Globalization: The Limitations on State Capacity

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Globalization increases the potential mobility of financial capital, real investments, goods and services, and to a more limited extent, highly skilled labor. As a consequence, mobile economic actors are better able to avoid undesirable state regulations, or to profit from more advantageous ones. To the extent that countries depend on these actors, or on the resources they control, they are forced into a competition for locational advantage that has all the characteristics of a Prisoner's Dilemma game, and that reduces the capacity of the territorial state to shape the conditions under which capitalist economies must operate.

Ceteris paribus, globalization should have the following effects:

• price reductions on the product markets, as a result of economies of scale and international competition between firms;

• frequent and far-reaching structural crises at the level of sectors and regions, as a result of the international competition between firms;

• as a response to structural crises, regulatory competition between states to attract or retain mobile factors;

• as a consequence of regulatory competition, a shift of public policy toward capital-friendly and business-serving measures, and a bias against policies imposing burdens on firms and capital incomes.

In sum, capital owners are able to extract higher rates of return, and consumers will benefit from more attractive offers in the product markets, but globalization will be costly for the interests that previously were favored by market-limiting and market-correcting public policies. In any case, the effects of globalization will not be neutral between mobile and immobile actors and factors of production. In particular, globalization is likely to produce distributive gains for capital at the expense of labor.

These changes are generally, and without much attention to empirical detail, welcomed by neoliberal economists (see e.g. Hefeker in the first round of the debate), which might be explained by a normative indifference to criteria of distributive justice or by a general distrust of the state when it is attempting to correct market outcomes. Scholars who do not share these premises are likely to take a less sanguine view of the overall welfare effects of regulatory competition. For that reason, they should be very interested in the actual effects of globalization. Unfortunately, however, to the extent that these have been studied at all, the empirical record appears quite ambiguous, with data from different policy areas, different countries, and different points in time suggesting different and seemingly contradictory conclusions. Under these conditions, what seems most needed and most useful is conceptual clarity about what can, and what cannot, be expected to occur as a consequence of regulatory competition. As a first step, it seems necessary to identify the objects over which states compete, and the kind of state intervention which may or may not be affected by competition.

Over what Do States Compete?

Regulatory competition under the condition of open borders can take two forms: states can compete against each other in order to reduce undesirable inflows (of refugees, welfare clients, drug addicts, terrorists, etc.) or undesirable outflows (of capital, investment, jobs, taxable resources, etc.). Here I will focus on the latter aspect which, since the middle of the seventies, has become a central theme in the debate on the consequences of globalization. For analytical purposes I suggest to distinguish competition over internationally mobile demand for goods and services, from competition over internationally mobile direct investments, and over internationally mobile taxable resources. For each of these we can identify specific policies that either reinforce or weaken a state’s locational attractiveness.

Competition for internationally mobile demand

While firms are the immediate competitors on product markets, their success or failure has a direct impact on jobs and public finance. For that reason, states cannot disengage themselves from the competition for market shares in the international economy. But international competition may be on price or on quality. Price is dependent on the exchange rates and on production costs. The latter are negatively influenced by wage and non-wage labor costs, capital costs, regulatory costs, taxes, and they are positively influenced by cooperative industrial relations, a qualified workforce, high quality of R&D, and well developed services, transport and communication systems. Some of the same factors are also decisive for product innovations and other aspects of product quality.

Public policies can have a direct or indirect influence on most of these factors. As the list suggests, governments attempting to improve international competitiveness are by no means limited to reducing production costs through tax cuts, deregulation, or currency devaluation. Comparative advantages can also be achieved through policies stimulating productivity, innovation and specialization. In other words, states are not necessarily compelled to enter a "race to the bottom" in order to defend market shares at the expense of welfare losses. Success in export markets can also be achieved in countries with high wage costs, demanding regulations and relatively high taxes.

As a consequence, increasing competition on product and service markets will presumably lead to different national responses. Countries with unfavorable starting conditions – like, for instance, the UK at the end of the seventies – may have to opt for cost reductions and deregulation. Other countries, however, may have a choice between the British low-cost strategy and strategies that would increase their comparative advantages in terms of productivity, quality and innovation. Given the multiplicity of – path-dependent – options, it is not surprising that comparative studies may not produce unequivocal findings.

Competition for mobile direct investments

In the medium term, however, competitiveness in product markets cannot be sustained without capital investments that maintain, improve or enlarge production capacities. Of course, locations where production is not competitive will hardly attract investors. Beyond that minimum condition, however, investments depend on the rate of return on the capital invested, rather than on the competitiveness of products. More specifically, the decision to invest locally is influenced by comparisons with both the expected net rates of return offered by foreign direct investments, and the gains from financial investments. Since current investments determine future jobs and growth, states cannot afford to ignore this variant of systems competition. But here their room for maneuver is more limited: What matters is expected profits *after* taxes. Regulatory competition then forces states to reduce taxes on profits, and is indeed likely to result in a race to the bottom.

Competition over mobile tax sources

Lastly, states compete against each other over revenue from mobile tax sources – in particular income from capital. International mobility increases opportunities for moving assets to countries with lower taxes. Under these circumstances, all states are tempted to reduce their own tax rates in order to avoid a further erosion of its tax base. As a result, the share of taxes on mobile assets in total revenue will fall below the level that all states would have reached otherwise.

In the literature, international tax competition is usually described as a Prisoner's Dilemma game. But since states are here involved in an iterated game, game theory would predict that they should be able to reach a cooperative solution. In the case of fiscal competition, however, international (or even European) agreement on the taxation of mobile sources has proven to be extremely difficult. The reason is that states do not find themselves in a symmetrical prisoner's dilemma: While very small states (like, for instance, Luxembourg) may opt for a reduction of tax rates to attract mobile

capital (and hence increase their revenues), big countries cannot afford a strategy that would result in very large revenue losses. Moreover, in some countries, such as in the UK, financial services have become an important part of business activity. Hence their interest in attracting foreign financial assets is not primarily defined by tax considerations.

So far our discussion does not contradict theoretical expectations that economic internationalization – and the related competition between states – favors, ceteris paribus, mobile actors and owners of mobile production factors, and limits the capacity of nation states to regulate the capitalist economy. However, the expected effects of different types of regulatory competition – in product markets, in investment markets, and over tax revenue – will differ significantly, It is not surprising therefore that empirical research focusing on particular aspects of the overall pattern should come up with diverse findings that may seem to support contradictory conclusions. The empirical picture is further complicated by the fact that different types of national regulations are affected in diverse ways by the different types of regulatory competition.

What Kind of Regulations are Concerned, and How?

In the following section, the focus is on market-limiting or market-correcting regulatory and tax policy. I will thus not discuss the potential role of macroeconomic monetary and fiscal policy under conditions of regulatory competition.

Regulatory policy

As the American experience shows, economic integration influences the regulatory policies of individual states. Again, however, the empirical record seems to be contradictory. On the one hand, the so-called "Delaware effect", named after the concentration of company headquarters in the state with the laxest corporation law, suggests a downward spiral of competitive deregulation. On the other hand, the "California effect", named after the quick diffusion of strict Californian car gas emission standards to other American states, suggests a race to the top.

In this instance, the seeming contradiction is theoretically resolved by the conventional distinction between product-related and process-related regulations. Product-related regulations may either have the character of coordinative standards that assure compatibility among different products, or of regulative standards that protect consumers and the environment. Process-oriented regulations, by contrast, do not affect the usability, the safety or quality of products, but regulate the conditions under which these products have to be produced – e.g., rules on environmental protection, work safety, working time, holidays, paid sick leave, etc. According to this distinction, the emission standards of the Californian example were product-related regulations, the corporation law of Delaware is an example of process-related regulations.

In the case of product-related coordinative standards, internationalization hardly reduces the regulatory capacity of states since, at the national level as well, such standards are typically defined through corporatist self-regulation. In any case, it is in the interest of firms to respect coordinative standards, so that a race to the bottom would be quite unlikely. In the case of regulative product standards, their purpose does make a difference. If they increase the safety or the usefulness of the product in the eyes of consumers, regulatory competition might – in line with neoliberal expectations – lead to the selection of the optimal national standard when national regulators respond to consumer preferences In this case, competition would not only allow stringent national regulations to persist, but also allow more demanding standards to diffuse across borders. This could even result in a race to the top, provided consumers are able to appreciate the increase in quality, and are ready to pay the price for it. Among recent examples of this consumer-oriented "California effect" are the quick adoption of the "Basle accord" on capital-adequacy rules for banks by countries that had not been parties to the agreement, or the adjustment of the German stock exchange law to more strict American insider-trading rules.

Ironically, however, the historical California example itself cannot be explained by reference to consumer preferences. There the more stringent gas emission norms did increase the price of cars without providing buyers with individual advantages. What mattered was that California was allowed, by federal statute, to interfere with the free movement of goods in interstate commerce by excluding cars that did not conform to its own standards.1 Similar effects may be expected whenever non-tariff barriers to free trade are legally accepted – as is possible for national norms protecting life, health, and the environment under both article XX of the GATTagreement and article 36 of the Treaty of Rome.

In the case of *process-oriented* regulations, by contrast, there are clear economic incentives to a competitive reduction of regulatory costs. This holds for rules on environmental protection and safety at the working place and, more generally, for all regulations of labor and social policy that increase production costs, without improving the attractiveness of a product. For the buyer, steel from furnaces with high sulfur dioxide emissions is indistinguishable from steel produced with the most expensive emission controls. In theory, therefore, price competition in the product market would generally favor a race to the bottom. In practice, of course, effects may vary from one product to the next, depending on the relative weight of regulatory costs in the overall costs of production. Moreover, downward economic pressures do not immediately translate into changes in regulation, but are likely to face (more or less) strong political opposition. This holds even in countries where governments favor deregulation, as is shown by the limited success of attempts at dismantling the welfare state in the US and the UK. Thus, under certain conditions national politics may resist the pressures of economic competition, albeit at economic costs (wage decrease, devaluation, inflation, public debt), which in the end may prove to be also politically too high (see the Swedish case in the nineties).

There are then good reasons to think that deregulation is more likely in processrelated regulations than in product-related regulations. But downward economic pressures as well as political resistance will vary among sectors and countries. No wonder, therefore, if empirical findings will vary as well.

Tax policy

Empirical studies on tax policies also produce ambivalent findings, especially if they fail to distinguish between mobile and immobile tax bases. There is, for instance, no theoretical reason to assume that the liberalization of capital markets should be associated with a reduction of social security charges. Here again analysis ought to be based on theoretically justified distinctions between different types of taxes – on immobile property, on consumption, on income from work, on income from profits, and on income from financial assets.

Property taxes, which play a very large role in the Anglo-American countries, and an almost negligible role everywhere else, are obviously least affected by international mobility. User charges, levied for the use of public services and infrastructure, are similarly unaffected. To a lesser degree, that is also true of taxes on consumption, and in particular of the VAT, if the principle of the country

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1 The rest of the "Californian story" is explained by economic logic. Since California had no car industry, there was no reason to worry about the competitiveness of local firms. At the same time, the Californian market was big and attractive enough to compel car makers to produce cars complying with Californian standards (which they could not sell elsewhere). As a consequence, the industry itself demanded uniform national rules consistent whith the California standard, in order to (re)gain former economies of scale.

of destination is maintained, i.e. if the tax is based on the consumption of a product, regardless of its origin (foreign or domestic). Between 1965 and 1994, the share of all consumer taxes in the total tax revenue of OECD countries increased from 11.9% to 17.4% on average. In these areas, therefore, the national capacity to tax will not be limited by the economic consequences of globalization but, rather, by the growing political opposition to high levels of taxation.

The same holds, in principle, for the revenues from immobile income, in particular labor income. Revenues from wage-taxes and social security charges are not much affected by globalization, since attractive exit options are available only to a limited set of high-income sport stars, artists, and mobile professionals. This explains the international trend towards taxing labor, whose share in the tax revenues of OECD countries has increased from 11.5% to 20.4% between 1965 and 1994, on average.

For taxes on capital incomes, the distinction between real investments and financial investments makes sense in theory. In the absence of capital flight, profits from job creating real investments might be taxed at lower rates than income from financial assets. Under conditions of globalized financial markets, however, financial assets are more mobile than real assets. For that reason, one would expect that the effective rate of taxation should be lower for income from interest payments and speculative capital gains than for income from profits. Unfortunately, the OECD does not provide data that distinguishes capital investments from real investments. It can nevertheless be noted that the share of income taxes (including wage taxes) in the total amount of taxes has remained stable between 1965 and 1994 (34.6% and 35.4% respectively), whereas the share of corporate taxes has decreased from 8.9% to 7.5% during the same period of time.

But again, economic pressures are opposed by political forces challenging the distributional consequences of tax cuts favoring the owners of capital. Moreover, the economic costs of non-adaptation will vary among countries. Even when all institutional barriers to the free movement of capital have been removed, there will be considerable differences in the actual mobility of capital. Thus, the threat of capital outflow is less significant in Denmark, with a large share of export-oriented small and medium-sized firms, than it is in Sweden, with a large share of big transnational corporations that can easily shift production and investments among several national locations. Again, given these differences comparative studies will hardly lead to uniform empirical findings.

Conclusion

In this contribution I argued that globalization is likely to produce different effects across objects of systems competition and types of state regulations. Table 1 summarizes the argument. The cells indicate whether, under systems competition, strict regulations or higher tax rates will prove detrimental to, or useful for, success in the international competition in product markets, investment markets, and for tax revenues.

***Table 1**: The likely effects of systems competition*

	Objects of systems competition		
Type of regulation	*Product markets*	*Real investments*	*Tax revenues*
Product-related			
Coordinative	useful	neutral	neutral
Regulatory	useful/neutral	neutral	neutral
Process-related			
Environmental protection	detrimental/neutral	detrimental/neutral	detrimental
Social policy	detrimental	detrimental	detrimental
Taxes on			
consumption	neutral	neutral	useful
immobile income	neutral	neutral	useful
capital income	neutral	very detrimental	detrimental

The table is meant to illustrate that even under systems competition states will still be able to maintain – if not to reinforce – a series of regulations at the national level, with no or low economic costs. This holds for product-related regulations, provided they are not ruled out as non-tariff barriers to trade. Similarly, taxes on immobile sources of income (especially wage taxes) and on consumption are not vulnerable to international economic competition, provided the country of destination principle is maintained. By contrast, higher taxes on capital income would affect investments and would hence be detrimental to future employment and growth. In addition, capital flight might reduce tax sources.

Process- and product-related regulations in environmental policy and in social and labor policy are also economically risky if they increase production costs and, therefore, reduce the competitiveness of firms, and the profitability of investments, and may thus induce capital outflows. The two policy domains might differ, however, with regard to the relative weight of the costs imposed, and with regard to the strength of the political opposition to economically motivated deregulation.

This conclusion has both scientific and political implications. First, there is no reason to expect uniform empirical results, and any attempt to explain empirical variation has to take into account the differences in – and contingency of – the explanatory variables. Second, policy makers should neither get scared nor feel unchallenged by the consequences of globalization. It is true that almost all domestic policy choices must now be evaluated in the light of international regulatory competition. However, this impact is by no means uniform across policy areas or even across policy instruments available in the same area. As a general rule, it can perhaps be said that national policy makers must now be more sensitive to the economic consequences of market-limiting or market-correcting regulations that do increase production costs or reduce profits. That does not imply that such policies should now be ruled out, if policy makers and the public are willing to pay the economic price. Beyond that, this essay was meant to show that the economic price itself may be higher or lower, depending upon the choice of policy instruments.