The impact of the global financial crisis: What does this tell us about state capacity and political incentives to respond to shocks and manage risks?

Literature review

Part 3: Globalisation and State Capacity

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This note provides an overview of the existing literature on globalisation and state capacity, with specific reference to the capacity of states to respond to economic shocks.

Outline:

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3. Constraints on State Capacity: Low stateness explained
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1. Introduction

The distribution of the effects of the recent global financial crisis, as well as similar events in the past, reveal the extent of interconnectedness that has come to define the global economic system. As Newell (2002:5) describes, 'While it is important to recall that many rural livelihoods in more remote areas of the world are not obviously and directly touched by changes within the global political economy, we should note the new forms of vulnerability that affect the rural poor as markets open up, and the shocks that reach distant suppliers when markets crash and financial crises unfold[1].' In this context, consideration of the changes in a state's capacity to respond to such economic shocks that have accompanied this greater degree of interconnection is critical.

The debates on globalisation and state capacity revolve primarily around the question of whether or not (and to what extent) a globalist logic is being forced on states, steadily reducing their policy space and thus perhaps their capacity to respond to economic shocks as well. As Haslam (1999:41) describes, 'It is commonly argued that economic globalization has restricted the ability of the state to realize a wide range of domestic macro-economic policy goals and undermined the "embedded liberalism" of the post-war welfare state and the policy autonomy guaranteed through the Bretton Woods system[6].'

The counter-argument suggests that the process of globalisation is in fact being shaped and driven by (some) states and that the impacts are highly conditional on the historical and institutional contexts of state capacity in different countries. From this perspective, states remain active agents, working on their own behalf to manage the challenges of a globalised world.

[1] See, for example, Dauvergne's (1999) work on the impact of the financial crisis in South-East Asia upon livelihood choices of the rural poor

In this sense, the interconnectedness inherent in processes of globalisation such as the globalisation of production and supply networks can be interpreted not only as means by which corporations bypass the power of the state, but also a key new challenge for states. The transmission of economic shocks across international borders is facilitated by the effects of globalisation.

This note provides an overview of the existing literature on globalisation and state capacity, with specific reference to the capacity of states to respond to economic shocks. Section two provides a brief overview of the ways in which the globalist and statist perspectives have been captured in the literature. Despite the variety of way in which the debate is framed, a number of key issues begin to emerge across the literature. The third section therefore presents those key features of change in the international system associated with globalisation that may limit the capacity of the state, while section four identifies where the literature on globalisation suggests the maintenance or even a potential expansion of state capacity.

2. Frameworks for the analysis of the impacts of globalisation on state capacity

As described above, the literature on globalisation and state capacity that began to emerge in the late 1990s is often thought of as presenting two alternatives. In the first, processes of globalisation, that is, the increasing interconnections across national borders (characterized by an increasing volume of cross-border financial capital flows, the internationalization of production by transnational corporations, and information and knowledge exchanges' (Haslam, 1999:41)) has eroded state capacity (Vernon, 1971 in Haslam, 1999:43 and in Polillo and Guillén, 2005:1764; Kennedy 1993 in Polillo and Guillén, 2005:1765; Strange, 1995 in Evans, 1997:65). In some accounts, this erosion by the forces of economic globalisation and a renewed belief in the efficacy of markets as mechanisms of social organisation has been reinforced by the collapse of the old bipolar world in which state-centric political and military rivalries underpinned world systems (Evans, 1997). One can imagine recent intra-state and non-state conflicts as lending credence to such views. At the other end of the spectrum are those who argue that globalisation, where it has occurred, has failed to diminish the power of the state, although it may well have led to changes in the mechanisms through which the state acts (Weiss, 1997;1998) or the locus of capacity within the state (Polillo and Guillén, 2005).

However, as Haslem (1999:43) points out, this simplistic framework is based on the assumption of a dichotomous distinction between the national and the global (the state and the market) in which the two are battling for supremacy. In fact, there is a great deal of variety and nuance in the literature that is not reflected in these two polarised positions. **Hobson and Ramesh (2002)** add an additional dimension to their analysis, by differentiating first between a structuralist position in which increasingly globalised structure constrain the behaviour of states and an agent-centric position in which states retain some degree of functional sovereignty, and second between 'hard' and 'soft' globalisation (figure 1). Once one moves away from the 'hard' poles of structuralism (supremacy of the global/market) and agent-centrism (supremacy of the state) there is increasingly space for interpretations in which the national and the global are tied up in a symbiotic relationship, drawing on and shaping one another.

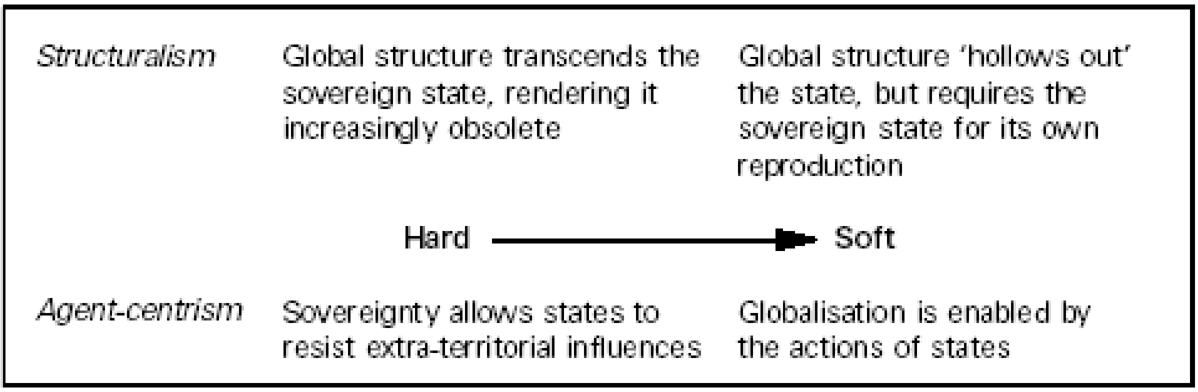

FIGURE 1. Classifying theories of the state and globalisation.

Source: Hobson and Ramesh, 2002:[2]

Weiss (1997, 1998) too presents a framework in which the assumed zero-sum dichotomy is rejected in favour of a more nuanced approach. Weiss (1997:5-6) identifies four hypotheses, each supported in the literature, regarding the impact of globalisation on state capacity:

i. Strong globalization; state power erosion.[7]

ii. Strong globalization; state power unchanged.[8]

iii. Weak globalization (strong internationalization); state power reduced in scope.[9]

iv. Weak globalization (strong internationalization); state power adaptability and differentiation emphasized.

Weiss distinguishes here between 'globalization', which suggests a reduction in the importance of national borders, and 'internationalization', which suggests that while cross-border activity may have increased, the nation-state retains importance as a mechanism of structuring human activity (and, in the case of hypothesis iv, an active agent in shaping that structure).

In both the more nuanced frameworks described above we can discern two lines of inquiry. First, what has been the nature of globalisation itself (hard vs. soft, strong vs. weak); and second, what is the degree to which constraints have been imposed (or not) on the set of actions available to states as a result of whatever globalisation has taken place. While the two are clearly related, for the purposes of this literature review the latter is key, and therefore the sections that follow present the arguments for and against the limitation of state power.

3. Key arguments regarding low stateness

Looking more broadly across the literature, there are a number of reasons cited to support hypotheses like those of Susan Strange, cited in Evans (1997), which suggest that

[2] For a discussion of how states have influenced the emergence of globalization, see Eric Helleiner. *States and the Emergence of Global Finance: from Bretton Woods to the 1990s,* (Ithaca: Cornell University Press, 1994). For a discussion of "embedded liberalism" and its decline, see John Gerard Ruggie, "Multilateralism: the Anatomy of an Institution," *International Organization* 46 (Summer 1992), pp. 561- 598.

globalisation is a key reason that '"state authority has leaked away, upwards, sidewards, and downwards" and in some matters "just evaporated".'

- **The internationalisation of production networks (embodied by the rise of multinational corporations as powerful actors) and potential footloose nature of corporations**

  As restrictions on cross-border movement of economic activity have eroded, the 'exit' option has become increasingly viable for corporations, either as a whole, or in part. As a result, states are left with little leverage to impose or enforce policies that may be disliked by corporations (such as the imposition of high levels of corporate taxation, policies adding rigidity to labour markets and strong environmental standards). Ongoing debates in the UK and the US regarding the imposition of a new 50% income-tax rate on high income earners, special taxes on bonuses earned in the financial industry and the potential implementation of financial transaction tax have all stirred discussion of corporate flight**.** The market/private sector is thus assumed to have gained in strength relative to the public sector in any given country. Weiss (1997) introduces this argument, but cautions against taking it at face value.

- **Rise of international finance and increased international capital flows**

  In a globalised (or internationalised) world, the state is no longer in control of all relevant policies. Perhaps nowhere has this been as clear in recent years as in the case of financial globalisation which both presents new challenges and limits the effectiveness of potential responses to those challenges. Evans (1997:72-3) argues that the speed and quantity of international financial transactions **'**makes for great allocative efficiency in theory, but it also makes for great volatility in practice... After a certain point, reducing the power of states to interfere increases collective exposure to risk more than it expands the possibilities for individual profits.'

  Recent work has focused on the extent to which the highly inequitable patterns of growth produced by globalisation and the growing income inequality gaps, both between and within states, have contributed to financial instability. Vandemoortele (2009) argues that it is precisely the inability of the US state to make the difficult political decisions that affect distribution of income, and to promote an equitable version of growth, that have led to the types of loose monetary policy that resulted in the housing bubble, the proliferation of debt-financed consumption and ultimately the financial crisis.

  At the same time, the ability to move capital increasingly freely across national borders has weakened the ability of national governments to manage economic cycles and, in times of crisis, to protect their societies. As Robert Wade (2000:146) argues,

  '[Financial globalization] imparts a deflationary bias to policy, and makes national-level countercyclical macro policy more difficult. If one government undertakes unilateral expansion by loosening monetary policy and lowering interest rates, capital moves abroad as investors and speculators seek higher returns and lower inflation. The government must either let the exchange rate depreciate (which may trigger inflation and further depreciation), or raise interest rates. Either way, it cuts off the unilateral expansion'.

- **Constraints on policy space arising from international policy norms/requirements**

  Globalisation has been associated with the imposition of both formal institutional constraints and informal 'pressures to conform'. Key policy decisions, including macroeconomic decisions critical to crisis response, are increasingly being made either by international decision-making bodies (in which many countries lack effective voice), or in accordance with the influence of powerful global financial actors. 'The state remains, in many ways, the vehicle through which these pressures are mediated, but the decision-making autonomy is compromised through negotiation with a broader range of social and economic global actors than has traditionally been the case' (Newell, 2002:3).

a. Formal institutional commitments - The clearest example of the restraints placed on states in an economically globalised world may be the requirements under international bodies such as the WTO (and previously under the GATT). While some regulations imposed on countries, such as those laid out by the WTO (following the abandonment of the rules of Special and Differential Treatment that helped define earlier world trade regimes), are meant to be applied universally, there are also a variety of formal commitments that apply to specific countries. Where international linkages are governed not by international institutions, but by regional and bilateral agreements, restrictions on policy space may be even more restrictive than global agreements (Evans 1997:71).

b. Informal constraints – In many cases, the constraints imposed on states by the world system can best be described as what Meyer et al. (1997, p. 157 in Polillo and Guillen, 2005:1773) call "the expanding externally defined requirements of rational actorhood." For some, (Evans, 1997) these requirements are inextricably tied to the dominant neo-liberal ideological paradigm that defined the period, such as the pressure to maintain international faith/confidence in your country's exchange rates through the use of the 'right' policy tools (note here the recent arguments between the IMF and Brazil over the potential use of capital controls by Brazil during the current financial crisis[3]). However, whether one limits ideological pressures to those associated with neoliberalism or permits a broader interpretation, this concept of informal pressure acknowledges that 'because of cross-national economic, political, and cultural competition in a context of globalization, the state is subject to coercive, normative, and mimetic pressures. In response to these pressures, the state reorganizes itself, with a strong tendency toward emulating the organizational forms and practices adopted by other countries' (Polillo and Guillen, 2005:1773).[4]

   One oft-cited pressure on domestic policy makers is that limiting fiscal space, with specific concern regarding budget deficits and long-term effects on inflation and credit ratings. Kaufman and Segura-Ubiergo, for example, find that 'trade integration has a consistently negative effect on aggregate social spending and that this is compounded by openness to capital markets' (Kaufman and Segura-Ubiergo, 2001:554).

   This is interpreted in various ways in the literature. One of the arguments favoured by those advocating the overwhelming influence of globalisation is the minimisation of the state (the retreat of the social welfare function) and the un-

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[3] See Rodrik (2009) at http://www.project-syndicate.org/commentary/rodrik37/English and Subramanian and Williamson (2009) at http://www.ft.com/cms/s/0/a0c04b34-c196-11de-b86b-00144feab49a.html?nclick_check=1

[4] It should be noted that the distinction between 'pressures to conform' and more formal institutional constraints can easily become blurred in the case of the imposition of strong conditionalities. Given the asymmetrical power relationships that many countries have with large international institutions, informal pressures can feel very much like formal constraints.

embedding of embedded liberalism (Evans 1997: 70-1; Ruggie 1992 in Haslam 1999: 41). These pressures may reflect the tension between the reduction of economic barriers and the potential increase in social/political tensions in Polanyi's framework of the double movement as described in *The Great Transformation* (1944).

In times of crisis, such an effect would be of particular importance as the state seeks to respond in a way that maintains well-being throughout the downturn. More recent debates in countries like the US and the UK have focussed on the tension between continuing, or even scaling-up, counter-cyclical macroeconomic policies and the perceived need to cut spending to limit budget deficits and head off inflation (see, for example, Krugman (2010)).

4. Key arguments regarding high stateness

In contrast to, or perhaps despite the consequences of globalisation listed in the previous section, the majority of the authors in the literature surveyed maintained the perspective that the potential for states continue to play an important role in protecting the well-being of their citizens and retain significant capacity for policy autonomy.

- **Challenging the collapse of the welfare state: the insulating effect of state spending in highly 'open' economies**

  A number of authors have challenged assumptions about the constraints (fiscal and other) placed on countries that would suggest a reduction of the role of the state in managing the economy and thus economic well-being. Closer examination reveals that the presumed connection between greater integration in the world economy and a reduction in the active role played by government is far from a foregone conclusion. Cross-country statistical work by Dani Rodrik (replicating and expanding on earlier work by others5) suggests a strong correlation between government expenditure (as a share of GDP) and exposure to trade. In other words, countries that are more exposed to trade have bigger governments (Rodrik 1998).

  Explanations for this apparent contradiction with theories of the globalisation-induced collapse of the social welfare function of the state remain diverse. The compensation hypothesis suggested by Rodrik (1998) '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' (Kaufman and Segura-Ubiergo, 2001:557). In other words, the specific recognition of the costs of integration may, in fact, result in increased demand for public provision of social welfare. Recent work by Epifani and Gancia has challenged this interpretation, arguing higher levels of government spending are the result of an increased ability of governments to shift some of the costs to overseas consumers rather than an increased demand for risk-mitigating provision.

- **Uniformity overstated**

  What then of the arguments that states' autonomy has been reduced by the forces of globalisation? One of the key arguments in favour of the retention of state capacity is

[5] See, for example, David Cameron, "The Expansion of the Public Economy: A Comparative Analysis," American Political Science Review 72 (December 1978); and Peter Katzenstein, Small States in World Markets (Ithaca, N.Y.: Cornell University Press, 1985).

Weiss' (1997:12) claim that the uniformity of state policies has been highly overstated. Citing the continued existence of differences in the price of capital (real interest rates) as well as savings and investment rates, Weiss argues that national institutions, which vary widely, continue to be significant. This contention is at the centre of arguments for 'internationalization', rather than 'globalization.' Note, this argument does not presume the various strategies employed by nations will continue to be effective (Wade's argument above regarding the ineffectiveness of changes in national interest rates as a policy tool is a clear example of this), but rather that countries do continue to have the space to choose those policies.

In fact, a number of authors (Hobson and Ramesh, 2002; Newell, 2002; Weiss 1997:15-16) note that globalisation may provide states with an added tool. In fact, it may be difficult to differentiate between 'the constraints that globalisation actually imposes upon governments, as opposed to those they choose to emphasise for strategic reasons' (Newell, 2002:7). Hobson and Ramesh's (2002) 'spatially promiscuous state' in which the state employs various adaptive and exit strategies that require it to move between the domestic and global realms suggests that the concept of globalisation can be usefully leveraged by national governments against a number of actors.

- **Adaptability**

What then allows states to resist the disempowerment assumed to come with globalisation? Changes in the international system associated with globalisation (i.e. the move towards free-floating exchange rates, the abolition of capital controls, and even the reduction in trade taxes) that result in the closing off of old strategies for state capacity are often taken as evidence of 'low stateness', or reduced state capacity, driven by processes of globalisation. However, Weiss (1997) makes the critical point that assumptions regarding the loss of state capacity are often based on a theory of state capacity in which the toolbox of policy instruments available to the state are predetermined and fixed. In such as theory, wherever a single policy tool is lost, state power is assumed to have decreased. However, a theory of state capacity in which the state is able to adapt its toolbox allows for new forms of capacity to evolve to meet the challenges of globalisation. It may be more accurate to describe this process as a shift in the role of the state, rather than a reduction.

Weiss suggests that the ability of the East Asian economies to engage in adaptive industrial policy, even while certain macroeconomic policy instruments were being proscribed, was critical in facilitating their success during the era of globalisation. This argument suggests that Evans' (1997) claim that the phenomenal success of East Asian economies 'demonstrates the possibility of a positive connection between high stateness... and success in a globalizing economy' should carry the qualification that 'high stateness' can take a number of different forms.

How changes in 'high stateness' have played out in response to globalisation will likely vary according to country context (see below on differentiated state capacity), but Polillo and Guillen (2005) provide a clear example of this process in their analysis of the effects of globalisation on central governments, arguing the strengthening of central banks is likely a key feature of state capacity to respond to financial crises. If we accept the international ideological norms that reduce the capacity of the state (neo-liberalism re: capital controls, exchange rates etc...) (and there is good reason to think that the GFC may, in the long run, help to challenge these assumptions), then the tools employed by central banks, including management of interest rates, reserve requirements and open market operations, become all the more important. The skill with which states can find new ways of exerting their authority is thus a critical determinant of their capacity to respond to crises.

- **Differentiated state capacity**

This requirement for skilful adaptation demands a key qualification to arguments that defend state capacity. Some states are simply better equipped to meet the challenges imposed by globalisation, and to shape the process to their benefit (Weiss, 1997; Newell, 2002). Two interpretations of differentiated state capacity are applicable here. The first is concerned with the degree to which states are able to resist the imposition of both formal and informal policy constraints. For Newell, the evidence on differentiated capacity is suggestive of a clear North-South dynamic in which 'the menu of policy choices available to governments is clearly more à la carte for some than others' (Newell, 2002:iii).

Yet we must also be concerned with capacity not only for autonomy, but also to manage economic activity in a way that takes advantage of the opportunities offered by globalisation. Weiss argues the issue of differentiated state capacity, interpreted in this second way, is key even when looking amongst states at similar stages of development:

'In Thailand in the 1990s, for example, the availability of easy finance coupled with the virtual absence of investment guidelines contrasts dramatically with the highly coordinated investment strategies put in place by the Taiwanese, Koreans, and Japanese at similar stages of development. Whereas the state-guided strategies of the latter generated high levels of investment in strong-growth industries, the Thai's uncoordinated approach has encouraged intense speculative activity, leading to a frenzy of overinvestment in the property sector and ultimately contributing to the recent currency crisis' (1997:5).

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