

MAS-ESS ESSAY COMPETITION 2002

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

Third Prize-Winner, Open Category

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Abstract

Economic globalization, or the rapid recent growth in international trade and capital flows, creates both exciting opportunities and serious challenges for national economies and the world economy. At the same time, globalization entails far-reaching repercussions for individuals and firms as well as the state or the government.

In this paper, we examine the relationship between globalization and the state. An especially notable loss of the state's power in the face of globalization is its reduced ability to collect taxes due to more internationally mobile capital and labor. However, this overlooks the possibility that low tax countries may have low quality of public services, making them less attractive for capital and labor.

The East Asian Miracle emphatically showed that whether a country can take advantage of the enormous opportunities inherent in international trade and capital flows depends to a large part on the quality of government policies. Globalization raises the reward for sound policy as well as the penalty for unsound policy. As such, policy quality becomes more relevant than ever in a borderless world economy.

The Asian currency crisis illustrated the importance of sound policy in minimizing the potential risks from globalization. Globalization is not inherently destabilizing or harmful. Instead, it is often inappropriate policy that turns globalization into a destructive force. A key role for the government in connection with reducing the risks and adjustment costs is to facilitate the re-allocation of resources between sectors.

The competitive pressures unleashed by globalization are not only relevant for firms and workers; they are equally relevant for governments as well. A borderless global economy with internationally mobile capital and labor exposes the state to the discipline of competition from other states. Globalization thus encourages governments to pursue good policies, and refrain from bad ones.

1 Introduction

Globalization, or the integration of the countries of the world into a single homogeneous community, is taking place across a broad spectrum of human activities. Globalization is an irresistible and relentless phenomenon touching and reshaping almost all aspects of our everyday lives. In the political arena, for example, multiparty democracy and ideological pluralism are gaining a foothold and establishing themselves in many countries that used to have more authoritarian political systems. Likewise, we find ourselves exposed to foreign culture to the extent that listening to foreign music or watching foreign movies or dining out at restaurants serving foreign cuisine has become second nature to most of us, as has visiting foreign countries or seeing foreign visitors wandering around our streets. In fact, with globalization proceeding full steam ahead, the distinction between foreign and homemade becomes less meaningful by the day.

In this essay, we look at one component of globalization, namely economic globalization, which refers to the rapid recent growth of international trade in goods and services, as well as international flows of capital and to a lesser extent, labor. Economic globalization, or global economic integration, thus implies the progressive removal of barriers to the movement of goods and services, capital, and labor across countries. That is to say, economic globalization denotes the process whereby the national economies of the world are moving toward a single economy with unfettered movement of goods and productive factors. While we still have long way to go to achieve a truly borderless global economy, the acceleration of international trade and capital flows in the postwar era suggests a clear movement toward rather than

away from that kind of an economy. Economic globalization entails far-reaching repercussions for individuals and firms as well as the state.

Our focus here is on the impact of economic globalization on the role of the state or the government. Although the private sector tends to determine the allocation of resources in market economies, the state continues to play a significant economic role in those economies. Although the extent to which the state intervenes in the economy varies substantially from country to country, the invisible hand of market forces has yet to completely displace the more visible hand of the state even in the most laissez faire economies.

As we will see below, economic globalization has significant implications for the role of the state. Economic globalization creates both exciting opportunities and serious challenges for national economies. While globalization weakens the government in some respects, the government and its policies help determine a national economy's ability to maximize its returns and minimize its risks from globalization. Put differently, the impact of globalization on a country's firms and individuals depends critically on how their government responds to globalization.

2 Economic Globalization, Factor Mobility, and The Disappearing State

An especially notable loss of the government's power in the face of globalization concerns taxes. Although the state can borrow or resort to inflation as a means of financing itself in the short run, taxes are its primary source of resources in the long run. As such, any reduction in the state's ability to collect taxes from firms and individuals translates directly into a general loss of its ability to produce services. According to conventional

wisdom, economic globalization renders the state less powerful at best and irrelevant at worst by limiting the state's ability to collect taxes and thus finance its activities.

The intuition is quite straightforward. As indicated earlier, economic globalization does not only entail greater cross-border flows of goods and services, but factors of production such as capital and labor as well. Greater mobility of productive factors does not bode well for the future of taxes and by implication, the state, since capital and labor will gravitate toward national economies that offer the lowest tax rates. There is mounting concern that factor mobility may even spark off a race to the bottom as governments fall over each other in cutting taxes in a competitive bid to attract and retain companies and workers. The growth of electronic commerce and the difficulty associated with taxing on-line sales further compounds the problem that globalization creates for the taxman.

There is at least some validity to such concerns since *ceteris paribus* firms and individuals find low-tax countries more attractive than high-tax countries, especially now that it is easier and less costly to relocate. However, while plausible in theory, casual observation suggests that they are considerably overblown. For one thing, although globalization in the sense of rapidly growing international trade and capital flows has been going on since the dawn of the postwar era, the government's share in national output has not fallen in most countries. If anything, the share has been large and growing, especially in developed countries. Furthermore, tax rates are one and only one consideration, albeit a major one, for companies and workers in deciding where to locate.

A related point is that tax rates and public services are not independent of each other. It is not too meaningful to talk about tax rates as being high or low without any reference to the quantity and quality of services produced by the government. To illustrate, facing a choice between a country with high tax rates but high-quality public transportation, education and health, and another country with low tax rates but low-quality public transportation, education and health, a perfectly rational company or individual may opt for the former. High tax rates are not a problem per se. They become a problem if and only if the government fails to give the citizens their money's worth for their tax payments. Therefore, globalization renders the government's efficiency all the more important, possibly setting off a benign international race for better and more affordable public services.

This suggests that globalization may strengthen the rationale for outsourcing or contracting out those services that the private sector is more efficient at producing than the government. The transfer of economic activities from the government to the private sector sometimes involves privatization or outright sales of state assets to the private sector. For example, while many governments are still involved in the energy and telecommunications sectors, there is no obvious reason why the government would do a better job of producing energy and telecommunications services than the private sector. On the other hand, there have been many real-world instances of botched privatizations that have produced neither lower prices nor higher quality. Whether privatization works or not in practice depends on how well the government implements it, for example in terms of regulating the privatized industry so as to promote competition, investment, and innovation.

Interestingly, in some cases economic globalization can loosen the resource constraints facing governments instead of tightening them. To illustrate, governments in many poor countries depend on financial assistance from rich country governments and multilateral financial institutions for their budgetary requirements. More significantly, in this age of massive international capital flows, the governments of rich countries and poor countries alike can and do borrow from foreign sources to finance their budget deficits. For instance, the United States government relied heavily on the willingness of Japanese investors to buy up its securities during the 1980s. However, a government's ability to borrow abroad is subject to strict market discipline. In any case, the positive impact of globalization on access to foreign capital is scant consolation for governments worried about its negative implications for taxes, its main long-term source of income.

As pointed out earlier, the demise of taxes and states are greatly exaggerated. What we cannot overemphasize under economic globalization is the need for greater commitment to efficiency on the part of the government. Whether the government itself produces a service or transfers production to the private sector is not nearly as important as the quality and affordability of the service. That is to say, the reliability and cost of, say, energy or telecommunications, matters much more to individuals and firms than who produces them. Therefore, confronted with footloose capital and labor, the government should pay more attention to customer satisfaction than ever before, both when it is itself the producer as well as when it is in a position to influence the producer.

3 The Promise of Economic Globalization and the State

A quick glance at a globe reveals that economies that are least integrated into the world economy, such as Cuba, North Korea or much of sub-Saharan Africa, are also among the world's poorest. On the other hand, the star performers of the world economy in recent decades, most notably many East Asian economies, have been precisely those economies whose economic transactions with other economies have grown the most rapidly. While globalization clearly entails undesirable consequences, on balance it is all but impossible to downplay its immense benefits for the world economy as well as individual national economies.

Nowhere are such benefits more noticeable than in East Asia in the postwar era. So much so that their meteoric economic rise has been dubbed the East Asian Miracle. Regardless of where one stands in the debate between proponents of market-led development and state-led development, it is only fair to acknowledge that the state played an instrumental role in enabling East Asian economies to take full advantage of the opportunities presented by globalization, in particular, access to foreign markets as well foreign capital and technology. While the degree of state intervention in the economy varied from country to country, throughout the region the state provided macroeconomic stability conducive to saving and investment, liberalized their foreign trade regimes in order to promote exports, and interfered less with the price mechanism relative to other developing countries.

Not surprisingly, those policies have helped to mobilize both domestic and foreign investment, especially in export-oriented manufacturing industries, and transformed the region into dynamic, high-growth economies. The region's

success in economic globalization, evident in its large and growing share of global trade and inward FDI, has driven the region's overall economic success. And, this is the crucial point here, the region's success in economic globalization owes a great deal to the generally sound economic policies of the region's states.

We can expect technological progress and multilateral trade liberalization, and the proliferation of regional trade agreements to further bring down barriers to international trade in the 21st century. At the same time, technology and liberalizing policies are also reducing the importance of borders in capital flows. Therefore, there is every reason to believe that the opportunities from globalization, in particular using exports as an engine of growth and foreign capital to finance productive investment opportunities, will continue to grow. But, as before, whether a country can grab those opportunities depends to a large part on the quality of the state's policies.

Consider a country that does not produce rubber, but is potentially good at making car tires, in fact so good as to be a world-beater. Now suppose that the country fails to make any car tires due to prohibitively high tariffs against rubber imports. The cost those tariffs impose on this country rises with globalization since the progressive removal of trade barriers expands the opportunities for exporting car tires. Similarly, globalization raises the benefits from reducing the same tariffs. Simply put, globalization raises the penalty for unsound economic policy and raises the reward for sound economic policy.

It is probably much more meaningful to talk about whether globalization renders policy, rather than the state, irrelevant. Our discussion so far yields an unambiguous answer – under globalization, the quality of policy becomes

more relevant than ever. This is not to say that government policy alone is the determinant of how well a country copes with globalization – far from it. However, given the capabilities of the country's individuals and companies, it is a critical factor at the margin. And, in a world of globalization and factor mobility, a razor-thin margin can make a world of difference.

The progressive removal of barriers to the movement of goods and services, capital, and labor associated with globalization necessarily implies greater competition among firms and individuals. What is less obvious but equally significant is that the removal of barriers entails greater competition among states to attract and retain firms and individuals. Globalization weakens the state's ability to get away with bad policies by limiting the state's monopoly over domestic capital and labor. The loss of policy autonomy often cited as a consequence of globalization pertains much more to bad policy rather than policy per se. Borders no longer protect policymakers from the consequences of their actions. The discipline of international competition can conceivably promote a race to the top among governments for sounder policy.

4 The Challenge of Economic Globalization and the State

If globalization were all gain and no pain, we would not see such vociferous opposition to it from so many different quarters around the world. In particular, economic globalization seems to be a favored target of violent anti-globalization protesters, whose exploits grab all the headlines during meetings of institutions that have come to symbolize growing international economic integration, such as the WTO, IMF or World Bank. Globalization is clearly not everybody's cup of tea. As hinted earlier, globalization not only presents vast

opportunities for improving human welfare but also throws up all-too-real challenges as well.

Ironically, those same East Asian economies that so vividly illustrated the tremendous promise inherent in globalization gave the opponents of globalization their most damning evidence of globalization's dangers. The Asian currency crisis that hit many of the Miracle countries like a tidal wave in 1997-1998 plunged the whole region into unprecedented financial, economic and social turmoil. Despite the region's subsequent recovery, the unexpectedness and severity of the crisis still serves as a powerful reminder about the two-faced nature of globalization. To many observers, the helpless vulnerability of the affected countries in the face of massive reversal of capital flows revealed the benefits of globalization to be a tantalizing but ultimately empty illusion.

Upon closer scrutiny, the Asian crisis illustrates not so much the risks of globalization as the importance of sound policy in minimizing those risks. A combination of heavy-handed state intervention and weak prudential regulation left the region saddled with financial systems that did a poor job of allocating resources to their most productive uses. East Asian governments' propensity to use their country's financial systems, especially banks, as tools for channeling resources toward favored firms and industries inevitably stunted the development of sound and efficient banks. Opening up the capital account, as East Asian countries did, under such circumstances virtually guarantees a sharp deterioration in the quality of investment, as indeed happened. What the Asian crisis tells us, then, is not that globalization is inherently destabilizing or harmful, but that bad policy can easily shatter its

promise.

The Asian crisis arose from the failure of government policy in yet another dimension. The other side of pre-crisis over-borrowing by East Asia's private sector was over-lending by rich country banks. Simply put, lured by high returns, the banks failed to do their homework in evaluating the potential risks involved in lending to the region. Of course, the responsibility for encouraging banks and other financial institutions to manage their risks sensibly falls ultimately on the state. Therefore, unsound policy in the form of weak prudential regulation in both the borrowing countries and lending countries was a major contributing factor in the Asian crisis.

At a broader level, it is worth noting that the essence of globalization is greater competition. As a country becomes more integrated into the international trading system, for example, its firms enjoy more opportunities abroad but at the same time, face more competition at home. Just as rapid technological progress calls for a smooth reallocation of resources within the economy, so do the daunting competitive pressures unleashed by globalization. Which means that the state should promote flexible output and factor markets to facilitate this critical reallocation. To illustrate, in countries experiencing a hollowing out of their manufacturing sector, deregulating and liberalizing the markets for services as well as the labor market will promote the expansion of service industries, which tend to be labor-intensive, and re-deployment of displaced manufacturing workers into those industries.

In some cases, a more direct and active role for the state may be justified. For example, the market may fail to provide enough training for workers laid off due to cheaper imports or the private sector may lack financial resources

or scale to make investments in potentially profitable but risky new industries. What matters for a country's competitiveness is that the reallocation of resources be quick and effective. If government intervention in any shape or capacity facilitates rather than hinders this critical movement of capital and labor, it is to be welcomed, not condemned on the basis of some presumed impotence of the state in a borderless global economy. The state can thus help the economy better adjust to globalization by directly and indirectly strengthening the economy's resilience in terms of uncovering new areas of comparative advantage and re-allocating resources toward them.

Globalization, like free trade, inflicts high costs on some firms and workers even though it generally benefits the economy as a whole. In this connection, an often ignored but necessary role of the state is to champion the cause of globalization to the public. The losses from globalization tend to be immediate and concentrated while the gains are distant and dispersed. It is only natural for a worker whose job has been exported overseas or a farmer whose livelihood has been destroyed by cheaper imports to be angry. The dislocations from globalization are real, especially to its short-run victims. In addition to policies that effectively facilitate adjustment and reallocation, what is required is a more compassionate state. This probably requires building a stronger social safety net and paying more attention to income inequality.

5 Concluding Thoughts

Economic globalization, or the breakdown of barriers to cross-border movements of goods and services, capital and labor, has already delivered sizable benefits to the world economy. To cite just one example, the flow of

capital from capital-abundant rich countries to capital-poor countries enable firms in the latter to undertake productive investments while providing a higher rate of rate of return to savers in the former. However, the distribution of globalization's fruits has been quite uneven across countries as well as within countries, and this goes a long way toward explaining widespread hostility toward globalization.

As we noted earlier, the demise of the state under globalization is greatly exaggerated. In one sense, the state matters even more in a borderless world economy. To be more specific, globalization magnifies the penalties for bad policies and the rewards for good ones because the consequences of policies no longer stop at the borders. Overvalued exchange rates not only keep away foreign investors, they also drive domestic capital abroad. Reducing red tape and corruption unleashes domestic enterprise, and at the same time brings in foreign capital and know-how.

Interestingly, globalization has not perceptibly altered the definition of good policies. For example, some say that globalization forces governments to provide a well-rounded, world-class quality of life so as to attract top talent from abroad. But aren't governments supposed to try to provide the best possible living and working environment for their citizens in the first place, globalization or not? The only difference is that success attracts skilled foreigners in addition to making citizens happy. And, failure not only makes for unhappy citizens, but citizens who emigrate, especially among the more able and thus more mobile.

This brings us back to an important point mentioned earlier, that the essence of globalization is greater competition. The discipline of greater

competition due to globalization is not only relevant for firms and workers; it is equally relevant for governments. That is to say, just as globalization promotes competition among the world's firms and workers whose national borders offer them much less protection than before, so it is with the world's governments. The yardstick for measuring the quality of a government and its policies is no longer limited to the quality of other domestic political parties and their alternative policies. Rather, that yardstick is increasingly the quality of governments and policies in other countries. Under globalization, capital and labor can and do vote with their feet.

In short, the state is alive and well in our increasingly borderless world, especially in the sense that the quality of its policies play a big role in determining the impact of that world on national welfare. At the same time, that world serves as a powerful force for positive changes in the quality of the state's actions. Which gives us strong grounds for optimism about the future of both the state and globalization. The optimistic scenario is one of mutual feedback between globalization and policy quality leading to states that continuously improve their policies and a globalization process that brings about ever-bigger benefits for the world.