the bottom and the optimistic view of a race to the cost-effective interior optimum are extremes. They are however helpful in defining the debate and in identifying testable implications. This paper takes a closer empirical look at the third question raised above by exploring the evolution of social expenditure patterns in the European Union over the years 1980 to 1997, a period that includes, with the Single European Act, a discrete decrease in mobility barriers.

The paper seeks to answer two questions. First, and fairly trivial, has there been an emasculation of social spending over the period? The unsurprising answer is no, evident from even a cursory look at the data. Social spending over the period has increased, not decreased, both in real terms and as a fraction of GDP. The finding is consistent with a substantial body of earlier evidence suggesting that the constraint on policy imposed by integration is present but muted.⁵

Second, has convergence taken place? The paper presents evidence on two convergence concepts.⁶ *Sigma-convergence* examines whether the cross-section variance of expenditure shares across EU members has declined over time, it is thus a direct test of increasing similarity. *Beta-convergence* examines whether the initial *level* of the expenditure share possesses explanatory power for the subsequent change. Of course, other factors also influence expenditure shares. The β -convergence test allows adding these determinants, the test is thus conditional. Specifically, three other potential determinants of expenditures are included: the change in the old age dependency ratio, the change in the unemployment rate and the initial level and change in the trade openness ratio. The first two controls capture changes in the size of groups entitled to receive resources under two important components of social spending, the latter aims to capture the argument that greater openness raises the demand for social insurance (Rodrik (1997)). The tests are performed both for aggregate social expenditure, and separately for some of the larger components.

⁴ Aspects of these complex linkages are discussed by Przeworski and Wallerstein (1982), Katzenstein 1985, Alesina and Perotti (1995), Cerny (1995), Sinn (1996), Rodrik (1997), Bird (1998), Garrett (1998) and Swank (2001,2002).

⁵ Recent studies examining aspects of this linkage include Pierson (1996), Clayton and Pontusson (1998), Garrett (1998), Mosley (2000) and Swank (2001, 2002).

⁶ A lively literature addresses the determinants of the choice of more or less extensive social safety nets, and the political economy aspects of reform. See for example Garrett (1998), Acemoglu and Robinson (2000), and Milesi-Ferretti, G., Roberto Perotti and M. Rostagno, 2000, Alesina, Glaeser, Sacerdote (2001) and Swank (2001). This paper sidesteps these questions, focusing solely on whether convergence has taken place, irrespective of starting point and the political economy of reform.

2. Data

The period examined, 1980 through 1997, is of particular interest in the integration/ globalization debate. While the European economic integration and harmonization process dates back to the 1950s – the 1958 Treaty of Rome contained the first harmonization statutes on gender-pay equality and workweek harmonization – the Single European Act of 1985 (and to a lesser extent the Social Charter of 1989) entailed a major decreases in de-jure and, judging from empirical studies, in de-facto barriers [Sapir (1996)].⁷ Examining this period thus permits a fairly sharp test of the effect of changes in integration on social expenditure patterns.

The source for the expenditure data is the OECD Social Expenditure Database, 2000 edition, covering the period 1980 to 1997. Countries for which data are not available for 1980, 1990 or 1997 were dropped. The resulting sample includes all fifteen current EU members⁸ and, as a control group, two non-EU European countries (Norway and Switzerland) as well as Australia, Canada, Japan, New Zealand and the United States.

The database distinguishes between thirteen expenditure types.⁹ The primary focus of the paper is on aggregate public and mandatory private expenditure, though the time pattern of the largest components, old age cash benefits, unemployment benefits and health benefits is also examined. To establish comparability across the sample countries, the expenditure data are scaled as a fraction of Gross Domestic Product. The GDP data (in local currency in current prices, matching the social expenditure figures) are taken from the International Monetary Fund International Financial Statistics (IMF-IFS, Series 99b.c). For the stylized facts, the expenditure data are also presented in real terms, using the GDP Deflator, taken from the same source (IMF-IFS, Series 99bi).

The convergence regressions include the change in the old age dependency ratio and the unemployment rate, as well as the initial level and the change of openness as additional controls to allow for structural changes in the demand for social expenditures. The old-age dependency variable, defined as the population aged sixty-five and above relative to the population aged between twenty and sixty-four years, is constructed based on the *World Population Projections* published by the World Bank.¹⁰ The unemployment rate is taken from the IMF International Financial Statistics (IFS) when available, augmented by the United Nations Monthly Bulletin of Statistics, the ILO Yearbook, and the World Bank World Development Indicators 2001.¹¹ The openness variable is constructed as the ratio of the sum of exports and imports in local currency to nominal GDP, all three series are also taken from the IFS.

⁷ The decision process leading to these discrete changes incorporated many of the issues discussed above, striking a compromise between harmonization avoiding undesirable beggar thy neighbor competition and differentiation allowing peripheral regions to offset location disadvantages [EC Commission, 1993].

⁸ Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden and the United Kingdom.

⁹ Old age cash benefits, disability cash benefits, payments for occupational injury and disease, sickness benefits, services for the elderly and disabled people, survivor benefits, family cash benefits, family services, active labor market programs, unemployment benefits, health benefits, housing benefits and other contingencies

¹⁰ Data for 1980, 1985 and 1990 were taken from the 1984, the 1987-88 and the 1994-95 editions, respectively. The 1997 age dependency is approximated by the projected dependency for 2000, also taken from the 1994-95 edition of the *World Population Projections*.

¹¹ For Germany, the 1980 and 1990 unemployment rates are for the former West Germany.

3. Results

Figure 1 and 2 report the level of social expenditures in 1980, 1990 and 1997 for the EU, both as a percentage of GDP (Figure 1) and in real terms (with 1980 set equal to 100). Table 1 reports the averages.

Table 1: Total Social Spending (Fraction of GDP)

	<i>Mean 1980</i>	<i>Mean 1990</i>	<i>Mean 1997</i>	<i>CoV 1980</i>	<i>CoV 1990</i>	<i>CoV 1997</i>
EU-15						
Total	0.220	0.239	0.250	0.253	0.193	0.176
Old Age Cash Benefits	0.064	0.074	0.080	0.257	0.268	0.300
Unemployment	0.013	0.015	0.017	0.984	0.743	0.619
Health	0.059	0.059	0.061	0.230	0.167	0.160
Full Sample						
Total	0.197	0.220	0.234	0.301	0.250	0.220
Old Age Cash Benefits	0.058	0.067	0.073	0.313	0.318	0.343
Unemployment	0.010	0.013	0.014	1.041	0.762	0.674
Health	0.056	0.058	0.061	0.235	0.159	0.138

Mean: As fraction of GDP. CoV: Coefficient of Variation. For unemployment benefits, data are missing for Austria in 1980 and Ireland in 1980. For health benefits, data are missing for Austria in 1980. Old age cash benefits include old age pensions (including civil servants and veterans), other cash benefits and early retirement pensions. Unemployment benefits include unemployment compensation, early retirement for labor market reasons and severance pay.

The figures and the table illustrate that far from declining, social expenditures, measured either as a share of GDP or in real terms have increased in twelve of the fifteen EU members over the period generally viewed as coinciding with a sharp increase in integration. Of the three exceptions to this pattern, Luxembourg and the Netherlands had high initial spending shares, while Ireland occupied a middle position. While the data do not provide support for a wholesale absolute evisceration of the social safety net, it must be born in mind that the figures do not control for the number of eligible claimants, they thus do not provide information about the change in per capita transfers.

The last three columns of Table 1 and Figure 3 provide an initial look at the issue of the first convergence concept (σ -convergence). Table 1 reports the coefficient of variation of the social expenditure share. Under either the race to the bottom or the general convergence hypothesis, increasing integration leads to responses reducing the cross-country dispersion of expenditure shares. This is indeed the case for the total expenditure share, and holds both for the EU members and for the control sample. The table reveals two further interesting features. First, the absolute level of dispersion within the EU is generally lower than for the control sample, consistent with a greater responsiveness of location choices to social expenditure patterns within the internally integrated European Union. Second, considering sub-categories, the feature strongly holds for unemployment benefits applying to economically active individuals and for health benefits applying to all individuals, but not for old age cash benefits applying mainly to economically inactive individuals.

Figure 3 presents the evidence on the second convergence concept (β -convergence), plotting the change in the share of social expenditure in GDP over the period 1980 to 1997 against the level in 1980. Under the convergence hypothesis, a higher initial social expenditure level is associated with lower growth in the share over the subsequent period. The figure indeed displays the implied negative relationship.

Table 2 presents the econometric evidence on β -convergence. The general convergence equation takes the form

$$(1) \Delta S = \alpha + \beta S_0 + X\gamma + \varepsilon$$

where S_0 denotes the initial level of social spending (1980 unless otherwise noted), ΔS denotes the change in social spending between the initial and some future period (1980 to 1997 unless otherwise noted), and X denotes a set of other explanatory variables that may be relevant in determining the evolution of social spending. As discussed above, these comprise the change in the old-age dependency, the change in the unemployment rate and the level and change in the openness ratio. The first two controls capture changes in

the entitlement groups for two important components of social spending, the latter aims to capture the argument that greater openness raises the demand for social insurance (Figure 4).¹²

Figure 1

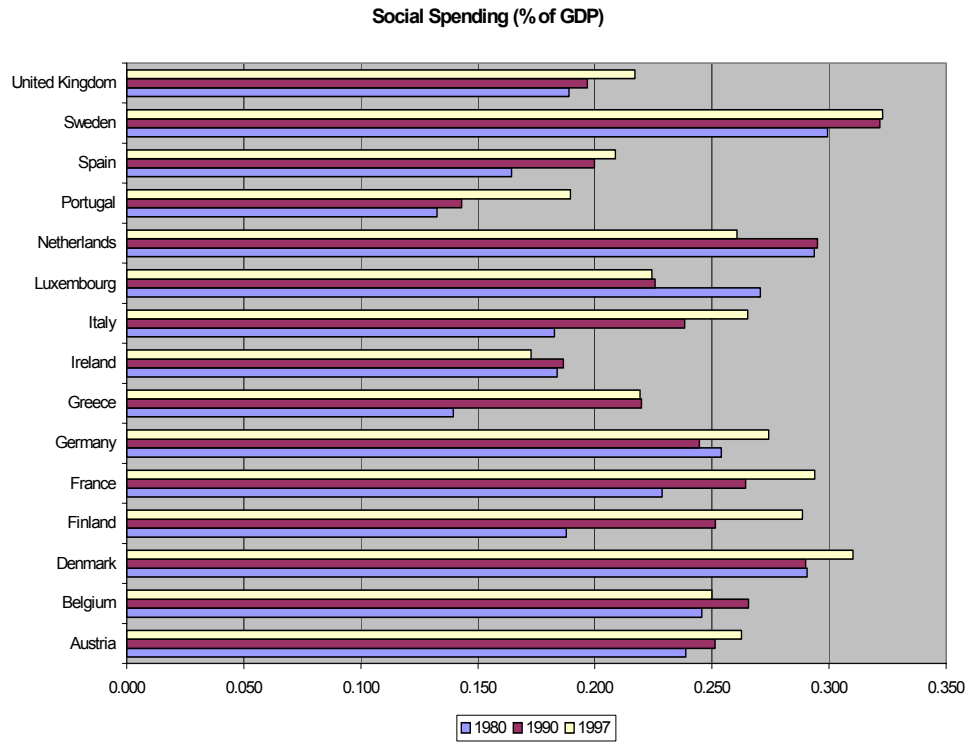
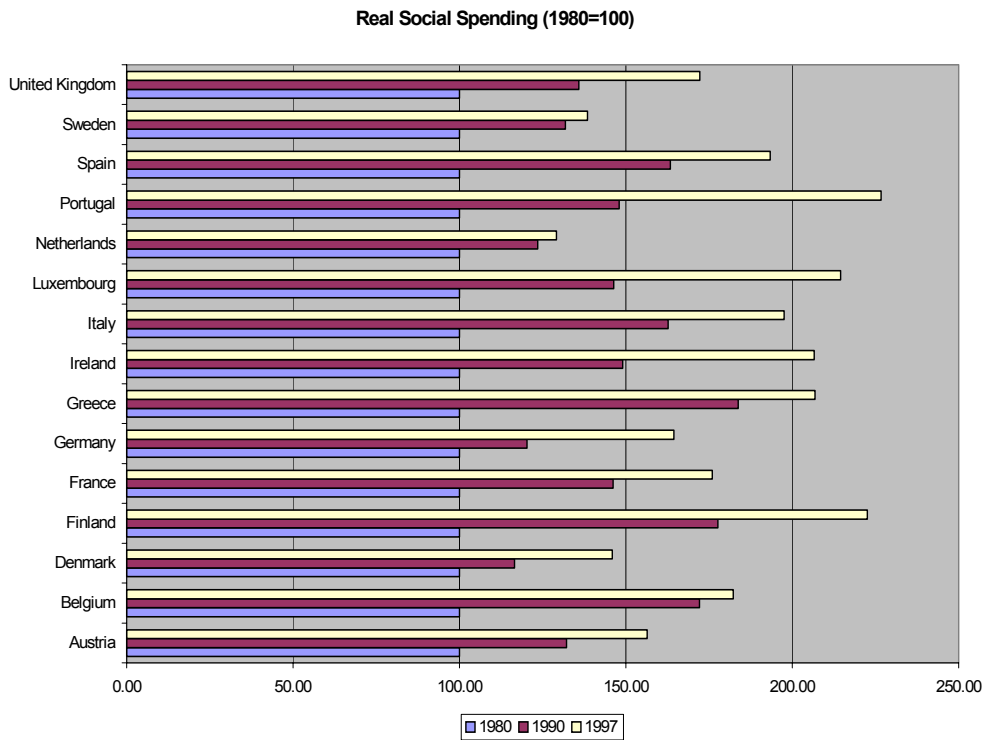


Figure 2



¹² The argument has been made in a variety of contexts. See for example Rodrik (1997).

Figure 3

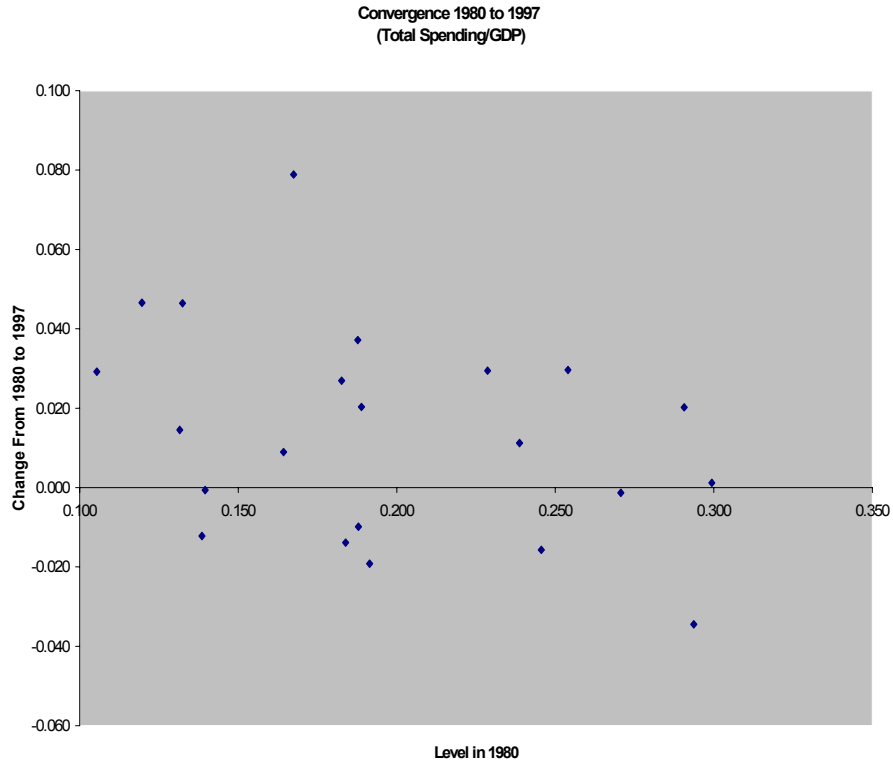


Figure 4

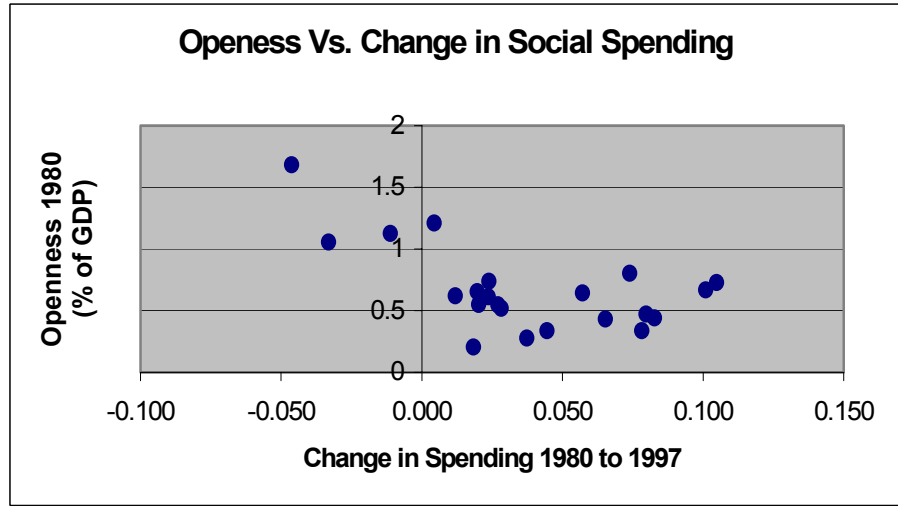


Table 2: Dependent Variable: Change in Total Social Spending 1980-1997

<i>Sample</i>	<i>Full</i>	<i>Full</i>	<i>EU</i>	<i>EU</i>
	1980-97	1980-97	1980-97	1980-97
Constant	0.106 (3.99) ^{***}	0.115 (4.14) ^{***}	0.134 (3.60) ^{***}	0.118 (3.60) ^{***}
Spending in 1980	-0.352 (2.72) ^{**}	-0.374 (2.53) ^{**}	-0.470 (2.86) ^{**}	-0.291 (1.95) [*]
Openness 1980		-0.016 (0.65)		-0.039 (1.35)
Change in Openness 1980-1997		-0.083 (1.75) [*]		-0.077 (1.07)
Change in Age Dependency 1980-1997		-0.189 (0.80)		0.129 (0.44)
Change in Unemployment 1980-1997		0.005 (2.71) ^{**}		0.002 (1.35)
Observations	22	22	15	15
R²	0.27	0.62	0.38	0.79

*, **, and *** denote significance at the 10%, 5% and 1% level, respectively.

Columns 1 and 3 in Table 2 exclude the additional controls, they thus measure the presence of unconditional convergence graphically captured in Figure 3. Both for the full sample and for the EU sample, the coefficient on the initial spending share is negative and significant. The data thus display unconditional convergence, with a somewhat faster convergence speed within the EU.

Columns 2 and 4 in Table 2 add the additional control variables, substantially increasing the explanatory power of the regressions. For the full sample, the convergence speed slightly increases, for the EU sample, it declines but remains quantitatively large and significant at the ten-percent level. Both a higher initial level of openness and an increase in openness during the sample period are associated with a sharper relative decline of the social expenditure share over the sample period, consistent with the view that higher international exposure imposes additional pressure to reduce social spending. These effects are however not significant for either the full or the EU sample; nor is the change in the age dependency ratio.

Table 3: Change in Total Social Spending 1980-1990 and 1990-97

<i>Sample</i>	<i>Full</i>	<i>Full</i>	<i>EU</i>	<i>EU</i>
	1980-90	1990-97	1980-90	1990-97
Constant	0.040 (1.52)	0.077 (3.33) ^{***}	0.076 (2.25) [*]	0.085 (2.94)
Spending in 1980 (in 1990)	-0.060 (0.45)	-0.263 (2.41) ^{**}	-0.143 (1.00)	-0.233 (1.99) [*]
Openness in 1980 (in 1990)	-0.021 (1.02)	-0.009 (0.57)	-0.039 (1.89) [*]	-0.024 (1.69)
Change in Openness 1980-90 (1990-97)	-0.029 (0.39)	-0.041 (0.96)	-0.056 (0.66)	-0.018 (0.47)
Change in Age Dependency 1980-90 (1990-97)	0.442 (1.06)	-0.302 (1.20)	0.335 (0.75)	-0.288 (1.03)
Change in Unemployment 1980-90 (1990-97)	0.003 (1.51)	0.004 (2.68) ^{**}	0.001 (0.56)	0.002 (1.66)
Observations	22	22	15	15
R²	0.33	0.49	0.57	0.58

*, **, and *** denote significance at the 10%, 5% and 1% level, respectively.

Table 3 reports the β -convergence regressions separately for the 1980-1990 and for the 1990-1997 period. Both for the full sample and for the EU sample, the convergence speed increases substantially for the later relative to the former period. To the extent that this convergence reflects policy concerns about the competitive effect of social expenditure divergences after the Single European Act, the increased speed of convergence is consistent with views emphasizing the tension between globalization and national political autonomy.

Finally, Table 4 reports the results for three major categories of social expenditure; old age cash benefits/pensions, unemployment benefits and health benefits. The table reveals sizeable differences across expenditure components. The null of convergence is rejected for pension benefits. In contrast, unemployment and in particular health benefits exhibit strong conditional convergence. Not surprisingly, increases in the old age dependency ratio and in the unemployment rate are associated with increases in old age cash benefits and unemployment benefits.

Table 4: Change in Social Spending Categories 1980-1997 and 1990-97

<i>Sample</i>	<i>Full</i>	<i>Full</i>	<i>Full</i>
	1980-97	1980-97	1980-97
	Pension	Unem-	Health
	Benefits	ployment	Benefits
Constant	0.009 (0.60)	0.000 (0.06)	0.059 (5.11) ***
Spending in 1980 (in 1990)	0.115 (0.40)	-0.283 (1.76) *	-0.932 (5.01) ***
Openness in 1980 (in 1990)	-0.016 (1.33)	0.008 (1.46)	-0.000 (0.11)
Change in Openness 1980-90 (1990-97)	0.000 (0.012)	-0.016 (1.32)	-0.007 (0.51)
Change in Age Dependency 1980-90 (1990-97)	0.256 (1.91) *	-0.007 (0.12)	-0.103 (1.28)
Change in Unemployment 1980-90 (1990-97)	0.001 (0.92)	0.000 (2.01) *	0.000 (1.29)
Observations	22	20	21
R²	0.46	0.45	0.68

*, **, and *** denote significance at the 10%, 5% and 1% level, respectively.

4. Conclusion

Increased economic integration is widely held to restrict national political autonomy in many areas, among them the choice of social expenditures. An extreme view takes the argument one step further, arguing that integration/globalization reduces national governments to passive reactors in a forced “race to the bottom” eviscerating national social welfare systems. The evidence presented above, matching earlier studies, unambiguously rejects this hypothesis for the member states of the European Union. Despite a step increase in integration in the form of the Single Market Act, average social spending levels, expressed as a share of GDP or in real terms, have risen in most EU members over the last two decades.

While the race to the bottom hypothesis is not supported by the data, we find substantial empirical support for a more general convergence trend towards an intermediate social expenditure share. The variability of social expenditure patterns across the EU member states has markedly declined over the last two decades; while the social expenditure share in 1980 is significantly negatively correlated with the subsequent change in social expenditure shares from 1980 to 1997.

To the extent that the policy decisions underlying this convergence trend reflect concerns about location choices of mobile factors (a point on which the evidence presented above remains silent), the findings are consistent with the existence of effective tensions between globalization and national political autonomy

emphasized in the literature, but suggest that such tensions are resolved through convergence to an intermediate level of social expenditures rather than a race to the bottom.

The evidence presented here focuses on the most easily obtainable metric, actual expenditures. A natural next question, much harder to empirically assess, is whether there also exists effective competition on the quality level, the ability to provide targeted social assistance and insurance in a cost-effective manner.

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