

# **Are Social Safety Nets Protected in Developing Countries at the Age of Globalization?**

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Abstract:

A number of scholars argue that the welfare state does not necessarily wither away with globalization; however their studies are mostly restricted to developed countries and examine the general level of government spending. This paper will look at the relationship between greater integration into the world markets and welfare state spending by decomposing the spending into two main parts; social security and welfare, and education. Additionally, it will discuss the effects of labor institutions –which might prevent a decline in governments’ fiscal commitments to social welfare- in the context of developing countries.

## ***I. Introduction***

The integration into the world markets has several impacts on domestic policy choices available to governments. Contradictory hypotheses about globalization arise from two different views on government spending. On the one hand, government intervention is claimed to create distortions and induce unproductive rent-seeking activities, and hence reduces the international competitiveness. Therefore, governments should downsize their social welfare spending to sustain economic viability. On the other hand, government spending might be a respond to the demands of the losing groups, which are adversely affected by greater integration. Thus, the increased insecurity and inequality, as a result of integration, would lead to greater government spending<sup>1</sup>. Throughout the paper these arguments will be named as efficiency and compensation hypothesis and will be discussed in detail in following sections.

This paper will investigate the relationship between government spending and liberalization of trade and capital accounts. Particularly, I would try to evaluate the compensation and efficiency hypotheses that propose contrasting views of the impacts of liberalization in the context of developing countries. As long as efficiency hypothesis overpowers the compensation hypothesis government spending is likely to decrease. However, if compensation hypothesis dominates, higher economic insecurity and inequality created by globalization would bring greater welfare expenditure. But the latter proposition is conditional on how well the social groups, whose risk exposure increased with globalization, are organized and can translate their demand for higher protection into policymaking.

I will argue that developing countries experience a different adjustment process to globalization than advanced capitalist countries and safety nets are not necessarily preserved as a result of a lack of strong labor institutions<sup>2</sup>. In addition, globalization and domestic politics have a much more complex interaction when social expenditures are disaggregated into social security transfers, on the one hand, and human capital spending on education, on the other.

For this purpose I first look at government spending across 48<sup>3</sup> developing countries and estimated the impact of trade and capital account liberalization, and political strength of labor on general government spending and then I have decomposed the spending into social security and welfare, and education. This exercise aims to examine the competing hypotheses in more detail.

We believe that if the rising insecurity and inequality is conducive to a higher government spending this is most likely to occur as subsidies and transfer payments to the economic groups that are most vulnerable under globalization. Economic insecurity and inequality in the short-run would be highly affected by the unemployment benefits, pension schemes, agricultural support prices, etc. Moreover, education expenses are

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<sup>1</sup> See Rodrik (1998) and Garrett (2000) for further explanation.

<sup>2</sup> For a similar argument see Nudra (2002). However, she defines the political strength of labor in terms of the ratio of skilled and unskilled labor.

<sup>3</sup> The countries are Argentina, Bolivia, Botswana, Brazil, Cameroon, Chile, China, Colombia, Costa Rica, Côte d'Ivoire, Dominican Republic, Ecuador, Egypt, El Salvador, Gabon, Ghana, Guatemala, Guyana, Honduras, Hong Kong, India, Indonesia, Jordan, Malaysia, Mali, Malta, Mauritius, Mexico, Morocco, Nicaragua, Nigeria, Pakistan, Paraguay, Peru, Philippines, Senegal, Singapore, South Africa, Swaziland, Thailand, Tunisia, Turkey, Uganda, Uruguay, Venezuela, Zambia, Zimbabwe.

likely to decline if the efficiency hypothesis dominates since it is a very substantial sector through which government can implement egalitarian policies and which have considerable effects on the long-run material well-being of the beneficiaries. Generally efficiency hypothesis would suggest deregulation and privatization instead of public spending on these services. Moreover, Kaufman and Segura-Ubiergo asserted that the negative effect of international economic integration operates primarily in the area of social security transfers (mainly pensions), while health and education expenses are far less vulnerable in Latin America<sup>4</sup>.

The paper proceeds as follows. Second section will discuss the so called efficiency and compensation hypotheses in further detail. Third section will look at the data and estimation methods and the will elaborate on the decomposition of the government spending. The fourth section will present the results of the estimations. Finally the fifth section will conclude by implications and suggestions for future research.

## ***II. The 'Efficiency' and 'Compensation' Hypotheses<sup>5</sup>***

Efficiency hypothesis rests on a presumption that high levels of social spending reduce competitiveness in world markets, which might operate through several channels. At the economic level, the increased government spending might be linked to higher payroll taxes that increases the cost of labor and reduce the competitiveness both of exports and domestic products exposed to import competition. In addition, the higher government expenditures can lead to higher interest rates, which crowd out the private investment and raise the value of real exchange rate.

These channels are debatable at large and there are controversies about how government spending might affect private activity. For example, human capital theory proposes that higher spending on education and health would in fact increases the competitiveness. In addition, selective subsidy programs and preferential credits can

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<sup>4</sup> For a broader discussion see Kaufman and Segura-Ubiergo (2001). They found a strong negative relation between government spending and integration, especially capital mobility.

<sup>5</sup> It should be noted that the names of the hypotheses might be misleading, and it cannot be assumed a priori that expanding social spending is necessarily less efficient than cutting it back.

contribute to the competitiveness of domestic firms. Moreover, the proponents of efficiency hypothesis presume a neutral distribution, at least in the long-run, and overlook the distributional consequences of decreasing government intervention.

At the political level, with greater integration, workers capacity to resist tends to decline. Although Hecksher-Ohlin theorem claims the opposite that in labor abundant countries increased trade will lead to an upsurge in returns to labor and to an increase in its bargaining power vis -a- vis capital, this has not been substantiated empirically. First, as Rodrik and others argue liberalization creates greater exit options for capital owners, thus putting them in a better position in the bargaining process. Second, in many developing countries trade liberalization resulted in higher demand for high-skilled rather than low-skilled workers. Finally, the unions are better organized in public sectors and these are seriously weakened by liberalization. Therefore, as economies become more exposed to international competition, the incentives for governments to curb social spending grow more powerful whereas the political costs of doing so decrease.

The compensation hypothesis focuses on the welfare state as a mechanism for offsetting the social costs of international integration and for contributing to the development of human capital. Again if we want to look at the economic and political sides separately, there are various mechanisms how higher government spending is required with liberalization. Public investment in human capital provides collective goods for the private sector, which ought to crowd-in private investment rather than crowd-out. This channel becomes especially important during the current era where the information-based technologies are the main way of competing.

Regardless of the specific gains that can be obtained by liberalization, the increased integration into the world markets is likely to increase the uncertainty and material inequality for certain segments of the society. The economic insecurity is mainly reflected via decreasing employment opportunities, high volatility of national income<sup>6</sup>, and the speculative financial environment. Economic inequality<sup>7</sup> is widened all over the

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<sup>6</sup> See Rodrik (1999) for a further discussion and the ways through which globalization affects the incomes of the middle and lower income groups.

<sup>7</sup> The pre-tax income inequality, measured by Gini coefficient, is almost the same for the advanced and many developing countries. However, the inequality declines substantially after the tax adjustments in the advanced countries while it remains almost same for most of the developing countries which indicates that successful government intervention is necessary for greater equality.

world, the wage differentials accelerated and agricultural terms of trade deteriorated. In the absence of a well-designed incomes or support policies the workers and rural population is left to shoulder the losses of integration. These in turn create a potential for political instability and/or backlash against market-oriented economic policies. Therefore governments should compensate by providing subsidies and transfers.

The affects of globalization on government spending hence depend on which of the above hypothesis is dominating. If efficiency argument dominates the compensation hypothesis, then we would expect a decline in public expenditures along with greater trade and capital liberalization. Whereas under the case of a strong compensation by governments the public sector is likely to be enlarging or both effects can counterbalance each other indicating no considerable alteration in government spending.

Besides the aforementioned propositions, the net effect of economic liberalization on welfare expenditures relies on the domestic political institutions and particularly on the responsiveness of governments to popular demand. Governments would react if the vulnerable groups have sufficient political power, and this amply depends upon the domestic political environment. Garrett argues that highly centralized labor markets will put pressure on governments for higher redistribution when there is greater risk exposure. Nonetheless, Rudra claims that globalization affects welfare spending in developed and developing countries differently. Growing numbers of low-skilled workers relative to skilled workers, coupled with large surplus-labor populations, exacerbate the collective-action problems of labor in LDCs and make it increasingly difficult for them to organize. Workers' potential political gains from expanded trade and investment are ultimately outweighed in LDCs by their inability to collectively pressure the government for social programs in their favor. Also, the type of the government would have an impact on the size of social spending since democracies are more prone to respond to redistributive demands<sup>8</sup>. Adsera and Boix showed that governments might be able to avoid higher

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<sup>8</sup> Garrett (1998) found out that social democratic states are more likely to compensate than the liberal ones do. This study looks only at 12 OECD countries.

public spending via exclusion of the sectors, which may lose from increasing economic integration<sup>9</sup>.

Consequently, social groups and their political power to affect decision-making become crucial for examining the interaction between welfare commitments and internationalization. Pierson attributes the limited retrenchment of welfare state in OECD countries to the cross-class coalitions<sup>10</sup>. However, his analysis is not applicable to developing countries since the beneficiaries of welfare state such as elderly and disabled are not sizeable and well organized in those countries. In developing countries, labor groups have historically been the most organized compared to other societal forces. Hence, the paper will take labor organizations, namely unions, into account in analyzing the welfare-globalization nexus and look at if unions are influential enough to successfully resist the dismantling of welfare states in less developed countries.

Moreover, we don't believe that an overall positive relation between trade and capital mobility and government spending necessarily suggest the domination of compensation hypothesis. Particularly, the subsidies and transfers and education expenses are considered to be important elements of compensation, and if these types of spending have a negative relation with greater openness, governments are not responding to the demands of the losing groups. In the short-run the transfers can back up for the decreasing wages and/or increasing wage differentials, and in the long-run, the education investment contributes to higher earnings. Thus, to confirm that globalization, indeed, led to higher government intervention the government spending should be decomposed.

### ***III. Data and Methodology***

Due to data availability problems pooled data won't be employed. There are few studies for developing countries, which attempt to display the relation between globalization and domestic policy choices using pooled data; however, these studies are

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<sup>9</sup> Adsera and Boix (2002) show that free trade authoritarian regimes, such as the East Asian economies, the public sector is 10 percentage points of GDP smaller than in a democratic system with similar levels of economic integration.

<sup>10</sup> See Clayton and Pontusson (1998) for an extensive critique of Pierson.

mostly looking at Latin American region<sup>11</sup>. This is the main reason why I did not apply pooled data and instead used cross-section. But the drawback of the cross-section analysis is it fails to capture the time effects. However, the paper alleviates this problem by introducing the change measures for both government spending and economic policy variables. The 1985 year is taken as a stage of relatively immature liberalization and the difference with succeeding years is utilized to grasp the dynamic element.

I have three dependent variables as central government spending, social security and welfare spending, and education spending, all as percentages of GDP. Total expenditure of the central government includes non-repayable current and capital (development) expenditure. It includes expenditures financed by grants in kind and other cash adjustments, but does not include government lending or repayments to the government or government acquisition of equity for public policy purposes<sup>12</sup>. Public expenditure on social security and welfare shows compensation for loss of income to the sick and temporarily disabled, payments to the elderly, the permanently disabled, and the unemployed; family, maternity, and child allowances; and the cost of welfare services, such as care of the aged, the disabled, and children<sup>13</sup>. The data on education spending<sup>14</sup> refers solely to public spending—that is, government spending on public education plus subsidies for private education. The data generally exclude foreign aid for education. They also may exclude spending by religious schools, which play a significant role in many developing countries. Data for some countries and for some years refer to spending by the ministry of education of the central government only (excluding education expenditures by other ministries and departments, local authorities, and so on).

I used the sum of exports and imports as a percentage of GDP as an indicator of market integration. For the level effects the 1985-2004 period is utilized and the change of trade openness is assessed as the difference between 1985-2004 period minus the 1970-84 period. For capital mobility the IMF codification is taken as a proxy of government restrictions on capital flows. This approach is useful given that it enables us

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<sup>11</sup> Rudra (2002) looks at a broader sample with pooled data but many developing countries do not have statistics for the variables utilized in this paper for most of the years under consideration.

<sup>12</sup> For more information, see Tables: WDI 4.13.

<sup>13</sup> For more information, see Tables: WDI 4.13.

<sup>14</sup> Data on education are obtained from the United Nations Educational, Scientific, and Cultural Organization (UNESCO).

to make comparisons with the other existing studies such as Quinn's finding of a positive relation between capital mobility and government spending.

To estimate the political strength of labor, I will use the non-agricultural union density. The data is taken from World Labor Report by ILO and it is the most standardized measure across countries. I will also look at the joint effect of union density and the globalization variables. Finally, the control variables include per capita GDP, population, land area, the dependency ratio, and urbanization as well as regional dummies.

The model in fixed-effect regressions tried to capture the effects of trade and capital mobility and labor institutions on government spending. The estimated equation is as follows:

$$\text{SPEND} = a + b_1\text{TR} + b_2\text{CM} + b_3\text{UN} + b_4\text{TR*UN} + b_5\text{CM*UN} + b_k \text{CONTROL} + K_n\text{REGION} + \varepsilon \quad (1)$$

The SPEND stands for the level of government spending as a percentage of GDP, TR is the level of exports plus imports as a percentage of GDP, CM<sup>15</sup> is the level of capital mobility and it is 1 if IMF denotes no government restrictions on the capital account; otherwise 0. UN is the union density in non-agricultural sectors, TR\*UN is the interaction between trade openness and unions and CM\*UN is likewise for capital account liberalization and unions. CONTROL stands for control variables and REGION stands for regional dummies. Ultimately, the initial theoretical expectations, the completeness of data coverage and the Chow and Aiken information tests that look at the contribution of the controls to the total variance, determine which control variables to include in the final model. All the variables except regional dummies are expressed as log transformations to deal with heteroscedasticity problems.

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<sup>15</sup> Log of the capital mobility used in the paper is  $\ln(\text{capital mobility}+1)$  since it varies between 0 and 1.

Next, I modify the equation to assess the effects of the process of globalization that is the changes in trade and capital mobility instead of the impact of levels of market integration. A dynamic element is introduced by way of this method into the analysis.

The equation is:

$$\Delta\text{SPEND} = a + b_1\text{SPEND}_{t-1} + b_1\Delta\text{TR} + b_2\Delta\text{CM} + b_3\text{UN} + b_4\Delta\text{TR}*\Delta\text{UN} + b_5\Delta\text{CM}*\Delta\text{UN} + b_k\Delta\text{CONTROL} + k_n\text{REGION} + \varepsilon \quad (2)$$

First differences of all variables, as  $\ln(\text{average } 1985\text{-}2004) - \ln(\text{average } 1970\text{-}84)$ , are taken in the above equation, thus the invariant land area parameter is dropped. Also a lagged level of government spending is involved to cover for any tendency of convergence of government spending over time. If spending increased more slowly after 1985 in countries with higher levels of prior spending, the  $b_1$  would be significantly negative. Like in equation 1, positive estimates for  $b_1$ , and  $b_2$  would be consistent with the compensation hypothesis whereas negative coefficients support the efficiency view.

Finally I extend the discussion by decomposing the government spending into social security and welfare payments, and education expenses<sup>16</sup>. We believe that the domination of the compensation hypothesis is highly contingent upon the increase in social security and welfare payments as long as it presumes that government spending grows as a response to the insecurity and instability created by the openness. We will expect to have a positive effect if labor institutions are strong enough to push for higher compensation. Social security and welfare payments are the most direct and main mechanisms of securing against the insecurity arouse while education is effective in the long-run. Thus we look at the effects of openness, both trade and capital, labor market institutions, and their interaction on social security and welfare expenses, and education spending. The social security and welfare and the education expenses are expressed as a percentage of GDP. Moreover, to evaluate whether a rise in the overall government

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<sup>16</sup> My initial attempt was to also look at the health expenses; however, I could not find reliable data for many low income countries. The data for education spending is taken from UNESCO.

spending is driven by either of the above components the same set of countries are used. We change the dependent variable to social security and welfare, and education spending in above equations (1) and (2) respectively to test for the hypotheses.

#### **IV. Results**

Below, the results for the total central government spending are presented in Table 1, it covers 1985-2004 period, and in the estimations the log of the average of this period is utilized.

**Table1. The Government Spending: 1985-2004**

<b>DEPENDENT VARIABLE</b>	<b>TOTAL CENTRAL GOVERNMENT SPENDING</b>					
	(1)	(2)	(3)	(4)	(5)	(6)
<b>Independent Variables</b>						
<b>Trade</b>	0.273	0.123	0.178*	0.077	0.080	
<b>Capital Mobility</b>	2.414	0.731	2.194*	-0.089	-0.016	
<b>Trade*Cap</b>	-0.496		-0.579*			
<b>Union</b>	0.024	0.013			0.003	0.003
<b>Trade*Union</b>	-0.005	-0.002				
<b>Cap*Union</b>	-0.038	-0.060				
<b>GDP per capita</b>	0.108	0.101	0.092	0.062	0.078	0.078
<b>Population</b>	-0.127*	-0.150**	-0.126**	-0.151**	-0.151**	-0.157**
<b>Area</b>	0.071	0.096*	0.073	0.096**	0.098**	0.095**
<b>Dependency Ratio</b>	0.509	0.396	0.509	0.378	0.457	0.409
<b>Urbanization</b>	0.102	0.077	0.144	0.122	0.074	0.078
<b>East Asia</b>	-0.307	-0.356	-0.220	-0.274	-0.291	-0.290
<b>Latin America</b>	-0.54***	-0.535***	-0.542***	-0.530***	-0.531***	-0.530***
<b>Sub-Saharan Africa</b>	-0.358*	-0.317	-0.352*	-0.312*	-0.332*	-0.283
<b>Intercept</b>	2.936	3.851**	3.298*	4.215***	4.233***	4.625***
<b>Obs.</b>	48	48	48	48	48	48
<b>R-square</b>	0.435	0.413	0.421	0.376	0.382	0.372

\*\*\* p<.01, \*\*.01<p<.05, \*p<.10

The interactive terms are added to the analysis to examine if there is any joint effect of trade and capital mobility, trade openness and unions and capital mobility and unions as well on government spending. Union and related variables appear to be statistically insignificant throughout different specifications. Considering the general level of government spending, this is not completely improbable since this category includes all sorts of expenditures.

Once we drop the union related variables, we can test the rival hypotheses of efficiency and compensation. One would expect a negative sign for trade and capital mobility if the efficiency hypothesis overpowers the compensation hypothesis, however, the results indicate a positive sign and the coefficient is statistically significant in both cases. It is interesting to note that the sign on interactive effect of capital mobility and trade turns out to be negative and statistically significant. This overall picture tends to evince that there is no consistent relationship between liberalization and government spending. These results are in line with Nudra's findings, which look at roughly the same set of countries with different domestic policy variables. Nonetheless, two other papers<sup>17</sup> examining Latin American countries show that trade integration has a consistently negative effect on aggregate social spending and that this is compounded by openness to capital markets.

To illustrate the time effects I have estimated the second equation described above and the results are summarized in Table 2.

**Table2. The Change in the Government Spending: 1985-2004**

<b>DEPENDENT VARIABLE</b>	<b>CHANGE IN TOTAL CENTRAL GOVERNMENT SPENDING</b>					
	(1)	(2)	(3)	(4)	(5)	(6)
<b>Independent Variables</b>						
<b>Lagged Level of Spending</b>	-0.234**	-0.227**	-0.283**	-0.282**	-0.284**	-0.249*
<b>ΔTrade</b>	-0.093	-0.130	-0.138	-0.184	-0.189	
<b>ΔCapital Mobility</b>	-0.674*	-0.558*	-0.397	-0.249	-0.242	
<b>ΔTrade*Cap</b>	0.876		0.798			
<b>Union</b>	0.007	0.009			0.003	0.004
<b>ΔTrade*Union</b>	-0.002	-0.002				
<b>ΔCap*Union</b>	0.035*	0.035*				
<b>ΔGDP per capita</b>	0.133	0.115	0.151	0.131	0.132	0.144
<b>ΔPopulation</b>	0.110	0.042	0.448	0.437	0.452	0.681
<b>ΔDependency Ratio</b>	0.281	0.270	-0.021	-0.041	-0.034	0.006
<b>ΔUrbanization</b>	0.143	0.130	0.138	0.164	0.167	0.073
<b>East Asia</b>	-0.263*	-0.251	-0.151	-0.138	-0.137	-0.159
<b>Latin America</b>	-0.132	-0.141	-0.029	-0.032	-0.031	0.027
<b>Sub-Saharan Africa</b>	0.003	0.008	-0.023	-0.031	-0.032	-0.019
<b>Intercept</b>	0.724*	0.753*	0.739*	0.750*	0.744*	0.556
<b>Obs.</b>	48	48	48	48	48	48
<b>R-square</b>	0.357	0.347	0.284	0.274	0.275	0.243

\*\*\* p<.01, \*\*.01<p<.05, \*p<.10

As seen from Table 2, the coefficient on the lagged variable turned out to be negative and statistically significant supporting the convergence premise. The countries that have higher levels of government spending tend to decrease the pace of spending. In addition the R-squares are substantially low under any specification.

For us the most important finding is the negative impact of the change in capital mobility on change in government spending. According to efficiency hypothesis the greater capital account openness would bring more competition and to become competitive government spending ought to decline. The compensation hypothesis predicts the opposite that the higher competitiveness and openness would lead to

<sup>17</sup> These papers are by Avelino, Brown and Hunter (1999) and Kaufman and Segura-Ubiero (2001).

increased government spending to back up for the risks involved in the process. The results indicate a support for efficiency hypothesis; however, once we take out the union variables from the estimation the coefficient for capital mobility loses its significance. This calls for the importance of including domestic policy variables to explain the globalization-welfare nexus. Furthermore, change in capital mobility and union density jointly has a positive impact suggesting that labor organizations were at least partly successful in avoiding declines in government spending over time.

Next, the government spending is decomposed into social security and welfare and education expenses. I will provide the regression results for them together in Table 3.

**Table 3. Subsidies and Transfer Payments and Education Expenses as a Percentage of GDP: 1985-2004**

DEPENDENT VARIABLE	SOCIAL SECURITY AND WELFARE %GDP			EDUCATION SPENDING %GDP		
	(1)	(5)	(6)	(1)	(4)	(5)
<b>Independent Variables</b>						
<b>Trade</b>	-0.077	-0.219		0.197	0.253**	0.259**
<b>Capital Mobility</b>	-0.997	0.327		-0.979	-0.503*	-0.394
<b>Trade*Cap</b>	0.475			0.153		
<b>Union</b>	0.065	0.021*	0.020**	-0.001		0.005
<b>Trade*Union</b>	-0.011			0.002		
<b>Cap*Union</b>	-0.041			-0.001		
<b>GDP per capita</b>	-0.015	0.008	0.007	0.177	0.156	0.180
<b>Population</b>	-0.148	-0.134	-0.120	-0.187***	-0.179***	-0.179***
<b>Area</b>	0.072	0.066	0.069	0.135**	0.124**	0.126***
<b>Dependency Ratio</b>	-1.305	-1.151	-1.015	0.295	0.205	0.324
<b>Urbanization</b>	-0.180	-0.151	-0.122	-0.153	-0.073	-0.145
<b>East Asia</b>	-1.039*	-0.890*	-0.782*	0.005	0.037	0.011
<b>Latin America</b>	0.322	0.316	0.343	-0.290	-0.291*	-0.293*
<b>Sub-Saharan Africa</b>	0.267	0.239	0.109	-0.380*	-0.361*	-0.392*
<b>Intercept</b>	3.196	3.352	2.214	2.387	2.006	2.033
<b>Obs.</b>	48	48	48	48	48	48
<b>R-square</b>	0.397	0.382	0.354	0.475	0.460	0.472

\*\*\* p<.01, \*\*0.01<p<.05, \*p<.10

We are specifically concerned with the coefficients on trade, capital mobility, their interaction, union density, and its interaction with openness variables. For social security and welfare spending, both trade and capital account liberalization do not seem to have a consistent effect whereas the union density is positively and significantly related to the level of social security and welfare expenditure. The sign on union remains positive but loses its statistical significance when we add the interactive terms. This combined with negative signs on trade and capital mobility might signify that globalization undermines the effectiveness of labor institutions.

Considering the effects of trade on education expenses, we see that it has a positive and significant coefficient suggesting the compensation view's validity. This might imply that even if there is a positive effect of trade openness on government spending, this is driven by an increase in the educational expenses, which can be assessed as an attempt to raise the human capital. The sign of capital mobility and interactive term remain same for education as they were for social security and welfare spending, which show that liberalization of the capital account and the interaction of it with trade openness have the same influence on both kinds of government spending for the countries under concern. One distinction between these two types of expenditures is that the union density and its interactive terms stay insignificant for education spending under any specification. The domestic political institutions (measured as union density) in our regressions are not influential enough to have a bearing on the level of educational spending and they cannot foster the positive effect of trade liberalization. But, we might argue that it hinders the negative effect of capital mobility since sign on capital mobility turns out to be insignificant after including the union variable (under specification 6).

In the following table, the influence of globalization process will be elaborated by looking at the change of economic policy variables and social security and welfare payments and education expenses. The fixed variable land area is discarded from the estimation.

**Table4. Change in Social Security and Welfare Payments and Change in Education Spending**

DEPENDENT VARIABLE	CHANGE IN SOCIAL SECURITY AND WELFARE			CHANGE IN EDUCATION SPENDING		
	(1)	(5)	(6)	(1)	(5)	(6)
<b>Independent Variables</b>						
<b>Lagged Level of Spending</b>	-0.247***	-0.263***	-0.265***	-0.275**	-0.270**	-0.275***
<b>ΔTrade</b>	0.468*	0.318		0.052	0.051	
<b>ΔCapital Mobility</b>	-0.310	0.466		0.020	-0.050	
<b>ΔTrade*Cap</b>	2.171			0.285		
<b>Union</b>	0.011	-0.001	-0.001	0.003	0.007**	0.008**
<b>ΔTrade*Union</b>	-0.003			0.001		
<b>ΔCap*Union</b>	0.041*			-0.011		
<b>ΔGDP per capita</b>	-0.084	-0.110	-0.120	0.235	0.221	0.216
<b>ΔPopulation</b>	-1.299	-0.877	-1.291	0.738	0.573	0.577
<b>ΔDependency Ratio</b>	0.397	-0.038	-0.110	0.155	0.239	0.258
<b>ΔUrbanization</b>	0.571	0.667	0.836*	-0.286	-0.306	-0.290
<b>East Asia</b>	-0.598**	-0.423*	-0.363*	-0.035	-0.072	-0.059
<b>Latin America</b>	-0.003	0.153	0.071	0.042	-0.004	0.000
<b>Sub-Saharan Africa</b>	0.030	-0.025	-0.040	0.010	0.025	0.018
<b>Intercept</b>	0.716	0.559	0.696*	0.026	0.102	0.107
<b>Obs.</b>	48	48	48	48	48	48
<b>R-square</b>	0.421	0.353	0.311	0.270	0.262	0.26

\*\*\* p<.01, \*\* .01<p<.05, \*p<.10

As seen from Table 4, the change in trade openness positively affects the social security and welfare payments and it is statistically significant. The change in capital mobility is also inversely related with this kind of government spending, though insignificant. Interaction of the two liberalization variables has a positive sign but remains to be statistically insignificant as well. The union density alone does not appear to be effective but together with capital account liberalization it has a positive and significant sign. Regarding the negative relationship between change in capital mobility and change in social security and welfare payments, this leads us to construe that unions are capable of averting it. The estimation results for social security and welfare payments both level and change seemed to be confirming none of the hypothesis.

When we look at what happens to the change in education spending with greater integration into the world markets we get again an inconclusive story. Neither the sign on change in trade nor the sign on change in capital mobility are statistically significant. Besides, the union density has a positive and significant relationship with change in education spending with or without openness variables. Unlike the level estimates the change in education expenses seem to be responding to the demands of labor institutions.

## ***V. Conclusion***

It is widely argued that globalization constricts the domestic policy choices, especially the ways of government intervention. This view originates from the belief that government intervention is inefficient, hence, it should be cut back in order to achieve competitiveness in the world markets. Nonetheless, there are also arguments, which suggest that increased integration can lead to more government intervention because states should compensate the losers in the liberalization process. Moreover, more public investment in education and health would result in higher human capital, thus, more efficient outcomes. Generally the net effects of trade and capital mobility will depend on the relative strengths of these two contending views.

Furthermore, the domestic policy variables are as important as the international ones in shaping the outcome of any policy. Especially, social groups who can translate their demands for greater redistribution would be influential in determining the level and the change in government spending. In addition to greater integration to world economy, domestic political factors play a prominent role for policy choices. The strength of the labor unions, how well a society organized, and the nature of the government are all determinants whether a more interventionist government is preferred. Globalization, surely, put constraints on domestic policy choices, however, there is still room to maneuver. Social spending is, besides all the other factors, still a function of the degree of governments' commitments to provide social welfare. In developing countries the labor unions represent the most organized and powerful social group, hence, they are more likely to affect the decision making.

The study aimed to inspect the validity and the robustness of above competing hypotheses by incorporating domestic political variables, namely union density. Subsequently, a decomposition of government spending has been used to show that trade and capital markets openness can constraint certain types of public spending in different ways. We believe that even though globalization can lead to higher overall public spending it does not automatically bring the domination of compensation hypothesis. If the social security and welfare payments and education expenses are not rising with more integration we can't conclude that governments are trying to counterbalance the adverse effects of openness. The social security and welfare payments are the most direct mechanisms of supporting the losing groups, and education expenses might create higher earnings in the long-run. Therefore, a declining share of these types of activities would point out that governments are refraining from compensation.

The results did not reveal a clear relationship between government spending – total and decomposed- and globalization. Also, the domestic political institutions appear to be significant for both level and changes in government spending either alone or interacting with openness, which signifies the inclusion of such variables.

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