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**The Role of the State in an Increasingly Borderless  
World**

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**By**

**Mr Kwek Ju-Hon  
MINDEF**

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## **Executive Summary**

This essay focuses on the economic aspects of globalisation and considers their implications on state roles and capacities. A central theme running throughout is that borderlessness leads to intense competition for mobile factors of production, namely financial capital and highly skilled labour. Instead of causing a downward spiral in tax revenues (and therefore state capacities), this new competitive environment has led states to enter into a form of “policy competition”, to become a location of choice for these mobile factors.

The essay proceeds to consider the assertion that international capital markets now render states virtually powerless to make real policy choices, particularly with regard to monetary and fiscal policy. States hoping to benefit from inflows of capital are indeed forced to don the “Golden Straightjacket” of policies promoting low inflation, balanced budgets, and a well-regulated domestic banking system. While this is often portrayed as a severe curtailment of states’ discretionary power, this essay asserts that the present focus on the creation of macro-economic stability must be seen as a modern manifestation of the task of creating stable conditions of commerce and investment, a role that has always fallen on the state.

The ultra-competitive international economic environment leads to very different conclusions for the efficacy of industrial policy. The very pace of globalisation and technological change make the state more important in

exercising its unique capacity to identify new developments, and facilitate *transformation* in the national economy. The key to state success is maintaining the nimbleness to constantly reinvent its roles to suit the rapidly changing global context. “New” industrial policy must include tasks of technology diffusion, coordination of innovation, and the management of trade disputes. Seen in this light, state power is not likely be displaced in an increasingly borderless world. It is merely transformed to meet a new competitive context.

## The Role of the State in an Increasingly Borderless World

*"The nation state is about through as an economic unit"*<sup>1</sup>

-- Charles Kindleberger, 1969

Pronouncements on the demise of the state have been in vogue for over 30 years. Yet reading contemporary literature on globalisation and international integration, one cannot help but to be struck by the newfound confidence with which the state continues to be pronounced an outdated and moribund institution. These claims have reached new heights with authors such as Kenichi Ohmae declaring that in *The (already) Borderless World*, people, firms, and market matter more, and states less.<sup>2</sup> Echoing Kindleberger's words from 30 years ago, Lester Thurow has declared that "as an externally sovereign actor, . . . (the state) . . . will become a thing of the past."<sup>3</sup> If indeed this were the case then the simple answer to the question on the role of the state in a borderless world is that it is diminishing to the point of insignificance.

But rumours of the state's demise have been somewhat overstated. While borderlessness and the associated phenomenon of interdependence have certainly changed the context in which it operates, the modern state appears to be alive and well. This essay will consider the extent to which increasing borderlessness circumscribes the bounds of possible state action while at the

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<sup>1</sup> Charles P. Kindleberger (1969) p. 207.

<sup>2</sup> Kenichi Ohmae (1990).

<sup>3</sup> Lester C. Thurow (1999). p. 137.

same time transforming the roles of the state and creating new imperatives for policy.<sup>4</sup>

### **A Borderless World?**

The last two decades have seen an accelerating growth in the volume and variety of cross border transactions in goods, services, and international financial flows. This rapid integration of the world economy has been fuelled by new technologies, the spread of information, and the growing importance of knowledge-based industries. These have drastically lowered costs of transaction, information, and mobility for a wide variety of economic actors. Interdependence has grown not just between countries, but also among groups within them.

Obviously the world is far from being completely borderless – there continue to be numerous regulatory and political limits to free flows in trade, people, and technology. It is also clear that economic integration is uneven across industries; integration of financial markets for example, leads that of all other fields. Borderlessness and interdependence also show a clear geographical bias with the developed North being far more integrated than the

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<sup>4</sup> Interdependence that is borne out of the dissipation of international borders has clear political and social implications, each of which could be the topic of a separate piece of research. This essay will focus mainly on economic aspects of integration.

still developing South.<sup>5</sup> But all that said, it is fairly clear that the world economy is *more* borderless and integrated than it ever was before and that the overall trend is towards more rather than less openness. Therefore the intention of this essay is not to enter into a detailed debate about the extent of global integration, but to accept its inevitability and consider its implications on state policy.

### **International Competition: Diminishing state capacities?**

We should first begin by considering the key analytical argument about the impact of openness and interconnectedness on the state capacities. The assumption is that state capacity is an inverse function of economic integration; the more open or internationalised an economy, the weaker the state's capacity to govern industrial change. The argument goes something like this: increased permeability of state borders exposes private agents and governments to greater degrees of international competition, not just in the goods market, but also in the markets for factors of production. Labour and capital – the two mobile factors of production -- will flow to countries that offer the highest rate of return.

State capacities are financed by taxation, and revenues are raised by taxes on productive factors. Since interdependence forces fierce competition among states to attract these factors, and because owners of mobile factors can

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<sup>5</sup> Linda Weiss (1998), for example, points out that as of 1991 81% of the world stock of foreign direct investment was in high wage countries of the north. She adds that the extent of this concentration has grown by 12 points since 1967. p. 72.

vote with their feet, what results is an international “tax competition” which exerts a huge downward pressure on state revenues. Owners of capital and highly skilled professionals are free to take their resources where there they are most in demand. Economic integration allows capital and skills to migrate to low tax jurisdictions, and so the state’s tax base will invariably shrink. Governments will find themselves unable to finance social programmes, safety nets or redistribution of income. Anticipating this flight of capital and skills, governments have to cut taxes and dismantle the welfare state before migration or mass capital flight gets under way.

Put simply, increasing borderlessness limits state capacities to act because it limits their ability to tax. Dani Rodrik argues that “Globalisation has made it exceedingly difficult for government to provide social insurance ... at present international economic integration is taking place against a background of receding governments and diminished social obligations. The Welfare state has been under attack for two decades.”<sup>6</sup>

Yet as *The Economist* points out in its recent survey of globalisation, the opposite seems to be the case. In practice, governments around the world are now collecting more in taxes; not just in absolute terms, but in proportion to their economies. The US government collects some 30% of GDP in taxes, making for an average of US\$30,000 per household. Sweden, despite a much vaunted

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<sup>6</sup> Quoted in “Is Government Disappearing?”, *The Economist Survey of Globalisation*, p. 2.

taxpayer revolt in the 1990s, taxes up to 57% of GDP, and Denmark follows closely with 53%. These are all examples of extremely open economies. Denmark's ratio of imports to national income, for example, is 33% compared to the US' 14%.<sup>7</sup>

How do we explain this apparent anomaly? The immediate thought is that perhaps the world is not quite as borderless as it has been made out to be, perhaps because of a good deal of stickiness in international labour and capital markets. But this is clearly not the case for capital, much of which moves seamlessly across the globe at the touch of a button.

Stickiness is actually a reality for the majority of workers, who are tied to geographical locations by national regulations. However it does not apply so much to highly paid professionals whose skills make them globally mobile, and whose incomes put them in the highest tax brackets, ensuring that they pay the bulk of national tax bills. While there is indeed some evidence to show that labour mobility has precipitated a move from direct to indirect taxation – borderlessness seems more to have affected the structure of tax code as opposed to the overall burden of taxation.

What keeps these highly mobile professionals from fleeing to low tax havens? Some point to a flaw in the fundamental assumption of the analytical argument presented above – that workers are narrow utility-maximising

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<sup>7</sup> Figures cited in "Is Government Disappearing?", *The Economist Survey of Globalisation*, p. 1.

individuals with no ties to family place or culture, and argue that we need to take a broader view of the human condition. Borderlessness may remove the impediments free movement, but social and cultural factors are a source of inertia. “Since people seem to choose to be tied down, indeed relish it, governments, within broad limits, can carry on taxing them regardless of globalisation.”<sup>8</sup>

While this perspective is certainly valid, there is another way of explaining the tax base anomaly within the framework of economic analysis. It must be noted that whether labour or capital, factors of production will flow to where they receive the highest *risk denominated rate of return*. These returns are calculated net of the price transaction (i.e. tax rates) in a particular market. So mobile factors of production will remain in higher tax jurisdictions as long as the potential for returns remains high and the risk of transacting remains low. One way of looking at this is that these locations provide “value for money” in terms of the services provided by government and the environment created for business. Factors of production will choose to remain in a high tax location if they deem that their tax dollars are being spent on enacting policies that will boost returns and lower risks. This is why capital and highly-skilled labour continue to flock to relatively high tax locations of New York, San Francisco, London, Paris rather than to the tax havens of Bermuda and the Jersey Islands. It is a matter of “policy competition” between governments as to who can provide the best environment for doing business, the most stable framework for investment, and the best place

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<sup>8</sup> From “Is Government Disappearing?”, *The Economist Survey of Globalisation*, p. 6.

to live. Global flows of information, which are themselves a by-product of economic integration heighten such competition as they inform the owners of capital about alternatives.

The implication of this is significant – instead of just engaging in a competitive “race to the bottom” in taxes, states need to take a more holistic view of the overall package they offer to investors and highly skilled workers. Mobile capital, whether financial or intellectual, does not simply just flock to the cheapest location, but to the system that offers it the best value for money. So it is not simply the case that the state no longer has the means to play any sort of meaningful role, but that it preserves these means by showing to owners of mobile factors that it is a good value proposition. This explains why states continue to possess their capacity and what they should do to maintain it.

### **The End of Discretionary Power?**

But even if states continue to have the means at their disposal, a further question is whether they continue to have the discretionary power to decide on policy. Globalisation theorists point out that with increased integration, the very idea of a national economy, and the capacity of governments to manage it are being undermined. Governments are moving towards greater openness in trade and investment policies, which is often represented as the emergence of a new logic of global capitalism. According to this logic, “states are now virtually

powerless to make real policy choices; transnational markets have so narrowly constrained policy options that more and more states are being forced to adopt similar fiscal, economic, and social policy regimes.”<sup>9</sup>

Globalisation, particularly of capital markets, has made for a powerful countervailing force to the state’s discretionary power. To many, the power of the global bond market to undermine the monetary and fiscal policies of governments is all but taken for granted. All governments are impotent in the face of global finance. Thomas Friedman refers to this as the power of the “electronic herd”; perfectly mobile, it comes under no state jurisdiction. “When the herd decides to withdraw capital from a country, there is no one to complain to or to petition for relief. Decisions of the herd are collective ones. They are not made; they happen, and they happen because many investors individually make decisions simultaneously and on similar grounds to invest or to withdraw their funds. Do what displeases the herd, and it will trample you into the ground. Globalisation is shaped by markets, not by governments.”<sup>10</sup>

The “herd” moves vast amounts of capital in and out of countries according to their political and economic merits, and the State is powerless to challenge its will. Countries that wish to attract capital have to do what Friedman terms the “Golden Straitjacket”, a package of policies including

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<sup>9</sup> Linda Weiss (1998), p. 188.

<sup>10</sup> This characterisation of the “electronic herd” is provided by Kenneth Waltz, in his 1999 James Madison Lecture at the American Political Science Association, “Globalisation and Governance”.

balanced budgets, economic deregulation, openness to investment and trade, and a stable currency.<sup>11</sup> “As your country puts on the Golden Straitjacket, two things tend to happen: your economy grows and your politics shrink”.<sup>12</sup> In an increasingly borderless world, capital markets severely curtail a state’s freedom of manoeuvre in economic policy. This is the new context within which states are forced to operate.

Given that continued inflows of capital are a necessary ingredient for economic success, and that the tendency for capital flight is higher the higher the integration and globalisation of financial markets, a key role of the state is therefore simply about giving markets what they want. Owners of capital want a stable environment for investment, so the provision of macroeconomic stability rises to a new level of importance.

Increased inter-state competition for capital forces states and their central banks to concentrate on the goal of price stability in order to attract or avoid a drain of mobile capital. High inflation is generally perceived by markets to be a signal of bad policy and a proxy for political and economic instability. States are forced into a similar straitjacket with regard to balancing government budgets. Short-term bank debt has led many a developing country into trouble. The debt crisis, for example meant that the 1980’s were a lost decade for Latin America. The problem was one of governments borrowing heavily to finance recklessly

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<sup>11</sup> See Friedman (2000), pp. 101-111.

<sup>12</sup> Friedman (2000), p. 105.

large budget deficits. With such lessons in mind, borderless financial markets place a premium on state fiscal conservatism.

While government deficits are problematic, the case of corporate borrowers in developing countries becomes more complicated. These non-government entities occasionally borrow amounts that seem individually prudent given certain macroeconomic assumptions -- such as no devaluation of the currency -- but which become collectively unsupportable if those assumptions turn out to be wrong. This happened in East Asia in the 1990s, with the further complication that much of the borrowing was channelled through domestic banks, which meant that the ultimate borrowers were unaware of their exposure to system wide exchange rate risk. Some governments even went so far as to encourage significant amounts of foreign borrowing by firms without intermediation from domestic banks and financial institutions. This points to the importance of regulation and oversight of the banking sector.<sup>13</sup>

### **Whither the Role of the State?**

So does the emphasis on macro-economic stability mean that the state has entered a new era of powerlessness? Not so if the maintenance of macro-

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<sup>13</sup> Where such regulation is impossible due to immaturity of institutions, there may be some role for capital controls. Taxes or controls on short term currency inflows may well be better than the extreme alternatives of no inflows on one hand, and completely unrestricted inflows intermediated by a weakly or corruptly regulated domestic financial system.

economic stability is seen in the larger context of fostering the *overall conditions for economic well-being*, which has always been an invariant role for all states. These conditions, essentially the infrastructure for doing business, are a function of legal security (property rights and contract enforcement), social security, economic and political stability, and are public goods that only states can provide. Macro-economic stability is key element of this infrastructure as it safeguards transactions and so creates market conditions conducive for commerce. This is a role that states have always had to play. In the context of a borderless world, the imperatives for fulfilling this role have merely intensified. States are answerable not just to their domestic business constituencies, but also to the international markets which allocate vast amounts of capital.

A borderless world with an integrated global economy intensifies the competition among states for capital. States are thoroughly engaged in the process of *locational policy competition* to show that they are the best destination for talent and financial capital. A key preoccupation of the state is simply to ensure that it remains competitive. In addition to creating market conditions that are conducive to capital, it can enact significant supply side policies to improve the quality of factors of production. For example policies that boost productivity – if public spending on education boosts productivity, investment would be drawn to countries that invest heavily in top-quality schools and universities. The same would hold if public spending on social programmes such as health and welfare raises productivity by producing a healthier and more contented workforce.

## The Strong State and Industrial Policy

But surely the role of the state can and must go beyond the passive provision of the infrastructure and economic conditions that markets demand. Linda Weiss puts forward the perspective that “economic integration does not so much enfeeble the state as weaken the efficacy of *specific policy instruments*.” She notes that one result of financial liberalisation is that the instruments of fiscal and monetary policy are predetermined, leaving little room for creative adjustment. However, “the very opposite is the case with industrial policy. The very capacity for industrial policy is one that requires the state constantly to adapt its tools and tasks.”<sup>14</sup> Borderlessness and international economic integration heighten industrial competition, and accelerate the pace of change to the industrial context. States possess unique abilities to coordinate industrial change to meet the changing context of competition.

Economic history is littered with examples of how some states are more successful than others in anticipating and responding to economic change. This is what Weiss refers to as a state’s “Transformative Capacity” -- its ability to adapt to external shocks and pressures by generating ever-new means of governing processes of industrial change. These are essentially strategies to upgrade or transform the economy – in terms of structural shifts from declining to

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<sup>14</sup> Linda Weiss (1998), p. 197.

expanding sectors, means of technological diffusion and innovation, and the creation of new industries, products and processes. While the state is not the only body that possesses this domestic adjustment capacity, it can provide a potentially more powerful locus for coordinating change. “The state’s institutions can offer the most encompassing organisational complex for overcoming a number of widely recognised obstacles to change, including problems of collective action, bounded rationality and short-term horizons as well as unprecedented time compression in technological transformation.”<sup>15</sup>

Most importantly among these is the fact that only the state can readily absorb and socialise the high degree of risk that is inherent in modern production technologies. State coordination is vital to induce firms to engage in activities where the risk level would be so great as to deter firms acting alone. This is particularly so where investments must be made on a large scale and where the sub-sectors are interdependent and therefore need to be created concurrently – for example the semiconductors and computer industry, or genetics and the pharmaceutical industry. An excellent example of this can be seen in the role that MITI, the Japanese Ministry for Trade and Industry, plays in promoting and diffusing technological innovation. It facilitates risk pooling arrangements, a form of “distributed cooperation”, where participant firms take responsibility for specific tasks of a larger research effort. Research is conducted independently in the firms’ own labs, but technology is exchanged through a system of shared

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<sup>15</sup> Linda Weiss (1998), p. 6.

patents. Such state sponsored cooperative arrangements allow the pooling of resources, while maintaining competition by keeping partners at an arms-length.

Weiss identifies five areas where the state's capacity to coordinate of industrial change remains important. First, the identification of emerging areas with new product and technological potential. An example of this is the role that the MITI played in focussing Japanese firms' attention on Robotics in the 1980s. Second, the promotion new infant industries (specifically the high tech industries of the future), present examples of which are biotechnology, micro-electronics, and materials science. Third, in maintaining a continuous long-term programme of investment and upgrading for mature industries. Fourth, in regaining critical ground lost to competitions in strategic industries (the US Department of Defence's sponsorship of Sematech, the public private consortium for restoring semi-conductor capacity lost to Japan is a good example of this). And finally, in enacting structural adjustment policies to assist the retreat of industries that are in decline whether due to falling demand or loss of comparative advantage.<sup>16</sup>

Far from being put on the defensive by the realities of a borderless world, states have the capacity to turn increasing borderlessness into an opportunity. "Catalytic states" are ones which grab the bull of globalisation by its horns and actively encourage internationalisation strategies of corporate actors. Singapore provides an apt example of this; pre-empting the threat of cheaper labour costs

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<sup>16</sup> Weiss (1998), p. 201.

to its manufacturing industry, the country's industrial strategy has shifted from one of attracting foreign companies to one of "internationalisation" to encourage regional relocation of production networks offshore to Singapore-created investment parks. Japan and the US have enacted similar internationalisation strategies by offering a panoply of incentives to finance overseas investment and to promote technological alliances between national and foreign firms.

Beyond just positioning themselves to thrive in a borderless world, states can and are also seeking to increase their control over their external environment. This is achieved by building or strengthening power alliances, and achieving their goals by assuming a dominant role in coalitions of states, transnational institutions and private sector groups. In this light, the emergence of regional economic arrangements such as the EU, APEC, and NAFTA should be seen as gambits for augmenting rather than shedding state capacity. Active members of these groups seek power-sharing agreements which will give them scope to shape the grouping and its environment. Far from being rendered powerless by the changes wrought by globalisation and economic interdependence, "strong states tend to be midwives (even perpetrators) rather than victims of globalisation."<sup>17</sup>.

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<sup>17</sup> Linda Weiss (1998), p. 13.

## **Conclusion: Flexibility as the key to State Success**

The increased permeability of international borders leads to a hyper competitive system in which the winners are rapidly imitated by the losers. The ubiquity of technology and the free flows of information have sped this process up immensely. In the old era, the strong ate the weak; in the new economic era, “the fast eat the slow”<sup>18</sup>. Technological innovation is rapid, and because economic conditions at home and abroad change often, states that adapt easily have considerable advantages. The policy imperatives of ensuring a nation’s economic development are fixed, but the ways of going about them are highly variable in accordance to a rapidly changing context. To be successful in a borderless world, states must be quick to pick up on these changes and adapt their tasks to them, for example by moving from export promotion and industry creation to coordination of innovation, technology diffusion, the management of trade disputes and currency realignments. Indeed the “Transformative Capacity” of the state – not just its ability to transform its industries, but also its capacity to remain nimble and transform *itself* is a key to success in the world economy. “Change is hardly novel to the state: it is the very essence of the modern state, by virtue of the fact that it is embedded in a dynamic economic and inter-state system.”<sup>19</sup>

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<sup>18</sup> Klaus Schwab quoted in Thomas Friedman (1999), p. 213.

<sup>19</sup> Linda Weiss (1998) p. 195.

In a borderless world, the state maintains the means to enact policy, but because of the extreme mobility of productive factors, is forced into a straitjacket of conservative macro-economic policy to produce the conditions demanded by their owners. While this might at first seem like a severe curtailment of the discretionary power of the state, it must be seen in the contemporary context of creating the conditions of commerce, a task that has always fallen on the state. The imperatives for state action are similar, but the pressures are greater as it comes under scrutiny not just by its own internal actors, but by participants in international markets.

The ultra-competitive, rapidly changing globalised environment leads to a different conclusion for industrial policy. Here the very pace of globalisation makes the state more important in exercising its unique capacity to facilitate transformation in the national economy. The key to state success is the ability to be nimble and constantly reinvent its roles to suit the rapidly changing global context.

Seen in this light, state power is not likely be displaced in an increasingly borderless world. If anything it will become more salient.

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