RACE TO THE BOTTOM OR MOVE TO THE MIDDLE?
GLOBALIZATION AND WELFARE REGIME TRANSFORMATION IN THE
DEVELOPING WORLD

BY

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ABSTRACT

How does economic integration affect social protection regimes differently across the developing world? The existing literature predicts a causal relationship between globalization and larger welfare states under the assumption that larger welfare state sustains the openness against a “globalization backlash” (Rodrik 1997, 1998). In developing countries where the evidence for this relationship is scant, the conventional explanation often attributes the weak welfare state to the lack of influence of labor unions that characterizes most developing countries (Garrett 1998). These explanations, I contend, mischaracterize the nature of social protection in the developing world, resulting in an incomplete understanding of the impact of globalization. I argue that globalization produces both constraints and opportunities for governments to adjust social welfare systems. Therefore, instead of a “race to the bottom,” we have seen more of a “move to the middle.”

My findings demonstrate that the variations of social welfare systems in the developing world are rooted in the conflicting dynamics of industrialization and globalization. Industrialization in the developing world has an expansionary effect on welfare expenditures as it entails risks that fuel the demand for protection. The impact of globalization, however, is multifaceted. Globalization induces a structural change of preferences among major social actors with regards to social protection, which, in turn, leads to the fundamental change of policymaking strategies of politicians. Specifically, globalization has an equalization effect on the preferences among social actors, as the risks associated with economic openness become increasingly similar to social groups from different sectors. The changing structure of social preferences at the demand side fundamentally alters the incentives of policymakers at the supply side whose ultimate concern is to maximize political support from contending social groups that have been affected unevenly by globalization. The result is a trend towards an equilibrium welfare policy outcome in which the marginal support from different groups is equally weighed and politicians compensate groups only partially. In this equilibrium welfare regime, globalization imposes downward pressures on inefficient welfare programs but also induces governments to establish and expand social safety nets that are critical for market competition and sustainable development. Arguments are tested through both quantitative cross-national analysis and comparative case studies of China, Brazil, and South Korea.

KEY WORDS: Social Protection; Welfare State; Globalization; Skill Dependence; Developing World
To my wife, Yuanlun, my daughter, Rheeda, and my parent-in-laws, Hui and Nuanyang
For their love, support, and inspiration

“You are my sunshine, my only sunshine
You make me happy when skies are gray
You’ll never know dear, how much I love you
Please don’t take my sunshine away”
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The writing of a dissertation can be a long and painful process as many people have experienced. Yet, it doesn’t have to be a lonely and isolating one. For all I have received throughout these years, I realize that mine was a fortunate journey that has shaped me as an individual and has led me where I am now. In other words, it is process of learning to know myself and my life, in addition to understanding my subject. Many individuals deserve my gratitude not only because of their support and assistance but also because their willingness to be a traveling companion on this journey that was not always pleasant and necessary for them.

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CHAPTER 1

INTRODUCTION

With the political ascendancy of finance capital and extensive market liberalization that followed, the anxieties about globalization’s \(^1\) detrimental effect on social standards – the result of a so-called “race to the bottom” (Greider 1997; Soros 1998; Ohmae 1990) – are particularly visible in developing countries, which face more severe financial constraints compared to their western counterparts (e.g. Rodrik 1998; Garrett 2001).

For example, the once highly-acclaimed welfare systems in Brazil and China seem to be collapsing drastically as these countries begin integrating into the world market (Chan et al. 2008; Madrid 2003). According to the standard economic theories (e.g., Zodrow and Mierszkowski 1986; Wildasin 1988), collapse is inevitable, for welfare protection is incompatible with market competition, particularly for a cash-strapped developing country, which has been forced to provide favorable labor standards and maintain labor market flexibility in order to attract foreign investment.

\(^1\) Globalization here is narrowly defined to refer to economic integration, which, however, has many indicators with different or even opposing types of impact on welfare states. The most commonly used are trade openness and capital mobility. Other indicators used include integration of international financial institutions, debts, and international portfolio investments, etc. In this study I focus exclusively on trade openness, which is measured by the sum of export and import as the share of GDP.
This dissertation argues that this shift in welfare spending does not constitute collapse but, rather, a “move to the middle” – overall spending on welfare in these two countries is less, more segments of the populace are covered. In fact, almost half of the middle-income developing countries have expanded their overall welfare spending since the 1970s. For example, the welfare expenditures/GDP ratio doubled in both high-income countries such as South Korea and low-income ones such as Zimbabwe (IMF, various years). While some types of social protection programs have become vulnerable to retrenchment, others have been expanded. For example, pension and employment insurance programs have been targeted for retrenchment in many developing countries. At the same time, programs such as social assistance and poverty relief that were traditionally downplayed have made significant progress in many developing countries.

Developing countries are undertaking policy adjustments to accommodate new developments in the context of globalization. In doing so, their spending levels and structures - in terms of spending priorities across different policy areas – vary greatly. The current literature, which has explained a great deal about the causes and implications of social policies in the post-War OECD countries, reveals a very limited grasp of the underlying dynamics of welfare policy change in the developing world.

According to the current wisdom, developing countries can be expected to either follow the
OECD practice and provide more social protection in order to sustain openness, thus a race to the top” as Rodirk’s (1997, 1998) model assumes, or accept welfare retrenchments due to the weak influence of labor unions and leftist parties in these countries, therefore a “race to the bottom” if one applies Garrett’s (1998) model to the developing world. Both theories, however, fail to explain the diverse approaches adopted among developing countries. Both theories lack an appropriate understanding of the welfare-globalization nexus in the developing world. Social protection systems are the essential ingredients of development strategies and are critical in managing state-market relations. Misunderstanding the relationship between social protection and globalization can lead to inappropriate policy subscriptions in response to globalization.

In this Chapter, Section 1 will present some data in order to establish that social protection in developing counties has taken quite a distinct pattern compared to that in the rich industrialized countries. Such distinction calls for rethinking of the established conceptions of the nature of social protection and globalization in order to fully understand the welfare-globalization nexus in the specific context of the developing world. Section 2 takes such a task and discusses two distinct approaches of studying the nexus based on two opposite assumptions about the relationship between politics and markets. Section 3 addresses the methodology and research design used in this study. Second 4 discusses contributions of this study.
1.1 TREND OF SOCIAL PROTECTION IN THE DEVELOPING WORLD

The weakness in the existing literature in explaining the variations of social protection among developing countries is partially the result of the sample bias in current studies that have relied primarily on a handful of OECD countries. That bias has weakened scholarly efforts to provide alternative hypotheses that are applicable to the realities of developing countries. More specifically, previous theories have failed to specify under what conditions governments in the developing world may expand or reduce social protection in response to globalization.

Figure 1.1 below shows the trend of average spending on social security and welfare as a share of total government expenditures from 1972 to 1995 in both developing and OECD countries. Overall, the trend of welfare spending in OECD countries suggests two things. First, the overall level of spending in developing countries, which average between 10-15%, has been much lower than that in the OECD countries where the average has been between 35-40%. Second, the average spending level in OECD countries fluctuates much less dramatically than that in developing countries. In OECD countries, the difference between the lowest point during this period – 34.8% in 1984 – and the highest point – 39.5% in 1995 – is only 5%, which is very little given the high level of average spending of OECD countries. Taking that into account, it appears that the overall trend of welfare spending in OECD countries has been an upward one.
By contrast, the overall trend among developing countries has decreased during the same period. The difference between the highest spending (19% in 1974) and the lowest (9.4 in 1981) is a significant 31%.

**Figure 1.1 Mean and Standard Error of Welfare Spending as the Share of Total Government Expenditures (%) in Developing and OECD Countries: 1972-1995**

![Graph showing welfare spending and standard error for Developing and OECD countries](image)

Source: IMF GFS, various years

A closer look suggests that the fluctuation during the period of the 1970s is the most significant for both groups. In developing countries, however, the year-to-year fluctuation is much more drastic than that in OECDs. This may reflect the fact that welfare spending among developing countries was much more divergent than that among OECD countries during the 1970s due to a variety of factors. To confirm this assumption, the standard error for the mean of welfare spending is much larger for developing countries during the 1970s than that in the later period, as shown on the left panel. By contrast, the standard error in OECD countries remains more...
constant on a year-to-year basis, suggesting that the welfare expenditure in these countries evolves more smoothly. And their welfare expenditure since the 1980s has risen more dramatically. The differences among the two groups are important. In the OECD, average spending during the early 1990s is higher than that during the 1970s. In developing countries, however, despite that the spending level has been increasing slightly since the late 1980s, the average level in 1995 was about 15%, lower than that during the 1970s by a quite significant margin in comparison to OECDs.

It appears that the trend of welfare spending among developing countries has followed neither a “race to the bottom” as warned by the followers of the anti-globalization movement nor a “race to the top” as it seems to be the case among OECD countries. The differences of the overall trend of welfare spending in developing and developed worlds suggest that OECD-based theories of the welfare state are inadequate in explaining the welfare-globalization nexus in the developing world. A new theoretical framework is called for to shed light on our understanding of the welfare state in a new era of globalization.

1.2 SOCIAL PROTECTION AND GLOBALIZATION

To understand why the conventional theories of the welfare state are difficult to apply to the developing world, we must recast the question of social protection in the new context of
globalization. A fundamental question is: what is the role of welfare state in a globalized economy? As will be fully explored in Chapter 2, the welfare state is fundamentally a type of social protection, dealing with individual risks by collective means. Thus the idea of social insurance is essential. Through social insurance, the welfare state provides individuals with services through transfer, in order to cover the risks from loss of earning capacity.

Fundamentally, social protection is about establishing a social safety net in order to prevent individuals’ living standards from falling as a consequence of market turbulence. On a positive side, social safety nets also serve to increase the earnings capacity of individuals through continuing education, training and retaining. Thus the welfare state can serve to enhance the gains from market activities as well.

In this sense, the welfare state by nature is not incompatible with markets. The claim that the welfare state is the outcome of “politics against markets” (Esping-Anderson 1990) is not warranted. Instead, globalization requires politics to work with markets more closely than ever in order to produce the best policy and institutional packages of social insurance and maintain competitiveness and prosperity. That is to say, the change of welfare state in recent decades under the new circumstances of globalization is a process of restructuring in response to changing market conditions, rather than a process of retrenchment of social protection.
That being said, social insurance requires political intervention in order to make the risk pooling possible among individuals and social groups, which inevitably incurs redistribution and political conflict. This is where the misconceptions and controversies surrounding the welfare state and globalization take place. Table 1.1 below summarizes the two different understandings of the relationship between social protection and globalization under two different assumptions. The first assumption is “politics against markets”, and second “politics with markets.” Two questions are central to the debate: First, does globalization have a human face with regards to social protection? Second, what is the role that labor plays in the welfare-globalization nexus?

Is globalization a menace threatening our social agenda through a Darwinian competition, as argued in the “race to the bottom” literature? Bhagwati (2004) argues that globalization can advance, rather than inhibit, the achievement of a wide range of social agendas from reduction of poverty to promotion of gender equality (also see Irwin 2002). However, Bhagwati also reminds us that opportunities offered by globalization must be seized through appropriate governance. This is an important insight to the debate about the welfare-globalization nexus. It suggests that the welfare state is part of the framework that can provide complementary institutions and policies to speed the advancement of social agendas.
<table>
<thead>
<tr>
<th>Focus</th>
<th>Assumption</th>
<th>“Politics with Markets”</th>
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<tbody>
<tr>
<td>Social/political consequence of globalization</td>
<td>Market competition and efficiency leads to a “move to the middle”</td>
<td>I. a moderate level of welfare protection</td>
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<td>II. equal distribution of protection among social groups</td>
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<td>Poor countries have no choices but to follow either</td>
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<td></td>
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<td>I. a “race to the bottom” – welfare retrenchment</td>
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<td>II. a “race to the top” – welfare expansion</td>
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<tr>
<td>Labor in globalization</td>
<td>Welfare reduction as a social choice</td>
<td>Labor unions and left parties are the determinant of the welfare state</td>
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<td>I. With acquiescence/assent from the labor who sees the opportunities derived from globalization.</td>
<td>I. Labor suppression =&gt; welfare retrenchment</td>
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<td>II. Strong labor unions and left parties =&gt; welfare expansion</td>
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Under such a “politics with markets” assumption, welfare retrenchment that occurs across the globe has a creative dimension that benefits individuals’ well-being through liberating them from financial and political constraints attached to government protection and also through enhancing their earnings capacity. Consequently, welfare reduction can be seen as a social choice by the majority of labor forces who find no incentives to defend the traditional welfare protection because of the opportunities derived from globalization. Based on this assumption, the changing direction of welfare protection in the developing world in a globalization environment is better to be understood as a movement towards the middle ground in which welfare protection is
maintained at a reasonable level so as to be compatible with market efficiency and competition, and the protection is evenly distributed across different social groups so as to enhance the aggregate well-being of the society.

These insights, however, have been undermined in the conventional literature that follows the ‘politics against markets” assumption. In the mainstream theories based on post-war experiences in the OECD countries, the welfare state has been taken for granted as a mechanism of decommodification, as Esping-Anderson (1990) explains, a process that reduces citizen's reliance on the market for their well-being. In other words, market dependence has been considered as subjecting individuals to being a commodity and damaging their well-being. One of the consequences of this assumption is that politicians have looked upon welfare as a political instrument of welfare redistribution from the rich to the poor. The welfare state thus is taken as the antithesis of market economy. Political institutions, accordingly, are treated as the key factor in determining the pattern of social protection. Labor movements and left parties are seen as the driving force for welfare expansion. Their waning influence is attributed to globalization that gives capitalists unprecedented power over labor.

The discussion above suggests that the different assumptions can produce significant impacts on the understanding of the nature of the welfare state and globalization and their relationships. The
conventional literature has been confined by the “politics against market” assumption. As a result, their explanations of social protection in the developing world have been misleading. This study takes a different assumption in order to fully understand the complexity of the social protection in the developing world in a globalization environment. To do so, this study reconstructs the theory of the welfare state in the specific context of the developing world in order to reveal the mechanisms underpinning the “welfare-globalization nexus” that many scholars and policy makers have found elusive. The central argument is that, instead of a “race to the bottom,” we have seen more of a “move to the middle” with respect to the future of social protection in these countries. This “move to the middle” framework offers new insights into the welfare policy choices across countries and over time as the outcomes of the interaction between industrialization and globalization. It illuminates the strategic responses of politicians to the changing structure of social preferences, through which a balanced spending structure for social protection becomes possible as a strategy of maximizing political support.

1.3 METHODOLOGY AND RESEARCH DESIGN

This study takes a multimethod approach to test and substantiate the arguments through both the large-N quantitative econometric analysis and comparative historical case studies, engaging the two methods in a dialogue that allows achieving generalizability and establishing causality. The
quantitative econometric analyses, based on a sample of 53 developing countries from the early 1970s to the late 1990s test the relationship between globalization, industrialization, and welfare transformation. The objective is to examine the variation of welfare protection across the developing countries under the influence of globalization and industrialization.

Detailed case studies will then be used to trace the process of public decisions in a country-specific, dynamic setting and reveal the mechanisms underpinning the interplay between social protection, industrialization, and globalization. The case studies based on selected Latin American and Asian countries that have been undergoing significant reforms – Brazil, Korea, and China– not only serve to examine the validation of the theory and the findings in econometric analyses. They also provide a detailed analysis of the historical evolution of the welfare systems in each country under the constraints of industrialization and openness.

Any empirical study is subject to selection bias in the choice of cases for analysis. The large-N econometric analysis with a global set of countries subjects the hypotheses to the test of external validity, assuring that the arguments are not moored solely to the specific features of the chosen cases. In addition, the similarities and differences among the three cases that are chosen will further help to mitigate the impact of selection bias (Przeworski and Teune 1970; Lijphart 1971 and 1975; King et al. 1994; Collier 1995).
China and Brazil once were highly appraised for their well-developed and comprehensive welfare state systems. The drastic reduction in expenditures on welfare protection in these two countries since their integration poses interesting questions regarding the impact of globalization. At the same time, however, the welfare transformation in the two countries varies greatly in terms of the magnitude and speed of the change. These variations provide opportunities to examine the welfare-globalization nexus within diverse backgrounds.

South Korea adds nuances into the comparison and contrast among different welfare regimes. South Korea and Brazil have been commonly considered the two prototypical cases of residual and generous welfare states in the developing world. In South Korea, its government expenditures on social security and welfare have been low even compared to many low income countries. To the contrary, Brazil has been one of the most generous welfare states in the developing world. The average welfare spending Brazil during the 1990s was more than five times of that in South Korea. Does this contrast deserve any specific attention from the model developed here?

The South Korean welfare regime has come a long way and has gone through very different stages of development. Its “residual welfare state” image can best apply to its early stage of development from the early 1960s to the early 1980s. From the late 1980s, however, the welfare
protection has been expanded significantly. The government welfare spending has been doubled from the early 1970s and the late 1990s. What does this change over time suggest to the model? What does it imply to other countries such as China and Brazil where economic integration began much later? In addition, being a low protection country, does South Korea have anything similar to the post-Mao China which is often considered to be very low in its social protection? What distinguishes these two cases being weak welfare regimes?

These questions suggest that the differences and similarities among these three cases can provide sufficient information to mitigate the selection bias and understand the mechanisms that underpin the interaction between welfare protection and globalization.
CHAPTER 2

DISENTANGLING THE WELFARE-GLOBALIZATION NEXUS IN THE DEVELOPING WORLD

2.1 INTRODUCTION

The welfare state is one of the most studied subjects in the field of contemporary political economy. However, the literature of welfare states has been dominated by the experiences of industrialized western societies. It is not surprising, as discussed in the introduction, that the concepts, assumptions, arguments, and conclusions developed in this literature have tremendous difficulties traveling in the developing world, where the varying historical background and institutional heterogeneity across countries require a new perspective to understand what has underpinned these welfare regimes and what is ahead for their transformation in the new era of globalization.

In this chapter, Section 2 will discuss the mainstream theories that have dominated the conventional understanding of the welfare-globalization nexus. The problems indentified in these theories provide critical starting points to rethink the existing assumptions and arguments in Section 3, which help to develop a new theory suitable to the context of the developing world in
the new context of globalization. I then develop a dynamic model in Section 4 that emphasizes social insurance as the key element of the modern welfare state, which, nevertheless, involves redistributions. In this model, the level of demand for welfare protection is determined by risks associated with skill dependence and comparative advantages inherent in a country in a particular historical period. Globalization injects new dynamics into the process of both industrialization and policy choices, therefore changing both economic and power structures. Specifically, globalization has an equalization effect at both policy demand and supply sides. As a result, the risk gap between high-skilled and low-skilled sectors is narrowed, which induces politicians to modify their strategy for maximizing political support and produce a more balanced welfare regime that compensate more social groups. Ultimately, globalization re-conceptualizes welfare states from being a conventional instrument of social protection to a new form of social safety nets that serve to promote market competition and long-term sustainable development.

2.2 EXPLAINING THE WELFARE-GLOBALIZATION NEXUS: THEORIES AND DEBATES

Three theories dominate the discussion of the welfare-globalization nexus, which has produced two well-known hypotheses that are against each other – the efficiency vs. compensation
hypotheses. I contend that the concept of “welfare states” and the associated hypotheses in these theories conflict with the realities of the developing world, which has resulted in an incomplete understanding of the impact of globalization. That is, these theories all assume that welfare states and globalization serve one single purpose, either for redistribution or for insurance, but not for both. In addition, a coalition model underlies these theories, which suggests that politicians rely on a fixed coalition, for example, capitalists or labor, to make welfare policies that exclude other groups from protection.

2.2.1 Efficiency Theory: Tax Competition and the “Race to the Bottom”

The dominant theory in international economy literature is the efficiency theory, which argues that welfare state systems are inherently inefficient and uncompetitive against market forces due to their redistributive nature. Globalization, on the other hand, is detrimental to the welfare state by nature because it erodes the financial base for the provision of welfare. The logic of this theory is best presented in the well-known tax competition model (e.g., Zodrow and Mierszkowski 1986; Wildasin 1988), as shown in Figure 2.1 below.
Figure 2.1 Tax Competition Model

The tax competition model postulates that competition for export markets and for investment capital exerts downward pressure on labor costs, wages, payroll taxes, and import and export taxes, which reduces the basis for traditional social security contributions (Huber and Stephens 2003). A great deal of speculation has been derived from this assumption, and ultimately led to the now-famous “race to the bottom” prophecy (Greider 1997; Soros 1998; Amin 1997, Ohmae 1995). According to this prophecy, the lowest common denominator of welfare standards occurs because, all else constant, financial market liberalization allows “footloose capital” to flee the countries with generous social welfare systems and redistributive tax structures in order to lower their costs. The outcome is the reduction of welfare benefits and social protection in general as trade openness advances, as shown in Figure 2.2 below.
2.2.2 The Trade-based Compensation Theory: “Globalization Backlash” and “Race to the Top” of Welfare Expansion

The hypothesis that globalization would create downward pressures for welfare state retrenchment was countered by two streams of research. The first, which I call the trade-based compensation theory, emphasizes the compatibility, and indeed the benefits, of welfare states with international economic integration. In this view, welfare states are not simply inefficient and redistributive but rather play important roles as social insurance against the market volatility generated by openness. The risks associated with international markets call for the intervention of governments in order to cushion the impact of globalization, which, in this theory, incurs risks that are primarily concentrated on certain sectors such as those exposed to trade. According to this compensation hypothesis, higher unemployment and lower real wages during economic
downturns force governments to increase welfare expenditures in order to prevent the escalation of discontent over increasing poverty and declining standards of living (Cameron 1978; Ruggie 1982; Katzenstein 1985; Rodrik 1997, 1998; Burgoon 2001; Hays, Ehrlich, and Peinhardt 2002; Boix 2002). The result is a “race to the top” of welfare compensation induced by globalization, as illustrated in Figure 2.3 below.

**Figure 2.3 Trade-Based Compensation Model**

![Trade-based Compensation Model](image)

**2.2.3 The Power-based Compensation Theory: Left-labor Movements and Welfare Expansion**

The second stream of research against the efficiency theory, which I call the power-based compensation theory, emphasizes the mediating role of domestic institutions between international economic pressures and domestic political outcomes (Garrett 1998; Garrett &
Lange, 1995). Influenced by the prominent power resources theory (Esping-Anderson 1990), these scholars argue that the key determinant of welfare expansion is the strength of leftist parties and unions that are critical in ensuring labor-market institutions to be effective in negotiating between government and labor. When labor markets are highly centralized and well developed, labor and government can effectively coordinate economic performance with redistribution policies. Garrett (1998) argues that globalization may in fact strengthen left-labor movements, and as a consequence, help sustain cross-national partisan differences in developed economies. On the other hand, whereas labor organizations are weak and decentralized, the level of compensation tends to be low. In this model, globalization plays, at most, a second role and its impact is often conditional on domestic political institutional configuration. Figure 2.4 below illustrates the different trend of welfare protection in different situations. In countries with weak labor organizations, trade openness benefits capitalists and decreases compensation to labor, as shown on the left panel. In countries where labor organizations are strong, trend openness tends to increase compensation. Depending on their political weight and capacity to overcome the collective action problem, labor movements determine that the welfare state in a globalizing economy either follows a “race to the bottom,” coincident with the prediction of the efficiency hypothesis, or a race to the top” as the trade-based compensation hypothesis argues.
2.3 RETHINKING WELFARE PROTECTION IN A GLOBALIZING ECONOMY

In the context of developing countries, these theories collectively suggest a pessimistic future for welfare states. As regards the efficiency view, the “race to the neoliberal bottom” appears to be inevitable for these cash-strapped countries that face enormous fiscal constraints (Garrett 2001; Kaufman and Segura-Ulbergo 2001) and lack the luxury of borrowing on capital markets (Wibbel 2006). For both versions of compensation theories, developing countries simply lack political institutions that can ensure compensation. In Rodrik (1998), however, it remains a black box to specify why developing states fail to provide such institutions (Mares 2005; Huber and Stephens 2001; Adsera and Boix 2002). For Garrett (1998), the answer is the left-labor movement that is too weak in these countries to fight against capitalists. Rudra (2002) explicitly applies Garrett’s logic to the developing world and argues that the detrimental impact of globalization is the result of weak labor union strength in these societies due to low skill
endowments and the high level of labor surplus that contribute to the collective action problems and prohibit the articulation of labor rights. Other scholars argue that the underdevelopment of democratic institutions further aggravates collective action problems (Wibbel and Arce 2003).

The central problem contributing to this pessimistic view about the future of the welfare state in developing countries is that existing theories mischaracterize the functions of the welfare state. The efficiency theory and the power-based compensation theory incorrectly assume that welfare states are redistributive and anti-market in nature. This assumption leads to the implication that the welfare state is incompatible with globalization - where the welfare state serves as a redistributive instrument to benefit labor at the expense of capitalists, globalization explicitly counters this redistributive effect and instead benefits capitalists at the expanse of labor.

According to Esping-Andersen, the leading scholar of the power resource theory, welfare expansion is a process of “politics against markets” (Esping-Andersen 1985) for the purpose of decommodifying individuals from market dependency (Esping-Andersen 1990).  

Under this assumption, the relationship between labor and capitalists is a zero-sum game. The redistributive function of the welfare state, in this sense, encourages labor unions and the Left

2 Decommodification is a process through which, “a person can maintain a livelihood without reliance on the market” (Esping-Andersen 1990, 22).
parties fight against an unwilling capitalist class looking for opportunities to escape their welfare responsibilities. The development of the welfare institutions therefore is the result of the political triumph of labor movements over the political community of employers that has been forced into retreat (Korpi, 1983, 1989; Esping-Andersen, 1990; Garrett, 1998; Huber and Stephens, 2001).

Globalization, according to this assumption, aggravates the conflict since economic integration is in capitalists’ interests at the expense of labor. As a result, globalization affects welfare states in a one-way street, either following the “race to the bottom” when market competition and labor market mobility weaken the power of labor unions, which has seemed to be the case in the developing world, or leading to generous welfare expansion if political left and unions triumph as in many OECD countries. The issues discussed below will help to clarify the assumptions that are critical for a better understanding of the nature of social protection, in order to establish a model in the next section to explain the mechanisms underpinning social protection in the context of developing countries.

2.3.1 Why Protection? – The Welfare State as Both Social Insurance and Political Redistribution

The assumption that the welfare state functions as an instrument to save labor from the exploitation of capitalists goes against a rich literature in economics that emphasizes the
insurance function of the welfare state. This literature argues that this insurance function makes the welfare state compatible with, or even supplementary to, market efficiency in the context of globalization. For example, Barr (2001a, 2001b) points out that the insurance function is an integral part of the welfare state that aims to address market failures and enhance efficiency gains. Welfare states can reduce transaction costs in the economy and increase labor market efficiency by guaranteeing the portability of insurance entitlements. Moreover, the “functionality” of social insurance in modern economies also promotes flexibility, renewal, and investment of human capital within the labor force, which are essential for continuous development (Barr 2001a; Atkinson 1999). In fact, Wildasin (1995, fn1) argues that many welfare-state policies are redistributive in nature only in a “short-run” and ex post sense. From a “long-run” and ex ante perspective, however, they can be viewed as insurance programs.³

Given the nature of these discussions, it can be argued that social insurance and redistribution are the two sides of the same coin and the welfare state simultaneously performs both functions (Iversen and Soskice 2001; Moene and Wallerstein 2001). More specifically, the welfare state is

³ This is not a novel assumption in the literature but it has been insufficiently emphasized regarding globalization, because globalization has been overwhelmingly seen as being redistributive in nature. The insurance function of welfare states has been extensively discussed in public economics by, e.g. Harsanyi (1955), Buchanan and Tullock (1962), and Varian (1987), and also in philosophy by Rawls (1971). See Atkinson (1987, section 2.3) for a quick reference.
developed as social insurance against market fluctuation through the mechanism of risk-pooling. This risk-pooling mechanism, however, involves political intervention, thus inevitably producing redistributive effects, because pooling often occurs across sectors, social groups, or even generations that are inherently unequal in terms of risks and demands for protection.

2.3.2 How Politicians Make Policy Choices? – Endogenous Protection and Political Support

When it comes to the political function of public policy choice for protection, these theories all are weakened by their employment of a coalition model in their reasoning, which suggests that politicians rely on a fixed coalition to make welfare policies that exclude other groups from protection. Underlying this approach is the assumption of labor homogeneity, which sees labor as an anonymous commodity that can be aggregated into a single, undifferentiated factor (Iversen 2005). In both the power-based compensation model and the efficiency model, a zero-sum game plays out between labor unions and capitalists. In the trade-based compensation model, it is exporters and mobile factors against the import-competitors and non-mobile sectors. In reality, however, we often observe that politicians compensate certain social groups, for example,

4 Iversen (2005) criticizes that, in the power resources model, labor is an anonymous commodity, easily aggregated into a single, undifferentiated factor “L”, wherein each constituent unit – worker – is “replaceable, easily redundant, and atomized,” as claimed by Esping-Andersen (1990: 37). Politics, in this view, is labor against capital, L against C.
losers of trade openness, who are excluded from their coalition (Pahre 2008). This puzzle is solved in the endogenous protection literature (Becker 1983; Grossman and Helpmann 1994; Stigler 1971; Hillman 1982), which suggests that public policies are often the outcomes of politicians’ balancing of contending interests against one another. More specifically, politicians weigh the marginal support between social groups with conflict interests in order to maximize social welfare and political support (Grossman and Helpman 1994).

Pertinent to this study, the endogenous protection model suggests that exogenous changes, such as global economic shocks and technological change, also lead to balancing. As a result, politicians compensate groups only partially, reducing the harm to any one group by spreading it around (Pahre 2008. Also see Hiscox 2001). The difference between this endogenous political support model and the conventional coalition model can be illustrated in Figure 2.5, in a simplified style. Assume that a society consists of two major social groups – Left, be it either labor or low-skilled workers, and Right, be it either capital or high-skilled workers. In the coalition model, politicians who seek to maintain its political power look for the most powerful political coalition – either pro-Left or pro-Right – as their political base. As a result, politicians will make policies that fully compensate this coalition at the expense of another, which moves the policy outcome further away from the equilibrium compensation point, denoted as C’, where
political support can be maximized. In the endogenous protection model, by contrast, politicians compensate partially each social group, but compensate more groups. The outcome is the policy that moves toward the equilibrium compensation policy point $C'$.

**Figure 2.5 Political Function of Compensation: Coalition Model vs. Endogenous Model**

![Diagram showing the political function of compensation in the Coalition Model and Endogenous Protection Model](image)

It should be noted that globalization reinforces the tendency of politicians to partially compensate social groups in a competitive economy. That is, the endogenous model is more relevant in an integrated economy. This is because the exposure to the competition of international markets increases the risks of mismanaging the economy, thus making politicians more concerned with the aggregate well-being that can be affected by the international market. Politicians who only focus on the interests of their own and their closest allies are in a greater risk of mismanaging markets and thus losing political support.
This is indeed a significant departure from the reasoning that underpins the arguments in the conventional efficiency and power resources models. The following sections take this point of view into consideration and unravel how globalization and industrialization, as exogenous changes, determine the policy choices with regard to social protection.

### 2.3.3 Who Needs Protection? – Risks, Skills, and Structure of Social Preferences

Politicians choose strategies of maximizing their political support in response to the structure of social preferences among major social actors. The welfare policy supply therefore is a function of the demand for protection. A common misconception about the preferences for social protection is that the demand is negatively associated with income level – poor people tend to have more desire for protection. This assumption is incorrect because it overlooks that there is a direct link between social security contributions and benefits in most developing countries. That is to say, protection is not always free. Instead, social insurance compensates – as this word precisely suggests – those who have the most stakes to lose.

Who then have the most stakes to lose and are willing to pay more premiums for social insurance?

The mechanism underpinning social insurance consists of four elements: risks, the labor market shift, skill dependence, and comparative advantages.
I take risks as the central mechanism for social insurance following Iversen and Soskice (2001): “individuals who have made risky investments in skills will demand insurance against the possible future loss of income from those investments.” This statement suggests three hypotheses. First, all else being equal, insurance is more valuable for higher-level investments. High-skilled workers thus tend to demand more insurance because these workers would face more losses of skill investments in market fluctuation and therefore greater uncertainty. The uncertainty among these workers is further aggravated by wage differences (skill premium) between different sectors in a society. This point will become particularly salient in the developing world as discussed in the next section.

Risks are associated with the shift of labor markets, which produces uncertainty due to the adjustment costs and potential losses that may occur with shifting. Notice that risks are also the central mechanism in the trade-based compensation theory, which correctly emphasizes the social insurance function of the welfare state. However, the mechanism underpinning the relationship between risks and social insurance in that theory is problematic. Rodrik (1997, 1998) argues that labor-market risks are concentrated in internationally exposed sectors such as exporters, which implies that openness would lead to protection as countries become more integrated. Iversen and Cusack (2000) point out that this argument is problematic because, first,
price volatility in international markets is not necessarily greater than in domestic markets; second, trade does not always concentrate but may instead diversify risks.\(^5\) Because welfare expansion in OECD countries is not associated, monotonically, with increased risks from price volatility in the international market, the relationship between economic openness and larger welfare states found in Rodrik (1997) as well as Katzenstein (1985) is spurious. Iversen and Cusack (2000) argue that welfare expansion in OECD countries is instead a result of the shifting labor market that has occurred since the 1960s – workers in the declining traditional manufacturing found it increasingly difficult to transfer their skills to other sectors. In other words, skill dependence determines risk levels.

How skill dependence affects workers’ risks, however, depends on the context. The basic logic of the Stolper-Samuelson theorem (1941) posits that the demand for skilled labor increases in capital-abundant countries, because this factor is used intensively to produce those goods that are internationally competitive, and trade increases the price of these products. Profit-maximizing firms respond by expanding output in these sectors, which consequently converts unskilled labor into skilled labor through cross-industry shifts in labor demand. Skilled labor therefore gains

\(^5\) Also see Frieden (1991) for another example against Rodrik’s assumption. In Frieden, firms in non-tradable goods and domestic sectors with few international competitors have more incentives to lobby economic policies because they are more vulnerable to international markets.
from greater trade openness.

In contrast, unskilled labor is relatively abundant in developing countries, most of which are capital-scarce. In these countries, unskilled labor will gain from greater trade openness as a result of their comparative advantages relative to skilled labor in these economies. Recent studies of free trade opinions have found micro-level evidence to support this theorem. For example, the skill effect is opposite in skill-abundant and skill-scarce countries: in skill-abundant countries high skilled labor supports trade while the low-skilled labor opposes; the opposite holds in skill-scarce countries where high-skilled labor opposes trade while the low-skilled labor supports (Sheve and Slaughter 2001; O’Rourke and Sinnott 2001; Baker 2003; 2005; Beaulieu et al. 2004; Mayda and Rodrik 2005; Mayda at al. 2007).

Because skill dependence changes over time for both individuals and for countries alike, risk levels in a particular country can change as well, along with the changing level of skill dependence. Comparative advantages based on low-skill dependence cannot persist infinitely. According to international trade theory, the comparative advantage of country changes as development encourages capital accumulation and technological upgrade, which in turn enable the countries with low-skilled factors to move up the ladder of comparative advantage. This suggests that demands for protection vary across both space and time.
2.3.4 What Makes Social Protection in the Developing World Different?

In most developing countries, high-skill dependent workers are the most vulnerable to the labor market shift and therefore have high demands for protection. This point is crucial to understand why globalization affects social protection in developing countries differently. Industrialization is the key to understanding the dynamics for the origin and expansion of welfare protection in the developing world. The nature of social protection in developing countries is different from that assumed in the conventional literature of the welfare state. This argument resembles that of the “logic of industrialization” literature, which argues that technological changes are the root cause of the changing structures of welfare states (Wilensky 1975). However, the “logic of industrialization” argument is essentially a functionalist one that follows the tradition of modernization theories, which see welfare states as the automatic outcomes, or byproducts, of income growth. My arguments on the impact of industrialization in developing countries, on the other hand, essentially follow Little et al. (1970), who argue that the “logic” of industrialization in the developing world differs from that in the OECD countries.

Specifically, in most developing countries before trade and capital liberalization took place

6 See Boix (2001) and Skidmore et al. (2004) for recent applications of the “logic of industrialization.” For a recent review on that literature, see Pierson (2003).
around the late 1980s and early 1990s, social insurance systems were characterized by their narrow constituencies, stratified and hierarchical structures, and non-redistributive nature. These characteristics have persisted with significant consequences into the new era but, as globalization advances, they have undergone transformation into market-oriented structures.

First, high wage differentials. As specified in the previous section, investment incurs risks and fuels desire for social protection. In developing countries, industrialization is a process that produces growth while also entailing costs. Wibbels and Alquist (2008) in a recent study argue that social security systems in developing countries were the result of social choices because the creation of appropriate labor skills represented a significant investment by both national governments and firms interested in insuring such investments. As industrialization advanced, sectors with higher levels of skill factor endowments faced more risks, because workers in these sectors enjoyed much higher incomes than the general population. The stark wage differentials between high and low-skilled sectors produced considerable uncertainty for labor in the modern sector once labor market shift took place.

Second, stratified distribution of social protection, which further reinforces the wage differentials. This kind of structure of social protection can be explained by the following three factors. The first is the authoritarian origin of social protection common in the developing world,
as Mares and Carnes (2009) argued in a recent review. Second, protection in most developing countries tended to be urban-biased at the expense of rural workers due to the strategic position of urban industrial sectors for industrialization and political support (Little et al. 1970; Bates 1982). Third, social insurance in developing countries was non-distributive as a result of its contributory nature on an occupation-by-occupation basis. Social welfare programs therefore tended to insure the better-off who could afford making social security contributions, such as the workers in a relatively small number of economically and politically strategic formal sectors. That is to say, social welfare programs seldom served redistributive purposes aimed at the poor. Such policies instead tended to reiterate existing social hierarchies with a narrow range of beneficiaries (Mallet 1970; Mesa-Lago 1978; Wibbels and Alquist 2008).

Third, cross-class strategic alliance for social protection. Politically, these stratified welfare systems often cultivated a cross-class strategic alliance (Mares 2003) between workers and firms in the sectors with high skill dependence. Both labor and firms in this alliance found it in their interests to demand a high level of protection. Scholars have pointed out that, in addition to producing an industrial labor force and maintaining labor stability, welfare protection was also critical in the creation of a consumer base on the part of workers in order to guarantee a stable level of domestic demand (Mesa-Lago 1978; Malloy 1979; Mallet 1970). In this sense, the
creation and expansion of welfare systems can be seen as a response to the underlying demands of both capital for insuring its investment in workers, on one hand, and labor, on the other, for insuring itself from much lower wages outside of the manufacturing and public sectors (Wibbels and Alquist 2008:17). Once established, labor in these sectors became an economically and politically privileged working class that cooperated with industrial elites to lobby for more protection, including generous labor market legislations and the prevention of attempts to threaten the status quo (Mesa-Lago 1978).

These characteristics of social welfare policies in the developing world have long been recognized by scholars in different contexts as a factor that differentiates social welfare policies in the developing world from those in the OECD countries (Harris and Tadaro 1970; Mesa-Lago 1978; Pampel and Williamson 1989; Malloy 1979; Lund 1993; Baldwin 1990). Recent studies have again pointed out the consequences of these differences in the new environment associated with globalization (Wibbels and Alquist 2008; van Ginneken 2003).
2.4 GLOBALIZATION AND WELFARE TRANSFORMATION IN THE DEVELOPING WORLD

2.4.1 Equalization Effect of Globalization

Based on the assumptions developed in the previous section, industrialization and globalization have opposite effects on the risks facing workers with different skill levels in the developing world. In other words, industrialization and globalization are conflicting dynamics that pull developing countries into opposite directions with respect to welfare expansion. The argument is illustrated in Figure 2.6 below.

**Figure 2.6 Conflicting Dynamics of Industrialization and Globalization**

In this graph, assuming there are two sectors in a society, one with low skill endowment,
therefore low wages, denoted as $W_L$ at the left, and another with high skill endowment and high wages, denoted as $W_H$ at the right. Also assume that the low waged sector ($W_L$) is the abundant factor in most developing countries, with much larger size than the high waged one ($W_H$). The distance between the two sectors in terms of wage differentials is positively associated with uncertainty of the high-waged sector in market fluctuation, therefore the risk gap.

Essentially, industrialization in developing countries tends to widen the wage gap between low-skilled and high-skilled sectors, resulting in wider risk gap between the two sectors.

Globalization, on the other hand, equalizes wages between the two sectors and therefore narrows the risk gap. As the wage and risk gaps are narrowed by globalization, the changed preferences among major social actors at the demand side will lead politicians to adjust their strategies in making public policy in order to maximize their political support at the demand side. In sum, industrialization and globalization have opposite effects on welfare spending. Thus we have the following two hypotheses.

**H1:** Countries at higher levels of skill dependence are more likely to have a higher level of welfare protection, all else being equal.

**H2:** Countries with higher levels of international trade exposure are more likely to have a lower level of welfare protection, all else being equal.
The conflicting dynamics of industrialization and globalization determine the variations of social protection among developing countries. At the same time, the dual-function of the welfare state provokes differential impacts of globalization on different categories of welfare benefits.

Industrialization increases the level of skill endowments and as a result produces larger welfare states. This dynamic exists in all countries regardless of their levels of trade openness. However, the expansionary effect of industrialization will, over the long run, yield to the dictates of market efficiency as trade exposure intensifies. This is because countries under pressures of globalization will be forced to adopt new approaches to deal with social programs, in which, stronger government commitment to social protection needs to be supplemented by the contributions from both individuals and firms in order to lower the costs and the burden on the government. This trend is illustrated in Figure 2.7 below.

**Figure 2.7 Diminishing Return of Industrialization to Social Protection**
The tangent line, which becomes flatter along with the increase of industrialization and skill endowment, indicates the diminishing return of the skill level to social protection due to the pressure from trade openness, which leads to the following hypothesis:

\[ H3: \text{As a country becomes more exposed to international trade, the expansionary effect of industrialization on welfare protection decreases.} \]

As a result, globalization induces the government to make efforts to adjust their social welfare systems and achieve a reasonable size of welfare state with a balanced spending structure among different categories of benefits in order to be compatible with market mechanisms and sustainable development.

2.4.2 Changing Structure of Social Preferences

Globalization reduces the incentives for expansion of traditional welfare benefits on both the demand and supply sides. At the demand side, globalization reduces incentives for demanding excessive protection by transforming the structure of preferences among major social actors. The most fundamental factor that contributes to the low incentives for maintaining the traditional welfare programs is the logic of the Stolper-Samuelson theorem discussed earlier. In most developing countries, low-skilled manufacturing sectors are much larger than high-skilled
manufacturing sectors. When countries are more exposed to trade openness, job opportunities will increase in low-skilled manufacturing sectors that produce labor-intensive products. As a result, the employment losses in formal sectors can be absorbed by low-skilled manufacturing and informal sectors. In principle, this could reduce uncertainty among formal sector workers (see, e.g. Mares 2006: 19, fn1).

Openness not only reduces uncertainty for high skilled labor through increasing job opportunities. Market competition represses wage differentials among workers and encourages fluid labor markets, resulting in the equalization of labor wages between the manufacturing and public sectors on the one hand and informal sectors on the other. Notice that this argument differs from the one that globalization increases income inequality within a country. Even as overall income inequality may increase as the result of openness, factor price equalization following trade openness suggests that the wage difference between the formal and informal sectors should be reduced.

As the incentives among high-waged workers to lobby for more protection decreases, the strategic alliance between labor and firms with high skill endowments that aims to maintain traditional stratified welfare programs loses its dynamic. Another reason that loosens the ties of this alliance is that firms have become increasingly relying on international markets, thus no
longer in need of artificially increasing their prices above world prices (Tullock 1967; Krueger 1974). Instead, they find it costly to compensate workers as consumers in order to encourage them to purchase their goods. Likewise, consumers no longer find the compensation appealing due to the possibility of purchasing the same goods in international markets with less cost (Baker 2003). As ties become increasingly loose and the value of private benefits for corporate strategies declines, employers abandon the old order, resulting in a fundamental shift towards risk privatization and individualization (Hecker 2004). This impetus is undoubtedly more pronounced for firms in developing countries.

2.4.3 The Creative Dimension of Welfare Retrenchment

In a cross-national setting, this logic suggests that the traditional stratified protection is more difficult to maintain in countries with a lower level of skill dependence. For instance, Chinese urban workers found that their traditional comprehensive protection was dismantled fairly rapidly since the early 1980s. Yet, they offered relatively minor resistance to the reform, in part because these workers quickly found ample opportunities waiting outside of the formal sectors.

In Brazil, such advantages did not exist. The opposition from Brazilian civil servants and labor in the formal sector had no counterpart in China.

While these two countries are extreme cases, there is ample evidence that globalization provides
gains and opportunities for developing countries. Scholars suggest that certain types of welfare retrenchment occurring around the globe are not entirely a loss of protection but rather an adjustment aimed at avoiding resource misallocation. Brooks (2009), in discussing pension privatization reforms, argues that there is a creative dimension of welfare retrenchment. For example, the cutbacks in state benefit guarantees for old-age pension insurance in fact produce the possibilities for individual gains “under the mantle of expanding ownership, control, choice, and freedom and of increasing rates of return to old age pension contributions” (10).

2.4.4 Changing Strategies of Political Support and the Move to the Middle

The declining influence of the strategic alliance in high-skilled sectors is associated with decreasing incentives at the supply side to maintain traditional welfare benefits. The fiscal discipline imposed by market competition makes generous benefits enjoyed by the high-waged workers increasingly unbearable for governments. Furthermore, generous benefits are often accompanied by restrictive laws that prevent labor market flexibility. This problem further contributes to the declining incentives for governments to maintain traditional welfare benefits. Most importantly, the disincentives primarily come from the logic of the endogenous protection

7 See e.g. Irwin (2002) and Bhagwati (2004) for theoretical discussion. For developing countries, see Little et al. (1970), Bhagwati (1987), and Bigman (2002).
model mentioned earlier. Similar to the equalizing effect on factor price, trade openness and market competition also equalize political support among various social groups. The previously marginalized social groups, such as rural workers, women, urban workers in informal sectors, and those under the poverty line, become increasingly important for a healthy economy and long-term development. Governments have become increasingly aware that leaving any major social groups behind will backfire on their nations’ survival in international markets. It therefore becomes increasingly critical for governments to spread risks around among different social groups.

The changing strategies for politicians to maximize their political support can be reflected in government spending priorities that aim to compensate different social groups through different types of social programs. For example, the traditional welfare programs were mainly given to a narrow group of privileged waged workers with high skill endowments. By contrast, other programs such as those of education, health care, social assistance – particularly poverty reduction – target more population and are more critical to human capital development. In most developing countries, these programs have been underdeveloped compared to traditional social security and welfare programs. Globalization may produce a negative impact on all these major categories of social spending as a result of globalization’s fiscal disciplinary effect. In addition,
As discussed in the introduction of this chapter, globalization may induce governments in the developing world to maintain a low level of government expenditures using efficient and market-friendly fund management measures even if it also induces these governments to expand the coverage of social protection programs. However, the reductive impact is expected to be less detrimental to education, health care, and social assistance programs, because the latter categories promote human capital infrastructure and productivities that are critical to market competition and sustainable development. Thus the reductive effect is the strongest for the welfare spending which traditionally tends to be generous, stratified, and less efficient. The hypothesis can be expressed as follows:

**H4: As countries become more exposed to trade openness, welfare benefits that target skilled workers in traditionally strategic sectors decreases at a faster pace than those that target the general population.**

While traditional welfare benefits are under retrenchment pressure, globalization induces governments to expand other categories of social protection. Social safety net programs such as minimum wage guarantees, social assistance, poverty relief, education, and health care are critical for human capital infrastructure and continuous development, and these programs have become increasingly important for countries to pursue sustainable development. These programs
are characterized by inclusiveness, greater equality and equity in terms of beneficiaries covered. These characteristics certainly entail redistribution. However, the fundamental purpose of these programs is to enhance market competition and sustainable development rather than expropriate wealth. Motivation behind these redistributive efforts comes from states that are compelled to remodel their role from “welfare state” to “competition state.” In competition states, welfare effort is refocused toward a more Schumpeterian “competitor’ or “work-fare” state in order to provide an ongoing competitive advantage (Jessop 1993; Cerney 1995, 1999; Zysman 1996)).

This enabling effect of globalization has significant implications. Labor union strength becomes less relevant in welfare development than the power-based compensation model suggests, because the majority of the beneficiaries of social safety nets are those who face the greatest political obstacles to articulation of their interests, for example, rural workers, the self-employed, and poor families. In addition, “competition states” motivation mitigates the expansionary pressure on governments generated by these programs because governments become active in seeking efficient management of the funds through multiple market and social channels to diversify costs and increase gains. This has been the case in China where the new social assistance programs have been developed primarily through decentralization and socialization involving multiple partners including local governments, community organizations, and
corporations (see, e.g., Chan et al. 2008).

The above discussions, in essence, suggest that conflicting dynamics of the welfare state in developing countries pull countries in different directions. The particular direction in which a country moves, however, hinges on its previous spending pattern and the level of openness it experienced. In countries where the overall level of protection, including that for skilled labor in the formal sector, was previously too low when seen from a cross-national perspective – for example, in many East Asian NICs – the pressure to expand social safety nets would result in the growth of government. In sum, instead of a “race to the bottom,” we have seen more of a “move to the middle” in which governments pursue a moderate level of spending and a balanced distribution among different policy domains.
CHAPTER 3

ECONOMETRIC ANALYSIS

3.1 INTRODUCTION

The discussion in the previous two chapters has posited that globalization and industrialization have produced opposite dynamics that shape the transformation of the welfare regimes across the developing world in a new international market environment. These two conflicting dynamics set the welfare transformation in the developing world apart from what the mainstream theories have commonly predicted based on the OECD experiences. A “race to the bottom” does not occur to the social protection systems in the developing world as the result of the intensified market competition. Neither do these countries follow the practice of OECD countries to “race to the top” of compensation as an political effort to maintain openness against the potential backlash.

The mechanism outlined in the theoretical framework indicates that a “move to the middle” in the developing countries is the result of intensified trade openness that produces incentives for social groups and governments alike to abandon the traditional stratified and inefficient welfare regime and instead to transform it into a productive one. The primary function of the new welfare regime is to facilitate competition in a way that sustains the economy in the long run,
rather than to shelter individuals from market competition. A critical factor that makes this process possible in the developing world, as the data will demonstrate shortly, is that industrialization in the developing world has been undergoing a trend opposite to that in the developed world as a result of world economic integration. The intensified trade openness has induced these labor-intensive and capital-scarce economies to lower their skill dependence in order to maintain their competitive advantages in the international market. In the developed world, by contrast, trade openness drives the overall skill level up, which further worsens the labor market for manufacturing workers.

To put these arguments to an empirical test, I use both quantitative and qualitative methods in order to explore the causal mechanism underpinning the theory. In this chapter, I employ a large-N dataset drawn from more than 50 developing countries from the early 1970s to the late 1990s, a critical period in which globalization, in terms of intensification of the exchange of goods, capital and services across the border, took full effect in most developing countries. The panel regressions will be conducted in order to establish that the theoretical framework and arguments are generalizable across the developing world, before we examine three countries more closely.

Social protection in this study refers both to financial commitment and labor protection from the government. In the quantitative analysis of this chapter, social protection is measured by the
amount of government spending on social security relative to total government expenditures. The
case studies in the next few chapters will take social protection in a broader sense, including the
spending level and related labor protection.

This chapter is organized as follows. Section 2 describes the key variables and model
specification. Section 3 is an econometric analysis that tests the hypotheses with regard to the
impacts of globalization and skill dependence on social security and welfare spending. Section 4
examines the impacts of globalization and skill dependence on different categories of social
spending, including social security and welfare, education, and health care. These regressions
test the argument of the “move to the middle.” The findings will demonstrate that the welfare-
globalization nexus in the developing world has very different characteristics from what has been
commonly assumed in the existing literature. Whereas industrialization incurs more traditional
social security and welfare spending, globalization has significant reductive impact on it.

Globalization, on the other hand, also induces a more balanced structure of social spending that
gives more emphasis on the programs such as education and health care that cover more social
groups and are critical to long-term economic development. Section 5 concludes.

3.2 DATA DESCRIPTION AND MODEL SPECIFICATION

In this chapter, I analyze the changing dynamics of social spending in the developing world and
test the hypotheses presented in Chapter 2 using a time-series-cross-sectional dataset. The data are drawn from 53 developing countries from 1972 to 1995. The countries are listed in Table 3.1 below by region.

**Table 3.1 Country List by Region (N=53)**

<table>
<thead>
<tr>
<th>Latin America</th>
<th>Asia &amp; Pacific</th>
<th>Africa</th>
<th>Middle East</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>Bangladesh</td>
<td>Botswana</td>
<td>Cyprus</td>
</tr>
<tr>
<td>Bolivia</td>
<td>Fiji</td>
<td>Cameroon</td>
<td>Egypt</td>
</tr>
<tr>
<td>Brazil</td>
<td>India</td>
<td>Ghana</td>
<td>Greece</td>
</tr>
<tr>
<td>Chile</td>
<td>Indonesia</td>
<td>Kenya</td>
<td>Iran</td>
</tr>
<tr>
<td>Colombia</td>
<td>Korea Rep.</td>
<td>Lesotho</td>
<td>Israel</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>Malaysia</td>
<td>Liberia</td>
<td>Jordan</td>
</tr>
<tr>
<td>Dominican Rep.</td>
<td>Nepal</td>
<td>Malawi</td>
<td>Kuwait</td>
</tr>
<tr>
<td>Ecuador</td>
<td>Pakistan</td>
<td>Mali</td>
<td>Syria</td>
</tr>
<tr>
<td>El Salvador</td>
<td>Philippines</td>
<td>Mauritius</td>
<td>Turkey</td>
</tr>
<tr>
<td>Guatemala</td>
<td>Singapore</td>
<td>Morocco</td>
<td></td>
</tr>
<tr>
<td>Guyana</td>
<td>Sri Lanka</td>
<td>Tanzania</td>
<td></td>
</tr>
<tr>
<td>Honduras</td>
<td>Thailand</td>
<td>Tunisia</td>
<td></td>
</tr>
<tr>
<td>Mexico</td>
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<tr>
<td>Nicaragua</td>
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<td>Panama</td>
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<td>Paraguay</td>
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<tr>
<td>Paraguay</td>
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<tr>
<td>Uruguay</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Venezuela</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trinidad &amp; Tobago</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total by Region</strong></td>
<td>19</td>
<td>12</td>
<td>13</td>
</tr>
</tbody>
</table>

### 3.2.1 Three Categories of Social Spending

In the quantitative analysis of this chapter, I examine three categories of social spending in order to understand the different impact of globalization on government behavior in terms of social protection – social security and welfare, education, and health. In this study, I simply refer to the expenditures on social security and welfare as welfare spending, in line with the term “welfare
protection.” The explanation for each category is listed in Table 3.2 below, based on the
definition and classification from International Monetary Fund’s Government Financial Statistics
(GFS). The spending on each category here is measured as the share of total government
expenditures. It is common among globalization scholars to use welfare/education/health
spending over GDP as the dependent variable. However, given that globalization is measured by
trade over GDP, the dependent variable measured by welfare spending over GDP is apparently
inappropriate, because GDP is the denominator on both sides of the equation and this may drive
the correlation higher than should be the case.

Governmental social responsibilities encompass a variety of areas, which affect different
individuals and social groups in a different manner. According to IMF’s GFS data classification
(IMF 1986), government expenditures are classified according to 9 categories of government
function, including 1) public administration, 2) defense, 3) public order and safety, 4) education,
5) health, 6) social security and welfare, 7) housing and community amenities, 8) creational,
cultural, and religious affairs, and 9) a variety of economic affairs and services. Among these
categories, scholars commonly take the expenditures on education, health, and social security
and welfare to refer to social spending, implying that expenditures on these categories of
government function are an essential part of what governments do to enhance the quality of life
of their citizens and the human capital base of their societies, therefore reflecting the relationships between the government and the society (e.g. Brown and Hunter 1999; Kaufman and Segura 2001; Avelino et al. 2005). However, important differences among these three categories must be noted. Table 3.2 below presents the definitions and components of each of these three categories of government spending.

Most studies of the welfare state use the expenditures on “social security and welfare” to refer to the size of the welfare state. Expenditures on social security and welfare refer to transfers provided to individual persons and households. In contrast, expenditures on education and health care target the general population rather than individual persons and households. Beneficiaries of these three categories may overlap. For example, employees in formal sectors in most developing countries enjoy the benefits from all three categories, while those outside formal sectors usually are excluded from at least social security. Nevertheless, scholars acknowledge that the difference between social security and welfare vs. education and health is significant and reflects the different political weight of social groups in policy choices.

8 Expenditures on economic affairs and services, on the other hand, reflect the relationships between governments and markets.
Table 3.2 Three Categories of Social Spending

<table>
<thead>
<tr>
<th>Social Security and Welfare</th>
<th>Social security: Transfer payments to compensate for reduction or loss of income or inadequate earning capacity, including</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1) payments for retirement, pension, and disability plans for government employees, both civil and military, and their survivors. Payments are generally administered under a social insurance scheme or workers’ compensation arrangements;</td>
</tr>
<tr>
<td></td>
<td>2) payments for sickness, maternity, or temporary disablement benefits, generally administered under a social insurance scheme or workers’ compensation arrangements</td>
</tr>
<tr>
<td></td>
<td>3) payments for old age, disability, or survivor’s benefits for general population other than government employees;</td>
</tr>
<tr>
<td></td>
<td>4) payments for unemployment compensation benefits;</td>
</tr>
<tr>
<td></td>
<td>5) Payments under social insurance or other government schemes to individuals, including war veterans, for loss of income due to unemployment;</td>
</tr>
<tr>
<td></td>
<td>6) Payments for income assistance to family and child allowances.</td>
</tr>
</tbody>
</table>

Welfare: Assistance delivered to clients or groups of clients with special needs, such as the young, the old, the handicapped, or homeless. Payments for residential institutions that deliver services for these individuals, such as orphanages, children’s boarding homes, residential nurseries, and so forth.

<table>
<thead>
<tr>
<th>Education</th>
<th>Administration, management, inspection, operation, and support of</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1) Schools and other institutions providing training at certain levels of education at various levels, including pre-primary and primary; secondary, general programs and vocational and technical; tertiary, universities</td>
</tr>
<tr>
<td></td>
<td>2) Subsidiary services for transportation, food, lodging, medical and dental attention, and related subsidiary services chiefly for students regardless of level.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Health Care</th>
<th>Administration, management, inspection, operation, and support of</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1) general hospital and specialized hospital, medical and maternity center, nursing and convalescent home;</td>
</tr>
<tr>
<td></td>
<td>2) medical, dental, and paramedical practitioners;</td>
</tr>
<tr>
<td></td>
<td>3) public health such as blood bank operation, disease detection services, prevention services, population control, and so forth, which are frequently delivered by teams not connected with a hospital, clinic, or practitioner;</td>
</tr>
<tr>
<td></td>
<td>4) medicaments, prostheses, medical equipment, and appliances or other prescribed health-related products;</td>
</tr>
<tr>
<td></td>
<td>5) Applied research and experimental development related to health and medical delivery system.</td>
</tr>
</tbody>
</table>

*Data Source: IMF GFS Manual (1986)*

For example, social security spending in the developing world is considered to be regressive in the sense that it benefits only a narrow group of individuals who can afford social security.
contributions, because these programs, for instance, pensions and employment insurance, are employment-based and earnings-related. Only a very small amount of the expenditures under social society and welfare go to the programs that are non-contributory, for example, programs that encourage school attendance and primary health care visits of children. In Latin America where welfare protection has been the most advanced in the developing world, the latter programs are relatively scarce and poorly funded (De Ferranti et al. 2004: 268-72; Morley and Coady 2003: 268-72; Lindert et al. 2005). In the developing world in general, these programs are far more limited in coverage and financing.

Contrasting to social security and welfare, education and health care programs are less discriminative to the general public and instead tend to be more accessible to a larger amount of individuals and households. These programs therefore have wider beneficial effects than social security and welfare programs do (Wodon et al. 2003; Lindert et al. 2005).

Globalization, as the theory predicts, has different impacts on different categories of social spending. Whereas the most traditional social security and welfare programs are negatively affected by globalization due to their stratified nature in favor of skilled workers, other programs such as education, health care, and certain types of non-contributory assistance programs such as poverty relief and job training programs, which are critical to the long-term human capital
development may be less affected, or even be promoted by globalization. Figure 3.1 below presents the data for the average spending in the three categories – social security and welfare, education, and health, from 1972 to 1995.

**Figure 3.1 Spending on Social Security and Welfare, Education, and Health Care as the Share of Government Expenditures in Developing Countries: 1972-1995**

![Chart](chart.png)

*Data Source: IMF GFS data, various years.*

While the spending on social security and welfare has been declining overall during the period, education and health care spending has been largely constant. In fact, health care spending has increased since the late 1980s. It is therefore important to compare the different impact of globalization on these programs in order to confirm that a “move to the middle” is taking place in the sense that a balanced structure of social spending among various social programs is
constructed in order to compensate as many social groups as possible on a relatively equal base.

It should be noted that, in this chapter, only the data for social security and welfare, education, and health care are available for the quantitative analysis. The data for other programs important to test the “move to the middle,” for example, social assistance, poverty relief, and job training programs, are not available. In addition, these programs are not often perfectly reflected in government expenditures. Most of these programs are designed to cover the majority of the population with efficient measures intended to maintain the lowest level of government expenditures. For example, multiple channels are used by many governments to finance poverty relief or health care in many countries. The expansion of these programs does not necessarily lead to higher level of government expenditures even though government responsibility has been expanded. Thus, the evidence for the “move to the middle” may be difficult to observe in government expenditures. The case studies in the following chapters will provide better evidence to demonstrate how a “move to the middle” is possible in specific national contexts.

3.2.2 Globalization and Skill Dependence

Globalization is often referred to as economic integration, which, however, has many indicators with different or even opposing impacts on the welfare systems in the developing world. The most commonly used indicators are trade openness and capital mobility. Other indicators used
less frequently include international financial institutions, debts, and international portfolio investments. It must be noted that trade openness and capital liberalization could produce very different impacts on social protection in developing countries, as empirical evidence has demonstrated. In particular, the impact of capital liberalization on the welfare state in developing countries is highly precarious, which may imply that different mechanisms underpin the impact of capital liberalization and trade openness. In this study, I narrow the focus and use trade openness to refer to globalization. Trade openness is measured by the sum of import and export over GDP.

The level of skill dependence is measured using the ratio of the total number of workers employed in high-skilled manufacturing to the total number of workers employed in low-skilled manufacturing. A higher skill ratio indicates a higher level of skill dependence. The data were compiled by Rudra (2001), using the classification scheme for high and low manufacturing developed by Wood and Mayer (2001) based on the Standard International Trade Classification (SITC, rev. 2).

To understand why the interaction between globalization and skill dependence produces a different mechanism underpinning social protection in developing countries from what the conventional theories have commonly predicted, it is instructive to compare the interaction
between globalization and skill dependence in developing countries and OECD countries. Figure 3.2 and 3.2 below shows the average level of trade openness and skill dependence in both OECD and developing countries respectively during the period from the 1970s to the 1990s.

In terms of trade openness, both developing and developed countries have followed a similar upward trend in general, with the exception during the 1980s when a series of economic crises hit most countries, particularly many of them in the developing world, as the sharp and prolonged decrease of trade level in Figure 3.2 shows. The similar trend of trade openness in the two worlds, however, has been accompanied by rather different trends of skill dependence. The skill level has steadily increased in OECD countries. The speed is particularly fast during the 1970s. This is a period in which western societies began entering a post-industrial service economy, throwing traditional industrial workers into labor market transition. The level is stabilized during the 1980s but then again goes up during the 1990s. The change in the 1990s can be seen as the result of the further shift of labor markets in these countries as globalization has intensified and outsourcing of manufacturing sectors to the developing world has driven up the demand for high-skilled workers.
Figure 3.2 Average Trade Openness and Skill Dependence in OECD Countries: 1972-1995

Note:
1. Trade openness is measured by the sum of import and export as the share of GDP;
2. Skill level is measured by the ratio between the number of employees in high-skilled export-manufacturing sectors and the number of employees in low-skilled export-manufacturing sectors.

Data Source:
1. Trade openness from Penn World Table 6.0;
2. Skill level from United Nations Industrial Development Organization (UNIDO), Database of Industrial Statistics, various years.

In the developing world, however, the increasing trade openness is not been followed by the increase of skill dependence. For most of this period, as shown in Figure 3.3 below, the average level of skill dependence in the developing world – which is far below that in OECD countries and has been fluctuating significantly. Since the early 1990s, the downward trend in its skill level is particularly noticeable in the developing world. The reduction from 0.29% in 1992 to 0.25% in 1995 – a 14% drop – is significant, given the low skill level for the most part of the period in the
developing world.

**Figure 3.3 Average Trade Openness and Skill Dependence in Developing Countries: 1972-1995**

![Graph showing trade openness and skill level over time from 1970 to 1997.](image)

**Note:**
1. Trade openness is measured by the sum of import and export as the share of GDP;
2. Skill level is measured by the ratio between the number of employees in high-skilled export-manufacturing sectors and the number of employees in low-skilled export-manufacturing sectors.

*Data Source:* Trade openness from Penn World Table 6.0; Skill level from United Nations Industrial Development Organization (UNIDO), *Database of Industrial Statistics*, various years.

The reduction of the skill level in the developing world since the late 1980s is suggestive, given that trade openness increases rapidly at the same time – which is even faster than that in OECD countries at certain periods. It happens that the reduction in the developing world took place during the same period when the OECD countries began upgrading their industrial structure once
again and outsourcing their low-skilled manufacturing jobs to the developing world. In other words, the opposite trends of skill dependence in developing and developed countries suggest that trade openness has induced different strategies of industrialization in developing and developed world. Whereas OECD countries enhance their competitive advantages in skill and capital-intensive manufacturing, developing countries in general strengthen their low-skilled manufacturing sectors, which are more in line with their factor endowments. Referring back to the model developed in Figure 2.6 of Chapter 2, these different patterns demonstrate that the mechanisms underpinning the demand for social protection are different in developing and OECD countries. In the latter, the risks associated with trade openness are more severe to low-skilled workers because these workers, as a scarce factor not in line with the comparative advantage in these societies, become increasingly vulnerable as trade openness intensifies. Thus, both trade openness and industrialization have widened the wage and risk gaps between low-skilled and high-skilled labor, therefore incurring protection. In contrast, the low-skilled labor in developing countries is an abundant factor and is in an advantaged position in an open economy. Trade openness increases the wages of low-skilled workers and at the same time lowers the wage level of high-skilled workers, thus reducing the risk gap among the labor in different sectors.

The caveat of the above discussion is that the evidence about the decline of skill dependence in
the developing countries has only taken place in a very short segment of the entire period of three decades the data set is based on. Due to the limitation of the data availability, this argument is more a speculation than an assumption. However, it does give interesting suggestion that the international market since the late 1980s may have exerted unprecedented impact on the environment that shapes the welfare state in the developing world. The case studies in the following chapters will provide evidence to support this argument. In all three cases analyzed, the period since the late 1980s marks a critical movement of globalization in forms of the expansion of trade openness, which was accompanied by significant change of welfare systems.

3.2.3 Control Variables

I include several demographic and economic variables as control in order to isolate the main relationships between the key independent variables and welfare spending. They also help check on other influences on welfare spending. I follow common practices in the literature and use the following variables. The first variable is regime type. Under the assumption that democratic institutions give labor unions more opportunities and resources to mobilize and articulate their interests, a number of scholars have argued that political regimes play a critical role in assisting governments in countering the detrimental effects of globalization on social protection (Melzer and Richard, 1981; Brown and Hunter, 1999; Lake and Baum, 2001; Kaufman and Segura-
Ubiergo, 2001; Boix 2001; Adsera and Boix, 2002; Haggard, 2005; Rudra and Haggard, 2005; Avilino et al. 2005). In this study, this variable serves to test the argument by the power resources model that labor movements and left parties are the primary cause of welfare spending and stronger labor movements lead to higher level of welfare spending. The data are taken from Polity IV dataset (Marshall et al. 2004), which uses a scale of 0 to 10, with 10 representing strong democracy. The indicator is derived from the coding of the competitiveness of political participation, the openness and competitiveness of executive recruitment, and constraints on the chief executive.

The second control variable is urbanization, because the urban population tends to enjoy more welfare protection due to their strategic position for politicians to maintain their legitimacy. The third control variable is the number of dependents, measured by the population over 60 divided by the total population between 20 to 59. This is because the largest category of welfare spending usually is the pension insurance for elder people.

The fourth control variable is economic size, measured by GDP, under the assumption that larger economies tend to have larger welfare spending because of the larger public sector, following the prediction of the so-called Baumol’s cost disease (Baumol 1967). The fourth control variable is the level of wealth measured by GDP per capita, which follows the so-called Wagner’s law that
economic development is accompanied by an increased level of public expenditures.

The sixth control variable is growth rate of GDP per capita, which measures the impact of changing economic environment on welfare spending. The last control variable is external debt/GDP ratio that is assumed to negatively affect the financial base for welfare spending.

Scholars commonly include control variables to ameliorate the danger posed by omitted variable bias. However, the justification for their specifications has long been criticized forcefully. By way of evidence, the journal Conflict Management and Peace Science devoted an entire volume in 2005 to discussions of this issue (see e.g. Clarke 2005; Achen 2005; Oneal and Russett 2005).

In order to avoid becoming entangled in that debate, I run models with control variables and models without. The effects of the key independent variables remain similar in all of the models regardless of whether control variables are included.

All of the models include country and time dummies in order to control for country-specific and time-specific fixed effects. The use of fixed effects is becoming the norm in panel studies of the welfare state, and is particularly important in this study, because most of the variables vary more across units than over time. Moreover, in order to assess the changes that occurred in different countries over time, the use of panel data combines the benefits of an increased number of
observations with the ability to eliminate country-specific fixed effects. The descriptive statistics
of the data and the description of statistical data sources are presented in Table 3.2 below.

Table 3.3 Descriptive Statistical Variable Information

<table>
<thead>
<tr>
<th>Variable</th>
<th>Obs.</th>
<th>Mean</th>
<th>Std. Dev.</th>
<th>Min</th>
<th>Max</th>
<th>Data Sources</th>
</tr>
</thead>
<tbody>
<tr>
<td>Country</td>
<td>53</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Year</td>
<td></td>
<td>1972</td>
<td>1995</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Spending Variables</strong> (% of public expenditures)**</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Social Security &amp; welfare Spending</td>
<td>1009</td>
<td>0.12</td>
<td>0.20</td>
<td>0.00</td>
<td>3.15</td>
<td>IMF GFSa</td>
</tr>
<tr>
<td>Education Spending</td>
<td>694</td>
<td>0.14</td>
<td>0.05</td>
<td>0.00</td>
<td>0.30</td>
<td>IMF GFSa</td>
</tr>
<tr>
<td>Health Care Spending</td>
<td>693</td>
<td>0.06</td>
<td>0.05</td>
<td>0.00</td>
<td>0.33</td>
<td>IMF GFSa</td>
</tr>
<tr>
<td><strong>Key Independent Variables</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trade Openness</td>
<td>980</td>
<td>68.04</td>
<td>56.71</td>
<td>6.32</td>
<td>439.59</td>
<td>PWTb</td>
</tr>
<tr>
<td>Skill Level</td>
<td>968</td>
<td>0.30</td>
<td>0.18</td>
<td>0.02</td>
<td>1.09</td>
<td>UNIDO DISc</td>
</tr>
<tr>
<td><strong>Control Variables</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Regime type</td>
<td>962</td>
<td>3.69</td>
<td>4.08</td>
<td>0.00</td>
<td>10.00</td>
<td>Polity IVd</td>
</tr>
<tr>
<td>Urbanization</td>
<td>1009</td>
<td>47.93</td>
<td>23.21</td>
<td>4.34</td>
<td>100.00</td>
<td>WDi</td>
</tr>
<tr>
<td>Age dependency ratio</td>
<td>1009</td>
<td>0.79</td>
<td>0.16</td>
<td>0.37</td>
<td>1.15</td>
<td>WDi</td>
</tr>
<tr>
<td>Growth Rate</td>
<td>947</td>
<td>0.00</td>
<td>0.02</td>
<td>-0.24</td>
<td>0.11</td>
<td>WDi</td>
</tr>
<tr>
<td>GDP(logged)</td>
<td>945</td>
<td>9.32</td>
<td>1.67</td>
<td>4.39</td>
<td>13.21</td>
<td>WDi</td>
</tr>
<tr>
<td>GDP pc (logged)</td>
<td>1009</td>
<td>7.44</td>
<td>1.15</td>
<td>4.98</td>
<td>10.40</td>
<td>WDi</td>
</tr>
<tr>
<td>Debt/GDP</td>
<td>1009</td>
<td>5.70</td>
<td>4.07</td>
<td>0.03</td>
<td>40.24</td>
<td>WDi</td>
</tr>
</tbody>
</table>

Note:

- IMF GFS: International Monetary Fund, Various years. Government Finance Statistics Yearbook
- PWT: Heston et al. Penn World Table Version 6.1
- UNIDO DIS: United Nations Industrial Development Organization, Database of Industrial Statistics
- Polity IV: Marshall et. al. Polity IV
- WDI: World Bank, various years, World Development Indicators
3.3 DETERMINANTS TO THE VARIATIONS IN WELFARE SPENDING

Recall the four hypotheses developed in Chapter 2:

**H1**: Countries at higher levels of skill dependence are more likely to have a higher level of welfare protection, all else being equal.

**H2**: Countries with higher levels of international trade exposure are more likely to have a lower level of welfare protection, all else being equal.

**H3**: As a country becomes more exposed to international trade, the expansionary effect of industrialization on welfare protection decreases.

**H4**: As countries become more exposed to trade openness, welfare benefits that target skilled workers in traditionally strategic sectors decreases at a faster pace than those that target the general population.

To test these hypotheses, I first determine whether and in which direction the key factors identified in this study cause the change of social security and welfare spending. Table 3.3 below presents the results. Model 1 is to test the impact of each individual variable on welfare spending so as to confirm the correlation between the key independent variables and welfare protection. Model 2 is a robust check on Model 1 by removing the control variables. Model 3 adds the interaction term between trade openness and skill level in order to test the conditional effect specified in Hypothesis 3. Model 4 is a robust check on Model 3 by removing the control variables. The first two models only include individual variables, while In model 3 and model 4, I allowed trade openness to interact with skill level in order to examine the conditional effect.
specified in Hypothesis 3. In both Model 2 and Model 4, removing control variables does not change the results substantially.

In all of the four models, trade openness exerts a negative effect on welfare spending while the effect of skill level is positive. Both variables are statistically highly significant. The results support the argument that globalization and industrialization yield opposing influences on the expansion of welfare states in developing countries, which confirms Hypothesis 1 and Hypothesis 2.

Among the control variables, only GDP size is statistically significant in different model specification and the sign is correct as predicted, suggesting that governments in larger economies tend to spend more on social security and welfare. Urbanization is significant in Model 1 at 0.10 level but the sign is incorrect. Furthermore, this variable becomes insignificant in Model 3, suggesting that urbanization’s impact on welfare spending is not robust regardless of the direction.
### Table 3.4 Cross-country Variations in Welfare Spending
(Dependent Variable: Social Security and Welfare Spending)

<table>
<thead>
<tr>
<th>Hypothesized Impact</th>
<th>Models</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
</tr>
<tr>
<td>Trade openness (logged) _t-1</td>
<td>-0.788***</td>
</tr>
<tr>
<td></td>
<td>(0.194)</td>
</tr>
<tr>
<td>Skill Level</td>
<td>+1.561**</td>
</tr>
<tr>
<td></td>
<td>(0.686)</td>
</tr>
<tr>
<td>Trade*Skill</td>
<td>-0.561***</td>
</tr>
<tr>
<td></td>
<td>(0.210)</td>
</tr>
<tr>
<td>Regime Type</td>
<td>+0.012</td>
</tr>
<tr>
<td></td>
<td>(0.020)</td>
</tr>
<tr>
<td>Urbanization</td>
<td>+0.023*</td>
</tr>
<tr>
<td></td>
<td>(0.012)</td>
</tr>
<tr>
<td>Dependency Ratio</td>
<td>+1.356</td>
</tr>
<tr>
<td></td>
<td>(1.026)</td>
</tr>
<tr>
<td>Growth Rate</td>
<td>2.895</td>
</tr>
<tr>
<td></td>
<td>(3.756)</td>
</tr>
<tr>
<td>GDP(logged) _t-1</td>
<td>0.370**</td>
</tr>
<tr>
<td></td>
<td>(0.157)</td>
</tr>
<tr>
<td>GDP pc (logged) _t-1</td>
<td>-0.413</td>
</tr>
<tr>
<td></td>
<td>(0.342)</td>
</tr>
<tr>
<td>Debt/GDP</td>
<td>-0.012</td>
</tr>
<tr>
<td></td>
<td>(0.013)</td>
</tr>
<tr>
<td>Constant</td>
<td>1.335</td>
</tr>
<tr>
<td></td>
<td>(2.360)</td>
</tr>
<tr>
<td>Countries</td>
<td>48</td>
</tr>
<tr>
<td>Obs.</td>
<td>632</td>
</tr>
<tr>
<td>$R^2$</td>
<td>0.096</td>
</tr>
</tbody>
</table>

**Note:** Fixed-effects regression estimates. Figures in parentheses are standard errors.

***$p < .01$, **$p < .05$, *$p < .10$.**
In model 3 and model 4, I allowed trade openness to interact with skill level. Including the interaction term did not change the sign of the constituent variables. However, the sign for the interaction term becomes negative, following the sign of globalization, whereas the sign for skill level remains positive. The negative sign of the interaction between trade openness and skill level confirms Hypothesis 3 which predicts a diminishing return from the expansionary effect of industrialization as globalization advances: although higher skill level is associated with higher levels of welfare spending, the rate of increase decreases as countries become more exposed to openness.

Figures 3.4 below displays graphically how globalization conditions the effects of skill dependence on welfare spending. The marginal effect of skill level is positive at 2.66 (which is the coefficient of skill level in column 3 of Table 3.3) when trade openness is assumed to be zero, meaning that higher level of skill dependence leads to more welfare spending. Yet, as trade openness increases, the marginal effect of skill level decreases, as shown by the decreasing line. When trade openness reaches about 4.8, that is, a trade/GDP ratio at about 120%, the marginal effect of skill level disappears, meaning that the increasing curve of skill level effect becomes flat, as Figure 2.7 in Chapter 2 illustrates.
Figure 3.4 Marginal Effect of Skill Dependence on Welfare Spending as Trade Openness Changes

Notes:
- Data are calculated with coefficients
- Controlling for veto player, regime type, urbanization, dependency ratio, growth rate, GDP, GDP per capita, and debt ratio

3.4 MULTIFACETED IMPACTS OF GLOBALIZATION ON SPENDING PRIORITIES

The hypothesis about the “move to the middle” (Hypothesis 4) will be tested in both the econometric analysis below and the country case studies in the following three chapters. The Table 3.4 below presents the regression table that shows how globalization affects different categories of social spending across countries over time. In all three models, the coefficient of
trade is negative, and highly significant, suggesting that globalization in general has a reductive effect on government size with respect to different categories of social spending. Removing control variables for each model does not change the result substantially.

The size of the coefficient for trade in the three models, however, differs. The value is -0.79 for welfare spending. For health care, the value becomes -0.28, and for education, -0.20. The different effects can be better understood by examining Figure 3.5, which shows that each unit increase of trade openness produces a much larger unit decrease in welfare spending than is the case for education and health care. In other words, the reductive impact of globalization is much greater for welfare spending than for education and health care spending.

Compared to that on welfare spending, the impact of trade openness on education and health care spending is less severe, though the reductive effect is slightly stronger on education than on health care. This can be interpreted in two alternative ways. One is that health care has a more immediate impact on the well-being of the population than education, which makes it difficult for governments to ignore its importance in a new environment dictated by globalization.
Table 3.5 Impacts of Globalization on Different Categories of Social Spending

<table>
<thead>
<tr>
<th>DV: Welfare Spending</th>
<th>DV: Education Spending</th>
<th>DV: Health Care Spending</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Trade openness (logged)</td>
<td>t-1</td>
<td></td>
</tr>
<tr>
<td>-0.788***</td>
<td>-0.778***</td>
<td>-0.255***</td>
</tr>
<tr>
<td>(0.194)</td>
<td>(0.193)</td>
<td>(0.044)</td>
</tr>
<tr>
<td>-0.257***</td>
<td>-0.203***</td>
<td>-0.199***</td>
</tr>
<tr>
<td>(0.044)</td>
<td>(0.066)</td>
<td>(0.066)</td>
</tr>
<tr>
<td>Skill Level</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.561**</td>
<td>1.656**</td>
<td></td>
</tr>
<tr>
<td>(0.686)</td>
<td>(0.647)</td>
<td></td>
</tr>
<tr>
<td>0.143</td>
<td>0.174</td>
<td>-0.468**</td>
</tr>
<tr>
<td>(0.157)</td>
<td>(0.150)</td>
<td>(0.233)</td>
</tr>
<tr>
<td>-0.401*</td>
<td>-0.468**</td>
<td></td>
</tr>
<tr>
<td>(0.221)</td>
<td>(0.233)</td>
<td></td>
</tr>
<tr>
<td>Regime type</td>
<td>0.012</td>
<td>-0.003</td>
</tr>
<tr>
<td>(0.020)</td>
<td>(0.005)</td>
<td>(0.008)</td>
</tr>
<tr>
<td>Urbanization</td>
<td>-0.023*</td>
<td>0.000</td>
</tr>
<tr>
<td>(0.012)</td>
<td>(0.003)</td>
<td>(0.005)</td>
</tr>
<tr>
<td>Dependency Ratio</td>
<td>-1.356</td>
<td>-0.170</td>
</tr>
<tr>
<td>(1.026)</td>
<td>(0.244)</td>
<td>(0.364)</td>
</tr>
<tr>
<td>Growth Rate</td>
<td>2.895</td>
<td>0.694</td>
</tr>
<tr>
<td>(3.756)</td>
<td>(0.877)</td>
<td>(1.307)</td>
</tr>
<tr>
<td>GDP(logged) t-1</td>
<td>0.370**</td>
<td>0.032</td>
</tr>
<tr>
<td>(0.157)</td>
<td>(0.038)</td>
<td>(0.057)</td>
</tr>
<tr>
<td>GDPpc (logged) t-1</td>
<td>-0.413</td>
<td>-0.009</td>
</tr>
<tr>
<td>(0.342)</td>
<td>(0.086)</td>
<td>(0.129)</td>
</tr>
<tr>
<td>Debt/GDP</td>
<td>-0.012</td>
<td>-0.002</td>
</tr>
<tr>
<td>(0.013)</td>
<td>(0.003)</td>
<td>(0.004)</td>
</tr>
<tr>
<td>Constant</td>
<td>1.335</td>
<td>-1.212**</td>
</tr>
<tr>
<td>(2.360)</td>
<td>(0.593)</td>
<td>(0.880)</td>
</tr>
<tr>
<td>Countries</td>
<td>48</td>
<td>48</td>
</tr>
<tr>
<td>Obs.</td>
<td>632</td>
<td>645</td>
</tr>
<tr>
<td>R²</td>
<td>0.096</td>
<td>0.167</td>
</tr>
</tbody>
</table>

Note: Fixed-effects regression estimates. Figures in parentheses are standard errors. 
***p < .01, **p < .05, *p < .10.
Figure 3.5 Impacts of Globalization on Different Categories of Social Spending

Notes:

a. Data are calculated with coefficients
b. Controlling for skill level, regime type, urbanization, dependency ratio, growth rate, GDP, GDP per capita, and debt ratio

Another explanation is that health care has traditionally been underdeveloped in most developing countries, while education has been emphasized in some countries, most noticeably East Asian countries, where education spending has been substantially larger than welfare spending as a proportion of total government expenditures. Due to the previous low level of development, there is less room to roll back health care spending.
All three of the models in Table 3.4 include skill level in order to keep the models consistent with previous models in Table 3.3. Again, for each dependent variable, I run the second regression in which I removed control variables. And the results are similar.

As regards education spending, skill level produces no impact at all, although the sign of the coefficient is similar to previous models. As regards health care spending, skill level is statistically significant but the effect is negative. If we assume that health care spending – and, to a less degree, education spending – represents a progressive program that targets more of the social groups that were previously ignored in public provision, the negative relationship between skill level and health care spending is consistent with the central argument of this study. That is, industrialization cultivates a privileged group of high-skilled workers for whom the expansion of social protection to the rest of the population might pose a potential threat to their privileges.

Globalization, consistent with earlier discussion, produces an opposite impact on this tendency and instead promotes health care spending that is critical for the long-term development.

3.5 CONCLUSION

This chapter has presented the findings from quantitative analyses based on the data drawn from 53 developing countries from early 1970s to the late 1990s. Based on the econometric analysis of the time-series-cross-sectional data, the findings have suggested that trade openness and skill
dependence affect welfare spending differently across countries and over time. More specifically, skill dependence incurs more costs that fuel the demand for public provision of traditional welfare protection, while trade openness decreases the demand for that type of protection.

On the other hand, trade openness has much less detrimental impact on social programs that can serve to sustain long-term economic and social development, such as health care and education programs that tend to benefit more population than the traditional welfare programs would. In fact, since the late 1980s, the developing countries on average have tended to increase their spending on health care in a faster pace than they do to increase spending on traditional welfare programs. This has occurred in a time when globalization began manifesting its impact across the developing world.

These findings suggest that a “move to the middle” has taken place across the developing world as governments follow the dictates of globalization and place a more balanced emphasis on different spending categories, which protect different social groups. These findings from quantitative data analysis, however, omit details about how this “move to the middle” is taking place in specific contexts. Moreover, as stated earlier, the evidence on the “move to the middle” is best reflected in governments’ effort to readjust welfare spending and improve the quality of management of the funds in order to lower the costs, as well as changing labor protection. These
adjustments, however, are not likely to be fully reflected in government expenditures. Case studies are therefore indispensible to provide important information to reveal the mechanisms that underpins governments’ strategies to achieve such a goal without incurring high costs under the constraints of their skill dependence and of their dependence on global markets. Case studies will also illustrate the process in which the interaction among these factors takes place under specific circumstances.
CHAPTER 4

CASE STUDIES OF WELFARE REGIME TRANSFORMATION

The case studies in the next three chapters, Chapter 5-7, will analyze transformation of welfare regimes in three countries: China, Brazil, and South Korea. In this chapter, I will first describe the variations across the three cases with a broad brush and discuss how the theory predicts the welfare transformation in these three countries. The description and discussion will provide a guide to go through the details in the following three chapters. I will then discuss some of the alternative explanations on welfare regimes in these three cases and in developing countries in general. These discussions will serve to further clarify the main arguments of this study by explaining some phenomena found in these three cases that may for some readers be used against the theory developed here.

4.1 VARIATIONS OF WELFARE PROTECTION

To understand the variations of welfare regime in these three cases, it is necessary to examine their welfare regime before and after they became integrated into the global economy. However, the three countries vary greatly in terms of the time they became integrated and the level of integration they have since experienced. For example, Korea became exposed to the international
market in 1962 under President Park Chung-hee. China’s Deng Xiaoping launched the “open-door policy” in 1978. Brazil began the process of liberalization in 1991 under the Cardoso administration. After each of these three turning points, the progress of economic integration in the three countries has been different. It has been strikingly fast in South Korea and China but only moderate in Brazil. Still, in each country, there have been some critical moments in which integration in these countries was further boosted. For example, in South Korea, there have been three major waves of liberalization since 1962, first in the early 1980s, second in the early 1990s, and third after the 1997 Asian financial crisis. In post-1978 China, there have been two critical turning points when the trade openness was further promoted, one in 1992 and another in 2001 when China became a WTO member. In Brazil, the beginning of the Cardoso administration from 1995 marked another key point of progress in Brazil’s integration.

Despite the variations, the time period from the late 1980s to the late 1990s was a significant decade not only for these three countries but also for the developing countries in general. During this period, both economic and political liberalization occurred among many developing countries across the globe (Haggard 1995). In the three countries studied here, this period marks the full exposure of these countries to the world economy as a series of far-reaching reforming policies were launched that targeted both economic and social issues. Even in South Korea where trade exposure has been high since the 1960s, further liberalization took place during this
period, making South Korea fully integrated into the global markets. As a result, important welfare policy reforms began taking place. Table 4.1 below presents a simplified description of the changing level of protection the three countries before and after they became fully integrated into the global economy around this period.

Table 4.1 Changing Level of Welfare Protection in China, Brazil, and South Korea

<table>
<thead>
<tr>
<th>Level of Welfare Protection</th>
<th>Time period I:</th>
<th>Time period II:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Pre-Globalization</td>
<td>Globalization</td>
</tr>
<tr>
<td>High</td>
<td>Brazil</td>
<td>--</td>
</tr>
<tr>
<td>Moderate</td>
<td>China</td>
<td>Brazil</td>
</tr>
<tr>
<td></td>
<td>South Korea</td>
<td>South Korea</td>
</tr>
<tr>
<td>Low</td>
<td>South Korea</td>
<td>China</td>
</tr>
</tbody>
</table>

The level of welfare protection can be classified into three categories – high, moderate, and low, in a relative sense. During the pre-globalization period, Brazil was at the high level of protection, China at the moderate level, and South Korea at the low level. In the globalization era, important changes occurred. Both China’s and Brazil’s welfare protection has been reduced, while South Korea’s increased. Grouping Brazil and South Korea into the same category of “moderate” may seem unreasonable since Brazil’s protection is still far beyond that in South Korea in terms of both spending level and labor protection. What matters, however, is that the two countries are moving towards the opposite direction and getting closer in their protection.
To explain these variations using the model developed earlier, Table 4.2 below places the changing trend of welfare protection in the context of globalization and skill dependence in these three countries. It describes the levels – again, in a relative sense – of skill dependence, trade openness, and welfare protection at the two time periods. It also describes how the interaction between trade openness and skill dependence in each country affects the process of welfare transition in terms of the difficulties each country has encountered. At the initial level, Brazil was at a high level of skill dependence, low level of trade openness, and its welfare protection was high. China was in a similar position, though China’s level of skill dependence was much lower compared to Brazil’s. South Korea was at a very low level of skill dependence but high trade openness, and its welfare protection was low.

Since their economic integration began, both China and Brazil have increased their trade openness, resulting in the decrease of welfare protection, as Figure 2.6 in Chapter 2 illustrates. However, since Brazil inherits a much higher level of skill dependence from the previous regime, the process of reducing welfare protection has been much slower than that in China, thus confirming Hypothesis 1 that countries at higher level of skill dependence are more likely to have more welfare protection. In addition, the much higher level of trade openness helps China to reduce its welfare protection in a relatively quicker manner (Hypothesis 2).
In South Korea, the initial level of skill dependence was low. It has since been constantly increased along with the process of economic integration, resulting in the increase of welfare protection (Hypothesis 1). However, since the level of trade openness has been constantly high in South Korea, the increase of welfare protection has been effectively curbed at a moderate level, thus resulting in the diminishing return of skill effect (Hypothesis 3).

<table>
<thead>
<tr>
<th>Skill Dependence</th>
<th>Trade Openness</th>
<th>Welfare Protection</th>
<th>Welfare Transition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time Period I</td>
<td>Time Period I</td>
<td>Time Period I</td>
<td>Time Period I</td>
</tr>
<tr>
<td>China</td>
<td>Moderate</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>Brazil</td>
<td>High</td>
<td>High</td>
<td>Low</td>
</tr>
<tr>
<td>South Korea</td>
<td>Low</td>
<td>High</td>
<td>high</td>
</tr>
</tbody>
</table>

Figure 4.1 below further illustrates the importance of globalization for the change of welfare regimes in these countries. The left panel illustrates what has happened in these three countries as described in Table 4.1 and 4.2, where $t_1$ and $t_2$ on the horizontal axis represent the time period – which certainly varies across these three cases – before and after these countries became fully integrated into globalization. The concave curve for China suggests that welfare protection in
China may eventually increase as the country’s skill dependence increases in the future, which has shown some signs in recent years. The right panel illustrates a counterfactual argument:

What would happen to their welfare protection if these countries continued their initial strategy of industrialization without the intervention of trade openness?

**Figure 4.1 Welfare Transition with(out) Globalization**

The answer is that their initial factor endowments and their strategy of industrialization would determine their initial starting level, which would likely continue to increase along with their industrialization in a linear manner. The consequences could be significant. The dash line \( W' \) denotes an equilibrium welfare protection level in the developing world. The model predicts that welfare protection in developing countries revolves around this level, in which the interaction of trade openness and skill dependence leads to a reasonable level of welfare protection that covers
all social groups. Without the constraints from trade openness, as the right panel illustrates, industrialization in these countries would drive protection beyond the equilibrium level that these countries may not afford. A stratified distribution of welfare protection following the model of either the pre-1978 China or pre-1991 Brazil would be the only option.

4.2 ALTERNATIVE EXPLANATIONS OF WELFARE REGIMES IN THE DEVELOPING WORLD

There have been some alternative explanations about welfare regimes and their transformation in these three countries, which reflect the common assumptions in the existing literature in understanding the welfare protection in the developing world in general. These explanations may explain some anomalies in the case studies here, but overall they do not offer a valid theory to systematically explain the mechanisms underpinning the welfare-globalization nexus in the developing world. Instead, these alternative explanations may lead to misleading policy recommendations.

First, the current literature tends to take a static assumption about the welfare regimes in these three countries. For example, South Korea and Brazil have been commonly considered the two prototypical cases of residual (or minimalist) and generous welfare states in the developing world. This static assumption implies that certain features in these countries – which will be
discussed below – determine their patterns of welfare regimes, which are not likely to be subject to change. This assumption leads to a structural analysis that is overly deterministic and permits no variations over time. For example, it is common in the literature for many East Asian and Latin American countries to be classified into two opposite types of welfare regimes, similar to the way South Korea and Brazil are approached above (e.g. Wibbels and Ahlquist 2008). The studies confined by such an assumption overlook the fact that some significant changes often take place in these countries that may suggest something similar among the distinct types of welfare regimes. For example, the expansion of welfare spending in South Korea has been doubled from the early 1970s to the late 1990s. In Brazil, the welfare spending has been declining quite significantly. The two cases suggest that these two regimes may move towards somewhere in between. Even in the studies that pay particular attention to institutions, a variable that stresses variations over time, the authors may well overemphasize the distinct characteristics among these regimes and conclude that path dependence constrains the transformation of these regimes within a fixed range and permits no intersecting (e.g. Rudra 2007). This study takes such an approach under direct scrutiny and instead offers a distinct model that gives particular attention to the importance of change over time. Welfare regimes evolve over time as the result of the interaction of globalization and industrialization, both of which are subject to the change of factor endowments and policy adjustment.
Second, the consequence of making such a static assumption is that the current literature tends to emphasize certain factors peculiar in these countries and takes them as the determinant to the welfare regime in these countries. For example, one such factor is cultural/societal characteristics. This is particularly common in the studies of the welfare regime in China and South Korea, as well as many countries in East Asia. The current studies of these countries tend to argue that welfare support from extended families and firms, as well as the Confucian values such as a strong work ethic, emphasis on self-discipline, filial piety, and respect for elders and authority, explains why the dependence on the state has been downplayed in these East Asian countries (Jones 1990, 1993; Rieger and Leibfried 2003). These cultural factors do matter and certain features of East Asian welfare systems, such as policy emphasis on the elderly rather than children, do appear to be coherent with some tenets of Confucian principles. These features, however, as Peng (2008:162) argues, are not unique to East Asia and there is no clear evidence of causal relationship between Confucian values and policy outcomes. Most importantly, these cultural/societal factors themselves are changing, subject to the influence of globalization and industrialization. In South Korea, for example, life-long employment and support from extended families, as well as many other traditional values and principles, have become increasingly rare to find, but South Korea is still considered in many studies to be a minimal welfare regime as a result of its distinct culture (e.g. Aspalter 2006). In this study, I argue that China and South
Korea, two countries that share certain East Asian cultural/societal features, vary significantly in their practices of welfare protection. When both countries resemble each other – for example, the post-1978 China and the pre-1980s South Korea – it is because both countries were similar in their skill dependence and trade openness. These two factors have changed, and their welfare protection has march in opposite directions. While the two countries today are different in terms of the changing direction of welfare protection, they both maintain a low level of welfare protection in comparison to Brazil, which must be explained by their distinct trade regime that effectively constrains welfare protection.

Third, the studies that focus on political explanations of the welfare regimes in these countries tend to assume that a welfare regime is subject, exclusively, to the pressure of a single political coalition – either labor/left parties in welfare expansion or business groups in welfare reduction, as discussed in Chapter 1 and Chapter 2. In the case of China, the dramatic change of welfare regime from the previous generous socialist welfare protection to today’s low level of state commitment has been lamented as the outcome of the declining influence of Chinese workers battered by crude market forces in an era of globalization (Chan et al. 2008). Similar arguments abound in the studies of Brazil and South Korea, as well as developing countries in general. For example, labor suppression is commonly seen as the primary factor contributing to the weak
welfare state in South Korea (Deyo 1989; Rudra 2007; Shin 2003). In post-1990 Brazil, the waning position of labor unions and left parties is seen as the victim of globalization that favors capitalists’ preference for reducing welfare protection. Such an argument sometimes can be developed into a stereotype. For example, weak labor unions and left parties have been commonly seen as a feature of East Asian countries. Absent the pressure from meaningful left parties or unions, Haggard and Kaufman (2008) argue that the share of the working class in the private sector enjoying social insurance was small and such programs were typically contributory in design and involved relatively limited public fiscal commitments or redistribution (2008:115).

The focus on labor unions and left parties is often intertwined with the focus on democratization. The declining welfare protection in China is seen as deriving from a lack of democratic institutions in constraining the authoritarian regime from encroaching labor’s rights. In Brazil, the weak democratic institutions are blamed for declining protection. By contrast, South Korea’s 1987 democratization is considered to be the primary contribution to the rapid expansion of welfare protection. In the developing world in general, democratization has been considered as the key factor determining the strength of labor unions and left parties, which in turn contribute to welfare protection (Rudra 2005; Rudra and Haggard 2005; Haggard and Kaufman 2008). However, these claims fail to explain that the declining trend of welfare protection occurred in
China and Brazil only after these two countries became less repressive. The post-Mao China, though remained an authoritarian regime, was much benign compared to Mao’s. Similarly, Brazil’s welfare reduction took place after the country became a full democracy since 1990. By contrast, the most critical period for Brazil’s welfare expansion was under the repressive authoritarian regime between 1964-1984 (see Draibe 2002 for similar discussion). In South Korea, several welfare programs were already implemented before the 1987 democratization.

This study does not deny that labor unions, left parties, and democratization can influence welfare protection. However, it contends that these factors, though affecting the magnitude of welfare protection within a regime, do not determine what welfare regime is chosen and which way a regime is moving. Instead, the impact of these factors on welfare protection is contingent upon the factors that determine the choice of welfare regime, that is, the interaction between industrialization and globalization. The case analysis in the following chapters will demonstrate that the impetus of welfare expansion was often in place before democratization took place. Most importantly, labor organizations and the position of left parties in these three cases have rarely changed dramatically. If anything, workers in the post-Mao China have gained more freedom in terms of expressing their grievances due to the loosened political restrictions, illustrated by frequent labor protests throughout the post-Mao era. Indeed, the low level of welfare protection
in South Korea before the 1980s and the declining trend of welfare protection in China and Brazil after reforms are a social choice, a choice made with the acquiescence/assent of labor, the majority of whom have no incentives to defend the traditional welfare protection because of the opportunities derived from globalization. It is telling that the Brazilian President Lula, a leftist who has spent his lifetime fighting for labor rights, has made more progress than his rightist precedent President Cardoso did in reducing traditional welfare protection.

In sum, these alternative explanations can offer insights to understand the richness of the welfare variations across different countries. Yet, they provide insufficient explanatory power to systematically reveal the mechanisms that underpin the welfare-globalization nexus. These factors themselves are subject to the influence of globalization and industrialization. Having said that, it must be noted that this study does not propose that the interaction between globalization and industrialization influences these countries in a uniform way, nor does it claim that the process of welfare transformation under each pattern of interaction will be automatic. Rather, each country’s experiences are distinct, highly contingent on their economic, social, and political conditions. For instance, the approach to deal with welfare transformation in China follows neither that of South Korea nor that of Brazil. Its rapid speed of opening up is way beyond that of Brazil and even of South Korea, given the sheer size of the Chinese economy and the initial level
of openness. Its lower level of skill dependence the in previous regime gives China tremendous advantages to move forward towards an equilibrium welfare regime with much fewer obstacles than Brazil has encountered. Still, the transformation in China is a process of trial and error, based on their preexisting institutions and new institutional arrangements, which are contingent upon politicians’ strategies. So are the processes in South Korea and Brazil. As a result, the welfare transformation is highly contextual, resulting in distinct outcomes in these three countries.
CHAPTER 5

WELFARE TRANSFORMATION IN CHINA

5.1 INTRODUCTION

Since 1978 when China began adopting the “open door” policy and transforming its planned economy, welfare protection in China has experienced a dramatic change. For many observers, the Maoist socialist welfare system, once acclaimed to be one of the best models in the world, seems to be collapsing almost overnight as the country began integrating into the world market. Many observers have become concerned about the negative consequences of economic and social reforms, particularly to the wellbeing of the ordinary citizens. Chan et al. (2008), for example, claim that China’s economic successes have also generated the erosion of social protection on workers. As a result, the well-being of ordinary Chinese workers in fact has been declining along with economic growth.

For both its establishment and alleged collapse, the Chinese welfare system has been puzzling. The common explanation has been that globalization has significantly weakened the ability of Chinese workers to defend their welfare benefits they enjoyed under the socialist regime before 1978. In this sense, China has been seen as a representative case of a “race to the bottom,”
which the declining working conditions are the result of China’s economic integration into the world market, as Chan (2001) has demonstrated in her passionate case studies of the working conditions facing rural immigrant labor. This process of exploitation of labor (Chan 2001) has been maintained and sped up by China’s authoritarian regime, its political leaders’ strong commitment to economic openness, and their skillful manipulation of the political and economic system. For others, China’s pursuit for globalization at the expense of its workers’ well-being has even had a larger impact – China’s approach is defining a new “bottom” in a way that forces other countries to drive down their social protection even further (Greider 2001).

Such an assumption, however, is unfounded. The Maoist socialist welfare system is not collapsing for two reasons. First, it was not a strong welfare state as we commonly believe; second, it is not following a so-called “race to the bottom.” As for the past, the Chinese government only mandated urban work units and rural communes to provide welfare protection to their employees and members but the state itself took little financial responsibility. As evidence, the share of government spending on social security and welfare in total government expenditures was very low compared to most developing countries. The spending level in China was 1.7% in 1978, while the average of developing countries was 11.5%. In addition, only a very
small portion of its populace, mostly the urban dwellers in formal sectors, enjoyed generous welfare benefits (More details in the next section).

Regarding what it is today, the welfare transformation in the post-1978 China is not following a race to the bottom. Instead, it is a restructuring of social protection, which does not constitute collapse but, rather, a “move to the middle” – overall spending on welfare is less, more segments of the populace are covered. Whereas pension and employment insurance programs have been targeted for retrenchment, programs such as social assistance and poverty relief that were traditionally downplayed have made significant progress. Most importantly, as the quantitative findings in the previous chapter suggested, this restructuring is occurring in most developing countries, where governments are undertaking policy adjustments to accommodate new developments in the context of globalization.

If there is anything unique to China’s welfare transition, it is that China has been running faster than most developing countries with the similar background, such as Brazil, in reducing its traditional inefficient welfare programs. Two reasons explain China’s fast transition. First is what Hypothesis 1 developed in Chapter 2 has suggested:

\[ H1: \text{Countries at higher levels of skill dependence are more likely to have a higher level of welfare protection, all else being equal.} \]
In this case, Brazil’s previous development in fact has hindered its welfare transition because of its higher level of skill dependence, compared to China’s. Another reason behind China’s faster transition relative to Brazil and many other developing counties is China’s quick integration into the world economy. In this sense, China’s rollback of welfare protection along with the increasing level of trade illustrates Hypothesis 2:

\[ H2: \text{Countries with higher levels of international trade exposure are more likely to have a lower level of welfare protection, all else being equal.} \]

China’s leadership may have, for a variety of reasons, enjoyed a better position than that in other countries to promote this process. However, the continuity of China’s policy orientation over the past three decades hardly suggests that this process was determined by any specific leaders. The timing of China’s reform and its trajectory, in fact, suggest that the post-1978 China is not exceptional in its social welfare transformation, as the literature often assumes. In terms of timing, it follows a general trend of economic and social transformation that took place in the developing world around the 1980s, as illustrated in Chapter 3. In terms of its trajectory of transformation, China’s reform, like South Korea, Brazil, and most developing countries, fits a general trend towards a balanced distribution of protection as the outcome of globalization.

Specifically, China’s integration into the global economy has fundamentally reshaped its
industrial structure and the structure of social preferences with regard to state protection, in a way that narrows the risk gap between different social groups with varying skill dependence. As a result, the government is able to readjust its strategy to compensate its citizens with a more balanced structure, thus a “move to the middle,” as Hypothesis 4 in Chapter 2 predicts:

\[ H4: \text{As countries become more exposed to trade openness, welfare benefits that target skilled workers in traditionally strategic sectors decreases at a faster pace than those that target the general population.} \]

Since China currently has been experiencing a downward trend in its overall welfare expenditures, it is not an ideal case to illustrate Hypothesis 3:

\[ H3: \text{The expansionary effect of industrialization on welfare protection decreases as a country becomes more exposed to international trade.} \]

However, it can be expected, as some recent signs have suggested, China currently may be in a critical period to turn to a high-skill dependent economy as it is moving up along the ladder of comparative advantage, at least with regards to its urban economy (Business Week 2006; Bradsher 2008; China Daily 2010). That possibility may suggest that the Chinese government will soon face pressures to increase its overall welfare expenditures in order to compensate its
currently underfunded welfare regime. However, as long as China maintains a strong
commitment to openness, the principle of market dependence as discussed later will help the
government to curb the increasing demand for protection and maintain the protection under a
reasonable level. The experiences in South Korea, as will be discussed later, can better illustrate
what China may experience in the future with regards to Hypothesis 3.

This chapter analyzes the mechanism underpinning this process of move to the middle in order to
illustrate how it can be applied in China’s particular setting. The chapter is organized as follows.
Section 2 briefly discusses the characteristics of the welfare regime prior to 1978. Section 3
describes the change of welfare regime after 1978. Section 4 and 5 examine how the new trade
regime has changed the industrial structures and the structure of social preferences as well.
Section 6 discusses how the government responds to the changing structure of social preferences
and aims for a balanced structure of welfare distribution. Section 7 concludes with a summary of
the findings and a brief discussion of the factors that affect the future of China’s welfare
development.

5.2 CHARACTERISTICS OF PRE-REFORM WELFARE REGIME

Prior to 1978, the Chinese welfare system was characterized by the following features. First, it
provided comprehensive welfare protection with benefits including social security, education,
housing, health care, maternity benefits, elderly care, and childcare (see Selden and You (1997) and Guan (2002) for review). The main dynamic for welfare protection was industrialization since the 1950s. Socialist strategies of political control reinforced the generosity of welfare protection in terms of comprehensive welfare benefits and rigid labor market institutions.

Second, urban work units and rural communes took primary financial responsibilities while the government functioned primarily as a regulator and only used a very small portion of its budget for welfare protection. This feature proved to be detrimental to the welfare system itself in that enterprises were overburdened by the social welfare functions they took.

Third, the socialist ideology did not obscure the fact that protection was highly stratified and biased in favor of high-skilled labor that took only a very small proportion of the labor force. Firms were classified into three categories of ownership. The first one was state-owned enterprises (SOEs), which could be further classified into different levels based on administrative hierarchy across sectors and regions. The second category was collective-owned enterprises, where the assets were owned collectively by employees. The third category included everything outside state sectors and other than state-owned and collectives. The categories of ownership were closely associated with skill levels of these firms. Large SOEs concentrated on heavy industries, which are skill and capital-intensive. Most of other firms were in light industries and
non-manufacturing sectors such as construction and agriculture with lower skill and capital inputs.

The association between the ownership of firms and their skill level is an important point to understand China’s welfare regime and its transformation, for social protection in terms of both welfare benefits and labor protection was distributed according to ownership. The SOE employers enjoyed much more benefits than those in other sectors did. For example, pensions and employment insurance were only available for SOE workers but not for the workers in other categories. Firing a worker from a SOE was almost impossible. The life-long employment in SOEs also made labor mobility across regions and sectors extremely difficult. Employees in collective-owned firms enjoyed certain welfare benefits and labor protection but in a much less degree. Most importantly, once retired, most employees in collective firms received no welfare benefits including pensions.

The price for enjoying such a highly protected welfare system was not trivial. The welfare system was maintained on the basis of a low level of living standards and lack of freedom of mobility. Some observers describe the Chinese welfare system prior to 1978 as “a high level of welfare in a low income country” (Guan 2001). The low income was the result of the low level of industrialization in China, where over 80% of population was in agriculture before 1978. As
discussed later, this factor was a strong motivation for individuals and governments alike to abandon the traditional welfare system in a relatively quick speed after reforms began.

An autarchic trade regime further sustained this welfare structure. Between the 1950s and 1970s, imports and exports together were rarely beyond 8 percent of GDP (Pen World Table, various years). After reforms, a huge low-skilled labor force combined with a high level of trade dependence have given China tremendous advantages to transform its welfare system in a relatively fast pace compared to some other developing countries such as Brazil that similarly inherited a protective and stratified welfare regime with a huge public sectors.

The traditional welfare system served to support an economic development strategy for quick industrialization that, however, was not in line with its factor endowments and comparative advantages. After a series of economic and political crises, the nation was finally forced to adopt a new development strategy in 1978. Once the new trade regime was adopted, a fundamental transformation of the welfare regime began taking place.

5.3 WELFARE TRANSITION SINCE 1978

China’s economic reform began in 1978 when the economic opportunities derived from the “family responsibility system” in the countryside created an economic growth miracle (Lin 1992;
Naughton 2007; Huang 2008) that quickly attracted urban residents. The comprehensive economic reform began after the historical document, “Chinese Communist Party Central Committee’s Decision of Economic Reform,” was issued in 1984. The key decision in this document was to replace the centrally planned economic system with the independent management of enterprises. Enterprises, which were the backbone of the traditional urban welfare system, began gaining autonomy and also were propelled to pursue profits. A crisis began occurring in the traditional welfare system.

Figure 5.1 shows the different trends of government expenditures on pension insurance and social assistance between 1978 and 2005.9 Pension insurance was the key component of the traditional welfare programs and only covered a small proportion of the labor force; most of which was employers of urban SOEs that were concentrated in high skilled sectors. Figure 5.1 shows that 1992 marked a turning point for government spending on pension insurance. Before 1992, the spending trend was upward from 1984, with some minor fluctuation in the early 1980s. Since 1992, the government’s spending on pension insurance has experienced a consistent decline in a relatively rapid speed in the entire 1990s, and only increased moderately since 2002.

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9 The data here stop in 2005 because, since 2006, the national Bureau of statistics of China dramatically changed its measure on social security and welfare expenditures under the section of “government finance.” The data in the recent yearbooks are no longer compatible with those prior to 2006.
The upward trend from 1984 up to 1991 can be explained by two reasons. First, the increase reflects the increasing demand for old age pension insurance due to government policies that encouraged early retirement in order to downsize redundant workers in SOEs as well accommodating the large amount of. As a result, the number of retirees increased tenfold from 3.1 million in 1978 to 30.9 million in 1995, including 24.0 million state sector and 6.2 million collective sector employees. Total insurance and welfare costs rose from 7.8 billion yuan in 1978 to 236 billion yuan in 1995, increasing from 13.7 to 29.2% of the total wage bill in state enterprises (Selden and You, 1997).
Another, perhaps more important, factor is the strong resistance of the strategic alliance of the employees and enterprises in state sectors in the early stage of the reform. For the entire 1980s, the reform of SOEs was slow. As Naughton (2007) points out, China did not privatize significant numbers of state firms until the early 1990s. “Indeed, it did not even systematically separate SOEs out from the hierarchical state bureaucracy in which they were embedded” (298). As state firms were still overprotected, the reforms instead pushed more individuals to get into SOEs for shelter or for benefits, which actually increased the welfare burden. Indeed, Naughton (2007) notes that SOEs became overstaffed in the late 1980s and early 1990s.

The priorities of government spending have been under significant change as well, as shown in the contrast between pension spending and the spending on social welfare. Social assistance programs target poor individuals and families that are at the low end of skill distribution. These programs are critical for human capital infrastructure and long-term development, therefore the key component of social safety nets in a market economy. It is striking to see that government spending on the latter category, after the slight decrease for the entire 1980s and the most 1990s, has increased dramatically in the early 2000s. These contrasts among different categories of government expenditures clearly demonstrate a significant shift of focus from traditional welfare protection to long-term development in a new market environment.
5.4 SHIFT OF THE INDUSTRIAL STRUCTURE SINCE 1978

What mechanisms have underpinned the declining trend of China’s welfare regime? Following the theory presented earlier, this section examines the interaction between China’s changing industrial structure and the trade regime. The findings presented below suggest that trade liberalization since the late 1970s, in particular since 1992, has fundamentally reshaped the industrial structure and closed the income gap between low and high skilled workers. That change has had significant impacts on the structure of social preferences among different social groups and has consequently affected the strategies adopted by politicians in policy choices.

5.4.1 Trade Liberalization and Skill Dependence

China’s economic reforms have been closely associated with its trade liberalization. Figure 5.3 below shows the trend of trade openness and foreign direct investment (FDI) in China since 1978. Before 1978, China’s total trade/GDP ratio never significantly exceeded 10%, and FDI did not exist. Since 1984 when the government set up export-processing zones in southern China, the new trade regime began taking off. The trade/GDP ratio experienced a steady and rapid increase, before becoming stabilized around 40% after 1992.
For most of the period since 1978, China’s rapid growth of trade openness has mainly been sustained by foreign direct investment (FDI). However, 1992 was a particularly important moment for China’s trade regime. That year, FDI volume jumped from $35 million in the previous year to $110 million, a growth rate of 152%. The volume further jumped again to $275 million in 1993, making China the second largest FDI recipient country next to the United States (United Nations 1999). The year 2002 marked another significant point, when both FDI volume and trade/GDP ratio increased substantially after China joined the WTO late 2001.

**Figure 5.2 Trade Openness and FDI in China: 1978-2007**

*Note: Trade openness is measured by trade volume (the sum of imports and exports) as a share of GDP. Source: trade openness from PWT 6.3 (current price: 2005 base year); FDI from UNCTAD, Foreign Direct Investment database*
What has made this rapid transition of trade regime possible is China’s abundant and low-skilled labor. Figure 5.4 below shows the distribution of labor forces in different sectors. In Chinese official statistics, enterprises are categorized into three sectors based on skill dependence: agriculture as primary enterprises, at the low end of skill distribution, manufacturing the second, and services the third with high skill dependence. The data suggest that over 70% of the total labor force was concentrated in the low skilled primary sector at the beginning of the reform, and that number only decreased to 50% in 2000.

5.3 Distribution of Labor Force by Skill Levels: 1978-1999

![Graph showing distribution of labor force by skill levels](image)

Source: *China Statistics Yearbook* (2001)

It must be noted that the secondary sector are manufacturing industries, most which are still heavily low-skill and low-capital intensive. Taken together, the primary and secondary sectors
took 87.8% of total labor force at the beginning of reforms, and still 73.1% in 1999, a significant part of which is low-skilled labor.

Table 5.1 below further demonstrates that the Chinese export manufacturing since the reforms has become increasingly low-skilled and labor intensive, a shift that is more compatible with China’s comparative advantage in abundant low-skilled labor. The values of export manufacturing goods are grouped into three categories – labor intensive manufacturing export (line 1), capital intensive manufacturing export (line 2), and raw material-based export (line 3).

The first two categories can be further classified according to the level of skill being used.

| Table 5.1 Export Values of Manufacturing Goods: 1965-1999 |
|----------------|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
|                | Value | %    | Value | %    | Value | %    | Value | %    | 1965-90 | 1980-90 |
| Total exports  | 1718  | 100  | 6303  | 100  | 18237 | 100  | 27764 | 100  | 80541   | 100     | 16.6 | 16.0 |
| Labor-intensive| 570   | 33   | 2253  | 36   | 7168  | 39   | 12319 | 44   | 59787   | 74      | 20.5 | 23.6 |
| Non-skill labor-intensive | 454 | 26 | 1557 | 25 | 5254 | 29 | 9742 | 35 | 41222 | 51 | 19.8 | 22.9 |
| Capital-intensive | 1113 | 65 | 3128 | 50 | 6353 | 35 | 7984 | 29 | 14978 | 19 | 10.9 | 8.9 |
| 2.1. Labor intensive | 148 | 9 | 473 | 8 | 1292 | 7 | 1708 | 6 | 12325 | 15 | 19.3 | 25.3 |
| Raw material-based | 961 | 56 | 3665 | 58 | 9116 | 50 | 13339 | 48 | 5290 | 21 | 22.7 | 2.9 |
| 3.1 Coal, oil, natural gap | 2 | 14 | 22 | 26 | 26 | 7 |


Most noticeable in this table is the rapid increase of the share of labor-intensive manufacturing goods (line 1), from 33% in 1965 to 74% in 1990, while the share of capital-intensive
manufacturing goods (line 2) decreased from 65% to 19% during the same period. It is interesting, however, to notice that while the share of capital intensive manufacturing goods has decreased, the growth rate of labor-intensive manufacturing goods within both categories (line 1.1 and 2.1) has increased significantly. For example, non-skill intensive manufacturing goods within the category of labor-intensive manufacturing goods (line 1.1) increased from 26% to 51%, while labor-intensive goods within the category of capital intensive goods (line 2.1) increased from 9% to 15%. Zhang (2003) also confirms this trend and further argues that the share of non-skill intensive manufacturing goods is even higher, about 45% constantly from 1978 to 1996.

Both studies presented above agree that this shift has become particularly salient since the late 1980s when the export-led trade strategy became a clearer agenda. This is illustrated in the changing growth rate in Table 5.1. Growth rate is calculated in two different periods: first, 1965-1990, and second, 1980-1990. The growth rates for labor-intensive (line 1), non-skill labor-intensive (line 1.1), as well as labor intensive in capital-intensive (2.1), are all higher in the second period between 1980-1990 than that of the first period, while the growth rate for capital-intensive (line 2) decreases from the first to the second period, suggesting an accelerating speed of the shift since 1980s. Both studies also found that the share of agricultural and raw material-
based products has decreased (line 3), which further indicates the increasing share of low-skill and labor-intensive manufacturing in China’s export.

5.4.2 Changing Industrial Structure

The new trade regime centered on low-skilled and labor intensive manufacturing has fundamentally transformed China’s industrial structure. The most important indicator is the downsizing of SOEs, which is accompanied by the expansion of non-state sectors that rely on low-skill factors. This change suggests that firms with high-skill dependence have become less suitable to new market structure. Instead, firms with low-skill dependence quickly grasped the opportunity of openness. For instance, township-village enterprises (TVEs) that exclusively depended on labor-intensive manufacturing quickly became the backbone of the new trade regime in the early years, later followed by urban private firms. The growth of TVEs and urban private sectors presented mounting competition for SOEs that relied on high skill and intensive capital inputs. Naughton (2007) notes that “SOE monopoly profits were competed away as aggressive TVEs drove price relationships into line with underlying costs. SOEs had to implement new incentive programs and improve efficiency in order to survive in the face of the TVE competitive onslaught”(275).
Under such pressures, the new “contract system” emerged in 1983 as an effort to change the labor-management relationship in order to accommodate the new industrial structure. This system broke the traditional “iron rice-bowl” system and instead tied workers’ wages to their productivity. SOEs were granted more autonomy to make management decisions with regards to production, marketing, investment, and profit distribution. In 1993, the boom of private sectors following the surge of FDI inflow forced the government to further relax labor market institutions in order to free SOEs from traditional welfare burdens. Laid-off workers became a new phenomenon from 1993.

The downsizing trend of high-skilled SOEs can be seen clearly in comparing the number of employees in SOEs and non-state firms, as shown in Table 5.2 below. The employees in non-state firms increased by 90% from 1992 (1.9% of total employees) to 1993 (4.0% of total employees). At the same time the growth rate for the employees in SOEs decreased drastically from 2.11% in 1992 to 0.28% in 1993. Notice that the category of non-state firms does not include private enterprises and self-employed. If these categories are taken into account, the non-SOE share can be much higher. In 1998, the number of employees in SOEs and non-state firms experienced another significant change. The share of SOE employees dropped by 18%, while that of private firms increased by 50%.
Table 5.2 Share of Employees by Ownership: 1992-2000

<table>
<thead>
<tr>
<th>Year</th>
<th>SOEs</th>
<th>Non-state Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>% of total</td>
<td>growth rate (%)</td>
</tr>
<tr>
<td>1992</td>
<td>74</td>
<td>2.11</td>
</tr>
<tr>
<td>1993</td>
<td>74</td>
<td>0.28</td>
</tr>
<tr>
<td>1994</td>
<td>73</td>
<td>-0.27</td>
</tr>
<tr>
<td>1995</td>
<td>73</td>
<td>0.60</td>
</tr>
<tr>
<td>1996</td>
<td>74</td>
<td>-0.05</td>
</tr>
<tr>
<td>1997</td>
<td>73</td>
<td>-1.67</td>
</tr>
<tr>
<td>1998</td>
<td>71</td>
<td>-18.18</td>
</tr>
<tr>
<td>1999</td>
<td>71</td>
<td>-5.37</td>
</tr>
<tr>
<td>2000</td>
<td>70</td>
<td>-5.50</td>
</tr>
</tbody>
</table>

Notes:
2. Including all enterprises of domestic funded cooperative units, joint-owned units, collective joint-owned units, limited liability corporations, state-funded corporations, and share holding corporations Ltd. but excluding private enterprises and township and village enterprises, as well as urban collective firms.

Data sources:

5.5 CHANGING STRUCTURE OF SOCIAL PREFERENCES

The interaction between China’s new trade regime and new industrial structure that are based on low-skill and labor-intensive factor dependence has significant impact on social preferences that underpin the demand for welfare protection.

To understand why the new trade regime and industrial structure have helped ease the demand for social protection, it is critical to understand that the new economic structure has narrowed not only the income gap among social groups, but also the risk gap experienced across different
sectors. A critical factor that determines this possibility is the risk exposed to urban workers, particularly urban skilled workers because they had more stakes to loss in the reduction of traditional social welfare benefits. At the early stage of reform, urban SOE workers were the group that felt most strongly the uncertainty from openness. For example, the breakdown of the “iron rice bowl” since the early 1980s and lay-offs from 1993, as discussed above, produced tremendous pressures on urban workers and managers. Thus it is critical to explain why the risks urban skilled workers were exposed to actually decreased by openness during this period.

5.5.1 Diminishing Risks for Skilled Workers

First, the new job opportunities greatly diminished their risks. The income increase undoubtedly has eased the anxieties for a majority of urban residents. This is partly because only a small proportion of urban employees, usually those at a higher level of the hierarchy, for example, large-scale SOEs and public sectors, previously enjoyed high wages and generous benefits. These sectors, however, were less threatened for the most part of the reform, because the government deliberately avoided putting these sectors at the front line of reforms. The government could afford to do so because employees from this group took a very small portion of entire SOEs. Thus generous protection for them is relatively easy to maintain. Instead, employees from small-scaled SOEs and other urban sectors were the first ones to face the
challenge of reform. And yet, since these sectors previously enjoyed a much lower level of protection and fewer benefits, the gains from the new opportunities have far more compensated the new risks exposed to them. More importantly, however, the booming private sectors, particularly in the service sector, provided bountiful job opportunities for urban dwellers who, in addition to continuing enjoying at least partial benefits from their work units, could have a so-called “secondary job” – a popular term in the 1980s – outside their regular jobs in formal sectors, and the benefits from the second job could be substantial. As many scholars have noted (Lau et al. 2000; Qian and Wu 2003; Naughton 2007), the reform in the early stage was the one “without losers,” because, as the outcome of a gradualist strategy of transition, state jobs were carefully protected so that marketization began with product markets and only slowly extended to labor markets (Naughton 2007:183).

5.5.2 FDI and Decreasing Wage Differentials

Second, openness has decreased wage differentials as well as the risk gap across sectors. This explains why high-skilled workers find the reforms less threatening to them. This point, however, must be understood within the context of China’s particular trade regime, which is sustained by low-skill biased FDI.
According to trade theories, FDI has significant impact on income distribution between skilled and unskilled labor because of the technology change induced by FDI. The impact of FDI thus can go both ways – increase or decrease income distribution across sectors, depending on whether FDI is relatively labor or skill biased (Feenstra and Hanson 1997b; Zhang and Zheng 1998).

Evidence suggests that China’s FDI has reduced wage differentials between low-skilled and high-skilled sectors. The primary reason is what the standard Heckscher-Ohlin theorem suggests that developing countries endowed with less skilled labor do not have a comparative advantage in producing high quality goods even with the same technology. Empirical results also show that usually multinational firms in the developing country will target lower quality brands rather than higher quality ones. Thus the developing country would prefer specializing in the lowest quality variety and producing no high quality varieties even when foreign capital is available.

This is precisely what has happened in China where abundant low-skilled labor force attracts FDI that looks for such labor to produce goods at the lowest end of skill process. Studies have found that China’s FDI primarily comes from the newly developed East Asian regions such as Hong Kong, Taiwan, Singapore, and South Korea (Wu 2001). Huang, Xie and Chen (1994) reported in their survey that 54.1% of FDI in the manufacturing sector came from these countries.
Echoing the previous findings about manufacturing sectors as discussed in the previous section, Wu (2001) and Huang et al (1994) note that the type of FDI from these regions is relatively labor biased rather than skill biased, because industries in these regions are at the lower-end of manufacturing chains in the world market. This type of FDI aims at taking advantage of China’s cheap unskilled labor and is mostly concentrated in China’s export oriented sectors. Precisely because of this logic, the Chinese government has utilized favorable policies such as tax breaks to attract foreign direct investment with labor biased technology.

Many other empirical studies have confirmed that FDI and trade liberalization in general have had equalizing impacts on wage and skill differentials in China. Particularly, based on their analysis of the characteristics of FDI across different provinces, Owen and Yu (2008) found that the effect of FDI on regional differences in wage inequality across industries in China hinges heavily on the type of FDI – whether it is export or import-oriented. Export-oriented FDI tends to raise the wages of workers in industries that rely more on unskilled workers and therefore will lower the wages of workers in industries that rely more on skilled workers.

5.5.3 Efficient Allocation of Skills

Third, trade openness not only reduces the wage gap between high-skilled and low-skilled sectors. It also induces efficient allocation of skills. Skilled workers may voluntarily migrate
from state sectors to private sectors, while unskilled workers can also find jobs in SOEs which are trying to lower their costs by downgrading the skill level of their product output and reducing the proportion of high-skilled workers. Prior to reform, skilled workers were concentrated in the SOEs. Since FDI inflow increases the job opportunities in the private sector, workers with higher productivity, due to higher education or better health or other factors, tend to move to private sectors for better wages even though the social welfare benefits in these firms are much lower and they need to purchase health and unemployment insurance out of their own pockets. For example, Wu (2003, 2005) found that since 1994 the percentage of engineers and technicians in non-state sectors has begun surpassing that in state-owned and collective-owned sectors. Since a uniform social welfare system had not been established across the country during the 1990s, and most private and foreign-owned enterprises were not required to provide pension and employment insurance benefits, the possibility to increase the contribution from the government side has actually decreased.

To further confirm this trend of efficient allocation of skills, Table 5.3 below presents data on average wage of employees by ownership. It demonstrates that the average wage in the nonstate sector is higher than that in the state sector, which suggests that workers in the non-state sector, on average, are more productive than those in the state sector. Since 1984, the average wage of
employees in the state sector was higher than the national average, but lower than that in private firms. This average wage gap between the state and private sector firms reached its highest peak in 1993 when FDI more than doubled. That gap was significantly reduced since 1998 after SOEs began to increase their productivity and competitiveness. The reduced wage gap between SOE and non-state sectors since 1998 suggests that a balanced

In sum, the new trade regime centered on labor-biased FDI has not only increased the size of the pie, but also increases the quality to divide the pie, for the wage and risk gaps between high-skilled and low-skilled workers are narrowed by labor mobility. Many studies demonstrate that there has been a race to the top in terms of income equality because individuals in all areas in China have experienced gains in average income (Luo and Zhu 2008; Wang et al. 2002, 2006). These findings echoes well the argument in this study, which is derived from the standard trade theory: as economic reforms deepen, labor market works more efficiently by balancing the demand and supply of skills. While scarce skilled labor commands higher premium to compensate the state protection they previously enjoyed, low-skilled labor find new opportunities created by openness to substitute for public welfare protection. That is, the free flow of skilled and un-skilled labor across different sectors decreases the attraction of state
welfare benefits. In sum, the low level of social protection is a social choice made by major social actors.

<table>
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<tr>
<th>Year</th>
<th>National Average</th>
<th>SOE</th>
<th>Private</th>
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<tr>
<td></td>
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<td>% of national</td>
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<tr>
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5.6 CHANGING STRATEGY FOR POLITICAL SUPPORT

The new industrial structure and the changing social preferences that followed provide politicians with opportunities to adjust their strategy to maximize their political support across the social spectrum. Since the reforms began, particularly after 1992, China’s political leaders have found their core constituencies under significant change.
5.6.1 Changing Structure of Political Support

Before 1978, the core constituencies for the regime were urban employees from formal sectors, which were critical for industrialization and economic autarky. After 1978, however, the shift of the focus on competition in international markets has weakened that sector. When the barriers to labor mobility across sectors are removed as the result of the changing industrial structure, the strategic alliance between formal sectors and skilled labor began to loosen. At the same time, the low-skilled labor that primarily concentrates in non-state sectors became increasingly critical for the economy that relies on low-skilled factors to enhance its comparative advantage. As evidence, by the end of 2004, the urban private sector, without counting foreign-invested firms, employed about twice as many workers as the traditional state sector: 55 million, compared with less than 30 million in SOEs (Naughton 2007:106).

The demand for a level playing field between private sectors and SOEs became intensified along with economic reforms since the early 1990s. By the late 1990s, discrimination that had been levied on private sectors largely disappeared. Instead, in the late 1990s, around the same time that SOEs were restructured, governments at all levels became wholeheartedly embracing privatization. The massive urban small-to-medium-sized SOEs and rural township and village enterprises were sold to private and foreign-invested firms. As a result, it became evident that the
ideologies of the Chinese Communist party needed to change in order to take private sectors into
the new political coalition. Following Deng’s urge in 1992 to stop asking whether policies were
“surnamed socialism or surnamed capitalism” and a surge of economic activity set off in the
1990s, Deng’s successor, Jiang Zeming, eventually dismantled many of the remaining
ideological barriers hindering growth of the private economy. The final result was the 2001’s
16th Chinese Communist Party Congress, during which the party allowed the private business
owners to join the party and promised to put private firms on a more level playing field with state
firms in such areas as market access, investment, financing, taxation, land use and foreign trade.
It also promised fuller legal protection for private property, which was materialized in 2004
Constitution and 2007 Property Rights Law (Lawrence 2002).

Establishing a level playing field between private and state-owned economies reflects a far-
reaching shift of policy orientation that has significant impact in many areas, in which welfare
transformation is part of the broad scheme. For example, the regional disparity between the
western hinterlands and the east coastal regions began to emerge in the late 1990s due to the
asymmetrical distribution of investment, infrastructure, and access to market across regions. The
government has been well aware of the consequences of regional disparity, as Deng Xiaoping
expressed a balanced view of development between coastal regions and hinterlands and stated, as
early as the 1980s, that one region needed to contribute to the development of another region at
different stage of development (Deng 1988). Since 1996, the government began to propose and
implement policies that encourage investment in the western regions (Zeng 2010). Related policy
change has been to eliminate the policy biases against agriculture and rural residents, which are
concentrated primarily in western regions. A number of new policies have been implemented
since the early 2000s in order to address the issue of the divide between urban and rural areas
that hindered the development of agriculture and rural economy. These policies address a variety
of issues concerning agricultural subsidies and taxation, land use, quality of village self-
government, and equal rights for rural migrant workers (Long et al. 2010; Su 2009).

5.6.2 Changing Strategy for Political Support

Despite the rapid policy change since the late 1990s, it remains arguable what underlies this shift
of policy orientation. It is interesting to note that the political influence of workers in both state
and private sectors has not changed fundamentally since 1978. The policies regarding workers’
rights remain the same. The organizational capacity of the SOE workers have certainly been
reduced due to the downsizing of SOEs and the loosened ties the workers have with their
employers. But they still remain much more powerful than the workers in private sectors, where
labor unions have been prohibited by the government and discouraged by the firms. Similarly,
western regions have, if anything, been much less influential in policy choices than they were before, due to the strong economic power of the coastal regions. Neither has any new policy given rural residents more political cloud, even though the political control in the countryside has been relaxed.

It is puzzling, from the point of view of the power resource theory, to see that the authoritarian regime has been willingly extending the benefits to those workers, sectors, and regions that still possess less political influence than the traditional constituencies. Some observers quickly point out that the transition of the leadership in 2002 motivated the new leaders to drastically depart the previous pro-business approach during the most part of the 1990s and adopted instead a pro-poor approach in order to cater the urban and rural poor and accumulate their own political capital.

The leadership transition certainly accelerated the process of policy shift, due to both new leaders’ incentives for change and the removal of the political hurdles associated with previous leadership. However, this argument fails to explain the shift of policy that had already occurred before 2002. In fact, maintaining a balance between different social groups in terms of distribution of economic benefits and social protection has been the tenet of the reform from the
outset, as discussed in reference to Deng Xiaoping’s grand scheme regarding development stages and regional disparity.

If political leaders are not critical for the transition, then how to explain that the critical policies only began to implement in the late 1990s and early 2000s, even though the significant shift of policy orientation already took place in the early 1990s? Two reasons can explain, and both of which are associated with the shift of economic and industrial structures and openness.

The first reason that policy change did not occur immediately after 1992 is because of the reform of SOEs. For the most part of the 1990s, the government was preoccupied with reforming the economic structure and welfare system in the state sectors, while paying much less attention to the need for social welfare protection on the low-skilled sectors. The booming economy since 1992 played a critical role in reducing the incentives of low-income and low-skilled workers to demand protection because they were the primary beneficiaries of the economic growth. By the late 1990s when the SOE reforms had largely finished and successfully reduced the financial burden on the government, new policies toward distribution of social welfare protection occurred. At the same time, SOE reforms also posed challenges to low-skilled sectors because the massive workers from SOEs now entered the private sectors, which intensified competition in these
sectors. In sum, SOE reforms changed both the demand and the supply of the new policies that become more concerned with low-skilled sectors.

The second reason, which interacted with the first one, was China’s entry to the WTO in 2001. In the late 1990s, when the WTO membership was anticipated, the pressures of sustaining future economic development and maintaining political support for market-oriented reforms after joining WTO were looming large. Without fundamental restructure, it would be unimaginable for China to sustain its fragile economy under international competition. In doing so, the government cannot afford leaving any sector behind. By the late 1990s, therefore, in both official rhetoric and academic research, “integration” or “consolidation” – which are similar in Chinese – became a popular term, referring to the need of synergizing domestic institutions, policies, social interests in order to enhance the competiveness of China’s economy. Responding to this consensus, the guiding principle for the future development, under the new leadership, is to establish a “harmonious society” based on “balanced and people-oriented development,” with an “emphasis on social equity so that entire population can enjoy the fruits of reforms and development” (CCP central committee 2005).

As a result, the concept of “public goods” that has been widely discussed in media and academia entered the official language in a series of new policies to emphasize the necessity of making
basic social welfare protection available to the general public without bias against any social groups. For example, in a key 2009 document concerning health care reform, an area that is widely seen to be neglected by the government in the most part of the 1990s, it is stated that “all urban and rural residents should be entitled to basic public health services” (State Council 2009).

As Wang (2006) points out, the changing rhetoric reflects the change of policy agenda, which is responding to the reshuffle of social interests. This is evident in a series of new policies implemented that deal with a wide arrange of social issues that were not on the top of the previous policy agenda. In the area of social security and welfare, an official document in 2006 emphasized the importance of establishing a comprehensive social security system, with the core objectives “to further expand the coverage of social security programs, guarantee an equal access to those programs by people in all kinds of employment in urban areas” (MOLSS 2006). Along with this change of policy orientation is the increasing financial responsibility the government has been taking for basic social welfare programs aiming at low-skilled urban and rural workers. Lou and Wan (2008) argue that, contrary to what is often claimed, policy and institutional reforms have been accompanied by a steady increase in government spending on public health in the past few years. This trend is reflected in other social policy areas such as social assistance and poverty relief that target the entire population.
5.7 THE “MOVE TO THE MIDDLE”: NEW WELFARE REGIME UNDER GLOBALIZATION

The discussion above suggests that the government’s priority of policy change since 1992 has experienced two stages: the first stage between 1992 and late 1990s, in which the government was preoccupied with restructuring SOEs; the second stage since the late 1990s, in which the government implements policies to target the entire population, but with more emphasis on the low-skilled and low-income sectors. Following this pattern, the welfare policy readjustment has also been through two stages. Before the late 1990s, the priority was to reduce the excessive welfare benefits in state sectors. Since then, it has been to expend welfare coverage to non-state sectors. In the process of interaction between these two trends, a balanced structure of welfare spending is emerging to cover the entire population with a low level of government expenditures.

5.7.1 Reducing Welfare Benefits in State Sectors

Since the early 1990s as the barriers between state and private sectors began breaking down, it has become evident that the costly and inefficient traditional welfare system was no longer sustainable but could only agitate political dissatisfaction. The first group in the state sector that experienced reduction of traditional welfare protection was workers in small and medium-sized SOEs. Laid-off workers became a phenomenon since 1993, and they mostly came from small
and medium SOEs. By the late 1990s as the date for China entering the WTO was approaching, however, lay-offs were becoming a norm for everyone. Since the early 2000s, “lay-off” and “unemployment” – which is associated with non-state sectors – began to be used interchangeably, suggesting that the line between state and non-state sectors is no longer discernable. As a result, the employees from large-scale SOEs and other public sectors found their benefits shrinking quickly.

The shrinking benefits are best illustrated in three categories of traditional welfare benefits: pension, housing, and medical care. Previously, workers in state sectors did not need to pay contributions for their pension benefits. The new scheme initiated in early 1990s requires both individuals and firms to contribute to the pension fund. Since 1994, privatization of housing has begun taking significant steps. A Housing Provident Fund (HPF) with the contribution from both workers and employers was established to enhance the purchase power of workers. In the late 1990s, SOEs were not allowed to build housing and had to gradually sell off their apartment blocks. The housing reform disentangled SOEs from social welfare responsibilities and also significantly reduced the financial burden of the government. Between 1981 and 1997, the states’ contributions to investment in fixed assets dropped dramatically from 28.1% to 2.8% (Zhu 2000). Similar reforms have also taken place in medical care. In 1994 the government announced that a
social pooling fund based on an individual accounts replace traditional almost-free medical care benefits.

5.7.2 Expanding Welfare Coverage to Non-state Sectors

As the government reduces traditional welfare benefits in the state sector, it also expands the coverage of these programs to the entire population. Since the late 1990s, government policies towards welfare distribution have become more equity oriented (Gao 2010). The government has begun establishing universal schemes in the early and mid-2000s in pension, housing, and medical care that cover all urban residents across sectors, including self-employed and temporary workers. These programs cover all work forces and also standardize the management of funds across regions so that individuals can transfer their welfare benefits across regions.

The more striking policy change, however, has been the establishment of various social assistance programs that target the population who were previously deprived of welfare benefits. These groups include urban informal sectors and, particularly, the rural population. The programs include minimum standard living system, social assistance programs for the urban and rural poor, and poverty relief programs that primarily target poor population in countryside.
In urban areas, the most noticeable new program is unemployment insurance that is designed to cope with the problem of unemployment caused by redundant workers released from the state sector and the huge size of the new labor force. After several years of experiments, the government established the universal unemployment insurance scheme in 1999, which broadened the coverage of the unemployment insurance scheme to employees in all categories of urban firms. Aimed at both unemployment and urban poverty, the Minimum Standard of Living System (MSLS) was introduced in the 1990s. The targeted population includes unemployed workers, low-income and disabled individuals. Initially local governments were expected to bear all expenditure of the MSLS. In 1999, central government resumed its role as the last resort.

In addition, the government has also set up new social assistance programs in education, medical care, and housing, to assist poor families and individuals in urban and rural areas. In education, for example, new initiatives were proposed in 2004 to target poor children in both urban and rural areas, such as free primary and secondary education, education subsidies and exemption. In medical care, a medical care fund established in 2004 provides financial support for poor families. The New Rural Cooperative Medical Scheme (NRCMS) was initiated in 2002 to deal with the problems of rural health care. In housing, the Low Rental Housing program (LRH) was implemented in early 2000s to assist poor households in urban area.
Finally, the most successful progress in the area of social assistance is the poverty relief program. It is undisputable that the Chinese government has made remarkable progress in poverty reduction among developing nations. From 1978 to 2004 the number in poverty reduced from 250 to 29 million, reducing the poverty rate from 64% at the beginning of reform to 10% in 2004 (Ravallion and Chen, 2005; Asian Development Bank 2004). The amount of investment put into poverty reduction work increased from 9.8 billion in 1994 to 30 billion in 2003 (Chan et al. 2008:86). Most importantly, the majority of the population under the poverty line resides in western regions that have been much less able to grasp the opportunities from economic growth and to exert political influence in order to change their position.

5.7.3 Market Dependence as the Principle of Welfare Reform

One remaining issue is that why the government under the new policy guideline would be able to expand the coverage of welfare programs to the massive low-skilled workers outside the SOEs without incurring the financial burdens on the government. This can be explained by two factors. First is China’s low level of skill dependence. Under current industrial structure, most new beneficiaries are low-skilled – therefore low-income – workers, the pressure for the government to provide financial support is low, since the new regime requires individuals to provide the substantial part of the contribution. Although social assistance programs require the government
to provide primary financial responsibility, the overall low level of income associated with
China’s labor force essentially reduces that pressure considerably.

In addition to the industrial structure, the low level of government expenditure must be explained
within the context of globalization. The pressures from international market competition and
from the level playing field at the domestic market make it difficult for the government to use
welfare benefits to carter any single social group in order to maintain its political support as it
did before. At the same time, however, globalization has also provided strong incentives for the
government to resist the attempt, from both old and new social groups, to make welfare benefits
a luxury good rather than a safety net.

In reforming the welfare system, the Chinese government strictly follows a principle of market
dependence, which ensures that the expansion of the coverage of welfare protection does not
impose welfare burdens on the state but instead serves to promote market competition and labor
mobility. Efficiency is both the principle guiding the design and implementation of the new
welfare system and a goal the new system aims to achieve. This is best illustrated by the “social-
pooling-plus-individual-accounts scheme” that has been applied in most welfare programs, such
as the old age pension scheme, medical care, unemployment insurance, and Minimum Standard
of Living scheme.
In designing these programs, dependency on government is discouraged, as the government makes explicit in its statement that this scheme is an innovation and is suitable to China’s particular condition as a low-income society. This approach simultaneously “reflects the merit of traditional welfare scheme as risk-pooling and also emphasizes the mechanism for individual workers’ self-reliance and self-motivation.” The strength for this scheme, according to the government, is that it not only ensures higher living standards and social stability, but also enhances productivity under varying economic conditions (MOLSS 1999).

In most of these programs, the central and local governments pay only part of the premium. For example, the government provides only basic pension insurance. Employers and individuals contribute the rest. In rural areas where the incentives for individuals to purchase old age pensions insurance is relatively low due to the persistence of social welfare through extended families, the system is more flexible. The rate of contribution is decided by individual participants based on their abilities and expectations.

In most of the programs in urban areas, the burden essentially is on individuals and firms. For instance, medical insurance in urban areas requires that employers contribute 6% of their total wage bills while employees pay 2% of their wages as premiums. All contributions from workers, together with 30% of the premium from their employer, go to the individual account. The
remaining 70% of the contribution from the employer goes to the social pooling account. In order to address the issue that most programs are underfunded, the government encourages and mobilizes multiple channels and resources to raise the fund and reduce the costs. Local governments, firms, social organizations – such as urban neighborhoods and other non-governmental organizations– and individuals are encouraged to participate in management and contribute to the programs (Chen et al. 2008).

5.8 CONCLUSION

China’s welfare transformation has been closely associated with its trade regime and industrial structure, which themselves are closely interacting and reinforcing. During the 1980s, the slow reform of urban economy failed to reduce the traditional welfare programs. Ironically, it instead induced more individuals to enter the state sector for protection and for benefits. After 1992, the China’s rapid integration into the world economy and the trade-induced change of industrial structure has produced a strong detrimental effect on traditional hierarchical distribution of welfare protection. This temporal change within one country helps to illustrate Hypothesis 2 that countries with higher levels of international trade exposure are more able to lower their welfare protection.

As this case study has demonstrated, benefits associated with openness reduce the incentives for
those beneficiaries to resist the welfare rollback, because great labor mobility across sectors not only decreases the risk facing the workers in the high-skilled sectors. In addition, the efficient allocation of skill in fact provides incentives for these workers to move out of their previous firms for better return to their skills even with reduced welfare benefits, suggesting the creative dimension of welfare retrenchment discussed in Chapter 2.

The Chinese government has been relatively successful in reducing traditional welfare benefits and protection on high skill workers and meanwhile expanding social protection to the rest of the population. The case study demonstrated that this process is not the result of better labor organizational capacity for the low-skilled workers or the declining capacity for skilled workers. Neither is it determined by certain political leaders that have more luck or skills than others. Instead, it is an active response of the government to the pressures and opportunities introduced by openness. In the new welfare regime, the government finds it in its interests to maintain a balanced welfare structure that compensates only partially to any social group yet caters to entire population, as Hypothesis 4 proposes. In doing so, the government is able to maintain an efficiency-oriented and market-friendly welfare regime so that aggregate well-being can be sustained in a competitive market and, in turn, can serve as the base for the government to survive over the long run.
The Chinese welfare regime has been moving toward this balanced structure of welfare
distribution in a relatively quick pace and yet without incurring excessive financial burdens on
the government. In addition to the multiple channels and resources that the government has
utilized, this can be largely attributed to the low level of skill dependence of the Chinese
economy prior to 1978. This is particularly evident in comparing China’s welfare transformation
to other developing countries such as Brazil, as the next chapter will illustrate. As Hypothesis 1
proposes, the low-skill dependence gives China some advantages to avoid excessive financial
burdens on its government.

However, as mentioned in Introduction of this chapter, China is currently moving towards a
more skill-dependent economy in its urban sectors after three decades of development, which
will fuel the demand for more government protection. Combined with the fact that the current
welfare system has yet to provide a robust social safety net because most welfare programs are
currently still underfunded, there is more space for future welfare expansion. It can be predicted
that the public social welfare spending will experience an upward trend once the government
takes more financial responsibilities. In fact, the strong increase of social assistance expenditures
since 2001 and the slight increase of the spending on social security since 2003 in Figure 5.1
indicate that such a trend may be undergoing.
At the same time, however, there are also signs that indicate a counterforce against this expansionary trend. First, the industrial structure still remains heavily low-skill based so far. In 2007, the employees in the agricultural sector still counted 40.8% and manufacturing 26.8%, compared to the service sectors 32.4% (MOLSS and National Statistics Bureau 2008). Second, China’s export has been further strengthened since China entered WTO in 2001, as shown in the surge of trade/GDP ratio since 2004. This suggests that China’s edge in labor-intensive manufacturing exports may not diminish any time soon. In addition, China’s huge rural labor surplus makes the wage growth largely an urban phenomenon. The loosened rules on rural/urban migration will not only strengthen China’s advantage in labor and low-skill-intensive manufacturing, but will also further narrow the wage gap and lower the incentives for welfare expansion. Lastly, joining WTO has further locked the economy in a competitive market and tied the hands of political leaders. As a result, the principle of market dependence may be strengthened rather than weakened. Though these changes have yet developed fully, it can be speculated that, the expansionary pressures on China’s welfare system, though inevitable as the result of skill upgrading, will diminish over the long run, as Hypothesis 3 indicates, under the pressure of globalization.
These two conflicting forces – the demand for low-skilled labor and the demand for high skilled labor – may produce fluctuation in China’s welfare regime at certain times in the future. The welfare policy choice will be a delicate game of balancing, highly contingent on politicians’ strategic choices. However, given the logic held in the theory and the factors discussed in this chapter, it is safe to say that China’s welfare regime, for a considerable time in the future, will not deviate too far from its equilibrium, in which a low level of welfare expenditures and a balanced structure are maintained to accommodate both social protection and market competition.
CHAPTER 6

WELFARE TRANSFORMATION IN BRAZIL

6.1 INTRODUCTION

Brazil, before the 1980s, was characterized by a relatively closed trade regime, an industrial
structure with high skill-dependency, and a generous and highly protective welfare regime.

Similar to what happened in China around the late 1970s and early 1980s, Brazil has been
increasingly exposed to international markets since the late 1980s. As a result, welfare protection
has been decreasing, as reflected in both its government expenditures on traditional welfare
programs and in labor protection on skilled workers. Though the pace and magnitudes of
transformation have not been as striking as in China, Brazil is moving toward the similar
direction as the country is increasingly integrated into the world economy – a balanced structure
of welfare protection among various social groups.

Similar to China’s case, explanations on the change that Brazil has experienced since the 1980s
has been largely a political story. For many scholars, both the origin and recent transformation of
Brazilian social welfare regime are closely associated with the political institutions that define
the distribution of power between state, labor, and business, or, in a simpler format, between
labor and business. For example, some argue that Brazil’s social protection system emerged in part as a result of labour pressures. As a consequence, “organized labor gained from official government recognition of its legitimate status as well as social policies that provided concrete benefits” (Malloy 1979:55). The strong influence of labor on government posed great obstacles for any reforms that aimed to dismantle the traditional welfare state. State intervention on behalf of labor reinforces barriers to lasting business coalitions, which in turn forces firms to dispute state power individually rather than act collectively to counterbalance labor (Schneider 2004; Weyland 1996a; Leff 1968).

The nature of the regime and political leaders’ manoeuvre are believed to reinforce these processes. In the early years of welfare expansion, governing elites used responsibility over social welfare and labor activity as a means of gaining their power and mobilizing public support (Kaufman 1990; Skidmore 1967; Welyand 1996a, 1996b). After integrating into the global economy, reformist political leaders, allied with business interests, have pushed forward the welfare transformation against the interests of workers. In this process, globalization has exerted a strong detrimental influence on Brazilian workers, making it “difficult for workers to form encompassing institutions that can negotiate on a par with business and government to block welfare reforms”, thus following a familiar “race to the bottom” (Rudra 2007:198).
These explanations do have their own merits – labor capacity and political leaders all can contribute to the particular characteristics of the Brazilian welfare state and its transformation.

Yet, these factors add the nuances to Brazil’s welfare transformation, but they do not determine the process. In fact, these arguments put the cart before the horse. As discussed in detail in the following sections, labor capacity is a result of the industrial structure that determines both labor’s protection and its organizational power. Political leaders respond to the changing industrial structure and make policy choices in order to maximize their political support.

This chapter will demonstrate that Brazil has been following a general trend of welfare transformation in the past decades, the similar process that China has been through. Essentially, the structure of welfare spending in Brazil in recent years has been gradually moving toward the similar pattern that China has had – a balanced distribution of welfare protection across various social groups with different skill endowments. As a result of this “move to the middle,” the different components of welfare programs have experienced different trends, as Hypothesis 4 in Chapter 2 predicts:

\[
\text{H4: As countries become more exposed to trade openness, welfare benefits that target skilled workers in traditionally strategic sectors decreases at a faster pace than those that target the general population.}
\]
Yet, significant differences depart Brazil from China. Due to the early years of development, Brazil has had a high-skill dependent industrial structure. Absent of trade openness in the most part of the period before the 1980s, this industrial structure has cultivated a highly protective welfare system protecting the workers from high-skill dependent sectors. These legacies, combined with its still low level of trade openness compared to China as well as most other developing countries, determine that Brazil’s welfare transformation has been much more difficult than that in China. In comparison to China, Brazil’s legacies illustrate Hypothesis 1, while its difficult process of welfare transformation currently undertaking illustrates, in a negative way, Hypothesis 2:

**H1:** Countries at higher levels of skill dependence are more likely to have a higher level of welfare protection, all else being equal.

**H2:** Countries with higher levels of international trade exposure are more likely to have a lower level of welfare protection, all else being equal.

Brazil’s recent development, however, suggests that the country has been speeding up its economic integration and its welfare transformation. As a result, the expansionary welfare regime currently has faced significant constraints, confirming Hypothesis 3:
H3: The expansionary effect of industrialization on welfare protection decreases as a country becomes more exposed to international trade.

In the following pages, Section 6.2 describes the characteristics of Brazil’s welfare regime before the 1980s. Section 6.3 explains that the Brazilian expansionary welfare regime was originated from the interaction of its previous high-skill dependent industrial structure and low level of trade openness. Section 6.4 will analyze the process of welfare transition from the late 1980s, demonstrating that the change of industrial structure along with its more open trade regime has exerted a tremendous pressure on its traditional welfare regime, though early development had also produced significant obstacles to the pro-market reforms. Section 6.5 analyzes the recent change of welfare reforms since the late 1990s and discusses the achievements and obstacles toward an equilibrium welfare regime.

6.2 CHARACTERISTICS OF EXPANSIONARY WELFARE REGIME BEFORE 1980s

Brazil’s welfare regime has been characterized by its generosity in terms of welfare benefits and its strong labor protection. Compared to most other countries at the same period, Brazil’s government expenditures have been one of the highest in the developing world. As shown in Figure 6.1 below, its social security and welfare expenditures averaged about 35% of total government expenditures during the 1970s, far beyond that of most developing countries in the
same period, which was around 15% (see Chapter 1 and 3 for details). The benefits included a wide range of programs including old age pension, protection from work injury and unemployment, as well as benefits for disability, death, sickness, and maternity. Both the level of welfare expenditures and comprehensiveness of benefits make the Brazilian welfare system a relatively advanced one compared to most developing countries. Since the mid 1980s, the spending has been fluctuating around 20%, which was still much higher than the average level in the developing world.

**Figure 6.1 Share of Government Spending on Social Security and Welfare in Total Government Expenditures in Brazil: 1970-1994 (%)**

Source: IMF GFS, various years

The Brazilian welfare state is also characterized by its extensive legal protection for job security. Brazil is said to maintain some of the highest labor market protections by international standards and has been ranked among the highest in the developing world in labor protection (Djankov et
al. 2003; Heckman et al. 2003). The labor code in Consolidation of Labor Laws (CLT) has often been categorized as one of the “world’s most advanced labor legislation,” given the breadth of matters covered with respect to hiring, firing, and guaranteed job tenure, among other aspects (Levine 1997). Firms have a huge legal and financial burden in firing workers (Amadeo et al. 2000; French, 1998; Vause and Palhano, 1995).

Though the level of protection has been high in Brazil, the Brazilian social welfare regime was characterized by stratification. Similar to the Chinese case before the 1980s, welfare benefits and labor protection were unequally distributed both within and between occupational categories, which were associated with bargaining power of various groups (Malloy 1979). In essence, workers in high skilled sectors enjoyed a disproportionately high level of protection relative to the rest of the population. This is best reflected in pension and employment insurance programs, which only brought legal coverage to those employed in so-called “formal” sectors, including the workers in high-tech and heavy industries that were mostly owned by the government, civil and military servants, and middle-class professionals (Mesa-Lago 1978; Draibe 2002). Since pension and job security were central to Brazil’s welfare system, social security benefits have long comprised the bulk of welfare expenditures in Brazil. Federal government spending on social security, both as a percentage of GDP and total budget, ranks very high among developing
countries. Over the last a few decades Brazil has spent, on average, 7 percent of its GDP on
social security, which is more than three times the average of LDCs (Rudra, 2008:181). In 2002,
Brazil spent more on social security as a percentage of GDP than the OECD average (OECD 2005).

The structure of social spending, consequently, was highly biased in favor of social security and
welfare programs, which were primarily enjoyed by skilled workers in formal sectors. In contrast,
it placed less emphasis on areas related to human capital productivity and infrastructure. Table
6.1 below shows government expenditures on security and welfare vs. those on education and
health care during the early 1990s, before the fundamental reforms on the social welfare system
took place under the Cardoso government. The share of social security and welfare took more
than a quarter of social spending, while expenditures on education and health care together only
took around 10%, which accounts for about one third of the spending on social security and
welfare.

<table>
<thead>
<tr>
<th>year</th>
<th>Social Spending / total gov. spending (%)</th>
<th>Social Security and Welfare / social spending (%)</th>
<th>Education and Health Care / social spending (%)</th>
<th>Education and Health Care / Social Security and Welfare (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>35</td>
<td>25</td>
<td>10.0</td>
<td>40</td>
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<td>1991</td>
<td>47</td>
<td>35</td>
<td>10.9</td>
<td>31</td>
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<td>1992</td>
<td>39</td>
<td>30</td>
<td>8.8</td>
<td>29</td>
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<tr>
<td>1993</td>
<td>36</td>
<td>27</td>
<td>8.4</td>
<td>31</td>
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6.3 EXPLAINING THE WELFARE REGIME BEFORE THE 1980s

6.3.1 Autarky, Industrialization, and Skill-Dependence

To illustrate how the Brazilian welfare regime is embedded in its industrial structure and how that embeddedness has been affected by globalization, this section will describe and analyze the industrial structure prior to the 1980s. These descriptions will demonstrate that the legacies of industrialization before the 1980s have interacted with its autarkic trade regime to hinder the process of transformation of the welfare regime. To recapitulate, Brazil’s high-skill-dependent industrialization affects welfare transformation following Hypothesis 1, while its low trade exposure negatively affects welfare transformation following Hypothesis 2.

Brazil’s trade regime, for most of the post-war period, has been an autarky, closely associated with its import-substitution-industrialization (ISI) development strategy. Figure 6.2 below compares the trade openness in Brazil and China. It shows that the average trade/GDP ratio in both countries before the 1970s was below 10%. In China, the increase of trade was rapid since 1978, though it only became significant from the mid-1980s. In Brazil, the level of trade openness was between 15-20% for the most part of the 1980s and 1990s. The late 1990s marked a turning point. The trade level increased to more than 25%. Compared to China, that level is moderate. However, given its previous low level of trade openness, the increase is not trivial. As
shown later, changing trade openness did have consequences on the welfare regime in Brazil, which began to decline since the 1980s when the trade/GDP ratio increased, as the data in Figure 6.1 above shows. On the other hand, the relatively low level of trade openness compared to that in China also suggests that Brazil faced more difficulties in reforming its welfare regime.

**Figure 6.2 Trade Openness in Brazil and China: 1970-2004**

![Trade Openness Chart](image)

*Note:* Trade openness is measured by trade volume (the sum of imports and exports) as a share of GDP. *Source:* PWT 2006 (current price: 2000 base year)

As most authors would quickly point out, the low level of trade exposure before the 1980s had a close relationship with its ISI industrial structure, and both of which had a profound historical root in the Great Depression. The severe economic condition in the world economy turned Brazil away from free trade and instead induced it to adopt an ISI strategy in hope of overcoming supply inelasticities from the world market. The essence of ISI policies was to reduce a country’s
foreign dependency by building a diversified domestic industrial structure so that the local production of industrialized products would substitute for foreign ones. This response to the world economy proved to be consequential. From then on, except for a few short periods – notably the period under military rules between 1964-73 which produced a so-called “Brazilian miracle” – import and foreign exchange controls would be a key element of government policies regardless of the ideological contours of the government.

**Figure 6.3 Skill Dependence in Brazil (%): 1997-1995**

*Note: Skill dependence is measured by the ratio between the number of employees in high-skilled export-manufacturing sectors and the number of employees in low-skilled export-manufacturing sectors.*

*Data Source: United Nations Industrial Development Organization (UNIDO), *Database of Industrial Statistics* (various years).*
The process of industrialization turned the Brazilian industrial structure into a high-skill dependent one. Figure 6.3 below shows that, by the early 1970s, the labor force in Brazil's high skill manufacturing industries had reached almost half of that in low skill ones, and continued growing. To illustrate how strong the skill dependence is in Brazil, Figure 6.3 compares Brazil’s skill dependence to the average skill level of developing countries. In the early 1970s, the average for developing countries was less than 30%, while that in Brazil was almost 50%. While skilled labor in developing countries had, on average, been declining relative to low skilled labor over the entire period, it continued growing in Brazil.

What makes Brazil’s ISI strategy consequential is its bias against exports and in favor of domestic industries. In other words, it forced Brazil to adopt an autarkic trade regime. This trade regime was in favor of domestic heavy industries while biased against the light industries, for a closed economy favors scarce factors such as skill and capital, which Brazil lacked. Before the 1950s, the manufacturing structure was dominated by light industries that required low skill input. For the next three decades, Brazil witnessed the rapid industrialization with heavy industries becoming the driving force. By early 1970s, as shown in Table 6.2 below, the manufactured output in HCI surpassed that of light industries in 1973 and continued growing. By the early 1980s, manufactured exports in HCI also surpassed that of light industry. To illustrate
Brazil’s dependence on heavy industries, it is worth noting that Brazil at the time was producing and exporting more steel and automobiles than Great Britain, whose gross domestic product was nearly three times that of Brazil (Frieden 1991:123).

Table 6.2 Percentage of the Heavy Chemical Industry (HCI) and light Industry in Brazil’s Manufactured Output and Exports: 1949-1988

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<tbody>
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<td>Output</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
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<tr>
<td>HIC</td>
<td>24.0</td>
<td>35.2</td>
<td>48.0</td>
<td><strong>51.0</strong></td>
<td>60.0</td>
<td>60.0</td>
<td>59.0</td>
</tr>
<tr>
<td>Light</td>
<td>76.0</td>
<td>64.9</td>
<td>52.0</td>
<td><strong>49.0</strong></td>
<td>40.0</td>
<td>40.0</td>
<td>41.0</td>
</tr>
<tr>
<td>Export</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>HIC</td>
<td>3.9</td>
<td>2.0</td>
<td>8.8</td>
<td>18.0</td>
<td>43.3</td>
<td>51.2</td>
<td>60.1</td>
</tr>
<tr>
<td>Light</td>
<td>96.1</td>
<td>98.0</td>
<td>90.8</td>
<td>82.0</td>
<td>56.7</td>
<td>48.7</td>
<td>40.0</td>
</tr>
</tbody>
</table>

Source: Moreira (1995:189)

Brazil’s industrialization produced a large and diversified manufacturing sector, whose value-added output ranked seventh in the world in 1988 (Moreira 1995:87). However, as the literature of ISI would point out, ISI eventually produced imbalance of government budget because of governmental subsidies to heavy industries and to urban population that was the key consumers for domestically produced goods. At the same time, however, industrialization without export ironically encouraged more imports because of the need for capital goods and industrial raw materials, which eventually produced current account deficits (Frieden at al. 2000; Fishlow 1972). Since political reforms to remedy these problems were extremely difficult once the structure had created a vested interest, governments opted for overvalued exchange rates and foreign debts to sustain the development, even though overvalued exchange rates further
discouraged exports debts, and foreign debts made the economy highly vulnerable as illustrated by several debt and financial crises occurring since the late 1970s.

ISI created the divide between heavy and light industries, as well as the divide between urban and rural economies. As Brazil’s industrial structure was “crowded” in urban and heavy industries, efficient allocation of resource and skill was severely limited. As a result, a wide risk gap between workers from high-skilled sectors and the rest of the population made a stratified welfare regime essential to maintain the industrial structure and the trade regime.

### 6.3.2 Strategy for Political Support in an High-skill Dependent Autarky

The discussion above explains why the Brazilian government, under an authoritarian regime for most of its history before 1988, would provide a generous welfare system. Conventional wisdom has claimed that strong labor organizations forced the government to reconcile with workers. In other words, the generous welfare protection in Brazil was the outcome of labor movements against the interests of capitalists, as the conventional power resource theory argues. If this argument is valid, it would be difficult to explain why capitalists had been so timid in fighting against this trend. Despite the fact that social welfare programs were costly, industrialists ultimately accepted them for a more cooperative, stable workforce, and other economic benefits in return. It therefore was not surprising to see a cross-class alliance formed along the line of
sectors and industries. It is a commonplace in the literature of ISI that the Brazilian government under ISI – or in any other ISI economy – relied on a cross-class coalition of industrialists, organized labor, and civil servants.

Such a cross-class alliance has been extensively discussed in the literature of “corporatism,” particularly in the branch focusing on Latin American countries (Levine 1997; Malloy 1979; French 1998). For some authors, corporatism is a “forced harmony” between the state and different components of civil society, implying that it was designed by the government to co-opt high-skilled workers by providing job security and social insurance benefits in exchange for strict regulations on freedom of labor unions. Such a claim, however, overlooks the economic structure underlying this strategy. Many scholars recognize that industrialization motivated the government to use protectionist measures to target both firms and workers. Protection reduced the degree of competition for domestic firms, thereby allowing industrialists to offer higher wages and benefits to workers. Also, industrialists are interested in expanding workers’ income in order to increase the purchasing power of the domestic market. On the other hand, workers enjoying higher income and more consumer goods were willing to offer political support to industrialists. Hence, ISI policy was both beneficial to industrialists and workers. It formed the basis of an “incorporating” populist coalition between governments, industrialists, and organized
States were certainly important in the process of maintaining this formula. As Levine (1997:11) explains, “Business leaders accepted this formula gratefully, because it assured that the state would play a mediating role between employers and their workers, and it promised to assure protection and a steady supply of capital.” However, it would be exaggerating to say that politicians orchestrated this corporatist formula in order to enhance their political support. If protection to workers was the interests of particular politicians in order to enhance their political support, it would be difficult to observe the continuity of protectionist policies over decades under various political regimes. In particular, it would be difficult to understand why politicians would adopt a pro-labor approach under authoritarian, and even military, rules. Notice that the heyday for welfare expansion first occurred under Vargas’s authoritarian regime (1930-1954), and later during the 1970s under the military regime.

An overview of the historical development of the Brazilian welfare state suggests that both welfare protection and labor movements were the outcome of the same dynamic – the impetus of industrialization that was initiated in the 1930s and heightened in the 1950s as a response to the grand shift of the world economy, a phenomenon that also had similar impact on most
developing countries after the World War II (Little et al. 1970). To achieve self-reliance through industrialization within an autarkic economy, a biased welfare protection system in favor of skilled workers at the expense of the rest of the populace was seen, by both governments and businesses, as an essential instrument.

6.3.3 The Costs of Expansionary Welfare State without Globalization

The cost of this strategy is costly not only in Brazil. As already presented in China’s case, high-skilled sectors exerted similar influence and as a result prevented the reforms in China’s social welfare system during the 1980s. What distinguishes Brazil from China, however, is that this strategic cross-class alliance has much stronger influence in Brazil than in China. The high-skilled sectors in China primarily concentrated in large-scale SOEs, which constituted a very small fraction of the work force due to the low level of industrialization. In Brazil, however, industrialization during the post-war period cultivated a much larger proportion of high-skilled workers. As shown in Figure 6.3 above, the level of dependence on skilled labor in Brazil’s industry was way beyond the average in the developing world. A staggering wage differential between this group and the rest of the labor force made the level of risk gap much higher in Brazil than in China. Brazil and China therefore were two extreme cases in this dimension, though the two countries were at a similar level of trade exposure before the 1980s. Once
globalization is embraced, the consequences are significant in the two countries. In China, this alliance in high-skilled sectors, though resisting the reform, was by and large passive and had no capacity to worsen the situation. In Brazil, however, this alliance proves to be powerful, making welfare transformation much more difficult and costly than in China.

This is best illustrated in the social welfare reforms in the late 1980s and early 1990s. Economic crises during the 1980s led to the collapse of the military regime and restoration of democracy in 1988. However, absent the constraints from trade exposure and international economic competition, the new democratic regime became an instrument for the privileged social groups to further enhance their protection in a time when the country was critically in need of an overhaul in its economic and social policies to better cope with the new economic environment. For example, the 1988 Constitution sanctioned state monopolies in the oil and telecommunications sectors and placed restrictions on foreign investment in mineral extraction, health, telecommunications, and oil exploration and refining (Panizza 1999:19). As a result, high-skilled sectors were further protected from domestic and international markets. Meanwhile, Constitution also established a generous system of social security and labor rights under the principle of universal coverage, resulting in an extremely rigid legal framework for labor protection (Draibe 2007; Amadeo and Camargo, 1993; Amadeo et al. 1995; Vause and Palhano 1995).
As the welfare system was still seriously biased in favor of the skilled sectors and incapable of changing the previously biased benefit distribution among different social categories, the social welfare reforms under the democratic system had became even more distant from real social protection needs (Draibe 2007:266). Rather, democratization enhanced the skewed distribution of welfare protection, because its accessibility by those most in need had been actually reduced in spite of the extended social rights and principles specified in the new legislation (Draibe 2002:67). According to a 1988 study by the World Bank, 34% of public expenditure was allocated to higher-income groups, which represented only 16% of the total population, while only 20% was allocated to the poorest 41% of the population (cited from Willumsen and Fonseca 1997:204). This led Mesa-Lago (1989) to describe the early reform as “vertical massive expansion,” which extended social benefits to groups already protected and benefited but failed to benefit those in greater need (Also see Weyland 1995, 1996).

As a result, the welfare system became more fragile and less capable of managing the new situation which had been aggravated by economic instability. It is then not surprising to see that the reform quickly showed severe limits. The legacies of the reform in the late 1980s proved to be consequential in the following decade which was troubled by declining resources and increasing demands. It added, rather than reduced, political difficulties for future governments to
make further effort, as illustrated by the failed attempts of the 1993 National Reconstruction Project under the Collor administration to reform the social security system. The project did not go beyond the stage of policy debate (Draibe 2002:67).

Nevertheless, it seems to be inevitable that this regime finally gave in to the pressures from globalization. Economic and social crises during the late 1980s and early 1990s forced the country to re-conceptualize social protection. The new economic and social policies since the early 1990s were implemented to be more compatible with the new environment dictated by globalization, even though at a difficult and slow pace, with outcomes highly mixed.

6.4 SHIFT OF THE INDUSTRIAL STRUCTURE SINCE THE EARLY 1990s

ISI created an economic structure that couldn’t pay for itself. However, the ideology associated with ISI and the vested interest produced by the political dynamics made it difficult to reform the system without an economic crisis. Over decades of development, a huge amount of external debt had been accumulated; inflation was high; and oil made up more than one third of imports, making the country vulnerable to the oil crises. The consequences were highly costly. By the early 1980s, macroeconomic imbalances created an environment of low, unstable growth and hear-hyper inflation, which forced the country to adopt stabilization policies. The policy changes started in the early 1980s, though more substantial reformed only took place since the early
1990s. The reform accumulated in the successful Plano Real (Real Plan) in 1994, which set in motion a period of far-reaching economic reforms in areas of trade and financial liberalization, privatization of state-owned enterprises, and fiscal discipline. Similar to what has happened in China since 1978, economic liberalization has produced significant impacts on Brazil’s industrial structure, which eventually led to the fundamental change of the social welfare system.

6.4.1 Trade Liberalization and Changing Industrial Structure

Since the early 1980s, the trade/GDP ratio began increasing, as shown in Figure 6.2. However, trade liberalization only became a policy priority since the early 1990s. During the 1990s, the majority of non-tariff barriers from the ISI period were eliminated. Tariff rate was reduced by more than 50%. Special import regimes were abolished. A crucial development in terms of trade liberalization was the establishment of Mercosur in 1991, the regional trade agreement initially comprising Argentina, Brazil, Paraguay and Uruguay. Mercosur has been crucial in attracting FDI to Brazil, as shown in Figure 6.4 below, particularly after 1995. Mercosur also has helped make the country a regional export base for many multinational corporations. Overall, Brazilian exports to its Mercosur partners increased 235% from 1991 to 2000, while imports increased 244% (Campos et al. 2003:5).
Once the trade regime has changed, the Brazil’s economy began to move away from import-substitution. Before the 1990s, the inward-oriented industrialization cultivated an excessively large domestic market, which consumed a significant part of manufactured goods. In Figure 6.5, the average level of manufacturing goods for domestic consumption was more than 25% before 1990, when the level of trade openness in Brazil was relatively low around 15%. Once trade exposure increased since the early 1990s, particularly since the late 1990s, the dependence on the domestic market became decreased significantly. By 1998, the share of manufacturing goods consumed domestically decreased to below 15%.
The decrease of the dependence on domestic market has been accompanied by the downsizing of high-skill-dependent industries. This is best illustrated in the effort to privatize state-owned enterprises that mostly concentrated in heavy and high-tech industries. The privatization had begun in the 1980s but the real effort took place during the 1990s when the Collor government launched the “National Privatization Program” in March 1990, targeting the large and oldest state-owned enterprises in sectors such as oil industries. Since 1990, over 100 state-owned enterprises were sold, including almost all public steel, chemical, petrochemical, and fertilizer companies, largest mining corporation, the railway system, and several electric enterprises. The entire telecommunications system was auctioned between 1998 and 2001 (Pang 2003; Campos et
al. 2002; Tavares de Almeida, 2004). During this period, other important sectors such as railways and ports were also partly or totally transferred to the private sector. As the reforms have moved forward, the decline of public enterprises was followed by the increase of informal (private) sector enterprises, which rely primarily on low-skilled workers.

The trade liberalization and privatization produced significant impacts on the Brazilian industrial structure. Similar to what has happened in China, the new industrial structure in Brazil since the early 1990s had downsized the high-skilled sectors. As a result, Brazil has witnessed greater mobility of labor movement across sectors so that workers now can find the appropriate package to fit their assets and needs (Maloney 2004). Greater labor mobility and more efficient allocation of skills and other resources that have been found in many studies (Moreira and Correia 1998; Muendler 2001) have tremendous impact on the distribution of wage and risks across sectors. Bento and Horridge (2005) and Harrison et al. (2004) found that reforms caused incomes of all groups to rise. More interestingly, both studies found that trade reform raises the returns to unskilled labor relative to capital, suggesting that trade reform helps the poor more than other groups. Azzoni et al. (2007) confirmed this finding, and also found that trade reforms will on balance cause Brazil’s income distribution to improve. These findings echo those described in China’s case, suggesting that trade openness in both countries improves the efficient allocation
of skills across different sectors and therefore reduces the risk gap among the workers from different sectors.

Having had that, it should be noted that trade openness and economic reforms during the 1990s were far from effective compared to China. For example, Brazil’s trade openness level and FDI were far from comparable to China. The process of privatization in Brazil has been much more difficult than that in China due to the obstacles from the formal sectors, which still remain a considerable size. This is illustrated by Cardoso government’s failed attempt in early 1996 to send a reform package to the congress, including the reform of the public administration, social security and tax systems. The proposal, however, became bogged down in parliament for almost four years. Without the approval from the congress, the government made little progress in overhauling the generous public-sector pension system, which has been the most difficult part of social welfare reform (Panizza 1999). Another example is that the privatization process of state-owned enterprises decelerated to almost a complete halt in President Cardoso’s second term from 1999 to 2002 (Campos et al. 2003). In energy sector, the Constitution committee of the Senate in amidst of the energy crisis in 2001 introduced a bill to prohibit all future privatization of state-owned power facilities, as the government announced the construction of 21 new hydropower and 26 gas-driven thermal plants (Pang:144).
These obstacles came from the beneficiaries of the traditional welfare system, and rendered the Brazilian welfare transformation in a slower and more difficult pace compared to that in China, even though both countries are moved toward the similar direction.

6.4.2 Changing Strategy for Political Support

Not surprisingly, the changing economic structures, even at a relatively slow process, have altered the distribution of social preferences among the social groups that had different interests and demands for state protection. The privileges enjoyed by import-substituters – concentrated mainly in public and formal sectors with higher level of skill dependence – have been greatly undermined by trade liberalization and privatization, which introduced greater level of labor mobility across sectors.

As a result, the cross-class political alliance among high-skilled sectors for state protection was no longer sustainable, because firms now have become increasingly export-oriented and longer depended much less on the domestic consumption capacity, as shown in Figure 6.5 above. The changing business preferences have ruptured the old corporatist relations between business, organized workers, and the state, as firms have become increasingly exposed to new growth strategies that are more concerned about labor protection and state intervention (Kingstone 1999).
The loosening ties between skilled workers and their employers changed the calculation of politicians in their political support. Labor unions from the formal sectors have witnessed their political influence declining along with the changing economic structure. In June 1996, a general strike called by the three umbrella trade-union organizations in protest against government economic policies elicited only patchy support, and was regarded as largely unsuccessful (Panizza 1999). The government has become increasingly intolerant to unions’ provocative actions. In May 1995, President Cardoso sent in military to break a strike by the powerful Oil Workers’ Union, a move seriously weakening union militancy within the public sector (Cook 2002:18). These cases do suggest that labor’s political influence is not longer as strong as it was before. They, however, hardly support the argument in the power resource model that the waning influence of labor unions was responsible for the welfare retrenchment. The power resource model fails to explain why labor unions’ influence has been declining from the late 1980s – in which unions successfully reinforced the welfare benefits for workers in formal sectors – to the mid-1990s, even though no significant institutional changes have been made to weaken labor unions’ political influence during this period. If anything, skilled workers have more political capacity to organize after Brazil redemocratized in 1988 than they were before under the authoritarian and military regimes. The declining influence of labor unions, therefore, is not a cause of welfare retrenchment but an outcome of the declining support from their firms as well
as from the public that perceives the excessive welfare protection on a narrow constituency to be unfair and that has become increasingly influential to policymakers.

In sum, the waning political influence of the labor from the skill-dependent sectors reflects the challenge of economic and political climates of the 1990s. Responding to these new climates, politicians began to recalculate their strategy for maximizing their political support by adopting market-friendly policies. Once the narrow constituency of skilled labor becomes less important, the government actively pursues new welfare policies that cater a broader set of social groups. This helps to explain why Brazil is able to continue the reform in a similar fashion against the partisan divide between Cardoso and Lula, who held opposite political ideologies. For some observers, it is puzzling to see that Lula, a strong leftist that upset the international investors during his campaign, has made significant changes to his campaign promises and faithfully pushed the liberalization and social reforms forward along with Cardoso government’s principle. For others, policy continuity from Cardoso and Lula can be easily identified (Draibe 2005). Lula not only inherited sensible macroeconomic policies from Cardoso but also further realized them. His government tightened fiscal policy, repaid foreign-currency debt, and guaranteed monetary orthodoxy. In doing so, he neglected the socialist economic ideas of his Workers’ Party (PT). Because of Lula, citing from Economist (2010), “there is now a national consensus against
macroeconomic foolishness.” Looked based on the logic of globalization, however, that consensus can hardly be attributed to any single politician.

6.5 THE “MOVE TO THE MIDDLE”: NEW WELFARE REGIME UNDER GLOBALIZATION

By the mid-1990s, after several economic stabilization plans failed to keep inflation under control, a desperate Brazil finally reached a consensus that a fundamental reform required not just stabilization and liberalization but also the restructuring of social protection. In other words, economic adjustment needs to pay social costs. Cardoso's Real Plan successfully brought inflation under control and gave the Brazilian public confidence for an overhaul of state structures. Soon after Cardoso took power in 1995, the Brazilian government began undertaking a series of fundamental reforms, in which the social welfare system became an integrated part.

Unlike the previous reforms, the new reforms are comprehensive in economic, political, and social spheres, underpinned by the rationale that the social welfare system plays an important role in assisting the Brazilian economy to fully integrate into the world economy by reconfiguring its political and economic structures and balancing off efficiency and equity.

Similar to China’s experience since the late 1990s, the social welfare reforms in Brazil consists of two critical elements. The first is to eliminate the excessive protection on the high-skilled
sectors. The second is to expand the coverage of social protection to previously deprived social
groups. However, as discussed above, the social reforms in Brazil have been more difficult than
those in China, particularly with regard to the reduction of protection on the high-skilled sectors.
Therefore the process of reforms in Brazil has been slower with more mixed outcomes compared
to that in China.

6.5.1 Reducing Welfare Protection in High-Skilled Sectors

Since 1995, the Cardoso administration, later followed by the Lula administration (since 2002),
lounced a series of reforms that target the traditional high-skilled sectors and aim to cut back
social security expenditures and relax labor protection. An important component of the reforms
with regard to cost reduction has been lowering the benefits of the employees in public sectors,
including both civil servants, who had special social security service regimes, and workers in
public enterprises who enjoyed generous benefits. Many important measures have been
implemented to remove the privileges enjoyed by public sector employees. For example,
mandated contributions collected from public servants were increased. New taxes were
introduced on higher-level civil service pensions. Benefit ceilings and stricter eligibility
requirements were set. A new benefit formula to calculate benefits based on actual lifetime
contributions was introduced. Early retirement – the average retirement age before reforms was
forty-nine, and many retired as early as thirty-four – was restricted and the age for benefits was increased to 60 for men and 55 for women. A minimum vesting period of ten years for civil servants to receive pension benefits was set (World Bank 2005a, 2001a; Madrid 2003; Brooks 2009:145-47).

More importantly, the reform replaced the old salary reference for public servants from the last wage received to the average contribution-salary over a worker’s career. As a result, public sector pensions would be determined by the same formula used to calculate private sector pensions. It is believed that this rule not only marked a significant curtailing of one of the most regressive policies in Brazil. In the long run, it would also improve the financial balance of the state pension system (Brooks 2009: 294).

Still, the effort to reform traditional social security and labor protection in order to keep welfare costs under control has proved to be difficult for the Brazilian government. This is mainly due to the huge financial burden accumulated in the past decades from pension and social security paid for the employees in the public sector. By the mid-1990s before President Cardoso’s first administration began, the financial burden of the social security system had already reached the proportion of 3.7 percent of GDP (Draibe 2004:87). The reform proved to have little impact on reducing the costs from social security. Since the late 1990s, the social security system has
provided welfare services for approximately 32 million beneficiaries at a cost of about 11% of GDP – roughly half the consolidated outlay on social spending for the three tiers of government (Draibe 2004:85).

The pressures to reduce the government's fiscal deficit created strong incentives for the Brazilian government to enact a structural pension reform (Madrid 2003; Brooks 2009). In the early 1990s, the Collor administration began proposing a privatization plan. Both the Cardoso and the Lula administrations have since continued pursuing the reform. However, after a few attempts, both governments stopped pursuing privatization but instead opted for modification of the pension system within the existing framework, using the measures such as restricting early retirement, creating a ceiling on benefits, and eliminating privileged pension schemes, as mentioned earlier.

6.5.2 Expanding Social Protection to Low-skilled Sectors

Compared to the effort of reducing traditional social security benefits in the high-skilled formal sector, the reforms have made better progress in expanding social protection into the sectors previously discriminated against, mainly the informal sectors with low levels of skill and capital input, so as to indicate a “move to the middle” that aims to build a social safety net and cover the entire workforce regardless of skill level.
The emphasis on the social safety net as the core element of the new social protection regime reflects the government’s commitment to allocate resources to those sectors most in need. At the same time, similar to what has happened in China, the reforms in Brazil have been guided by a more realistic and efficiency-concerned principle that emphasizes the need to restructure social services in order to keep costs under control and improve target efficiency and quality. The reforms under both Cardoso and la Lula de Silva administrations are largely guided by this rationale and strategy, even though still constrained by political struggles and the legacies of the previous welfare regime.

The traditional welfare programs such as pension insurance and medical care have been expanded to urban and rural informal sectors. The most noticeable progress, however, has been the social assistance programs that target those at the lower end of the skill ladder. Under the second Cardoso administration (1998-2002) and the Lula government, several in-cash programs were implemented to target poor families. The most visible of them is the School Grant (Bolsa Escola) by Cardoso government, which later was integrated into Bolsa Familia as part of the Lula government's Fome Zero (Zero Starvation or Zero Hunger) program. The Bolsa Familia program provides financial aid to poor families with children between 6 an 15 years of age, on condition that the children must attend school and be vaccinated. The program attempts to both
reduce short-term poverty by direct cash transfers and fight long-term poverty by increasing
human capital among the poor through conditional cash transfers.

The program had expanded to cover about 44 million people (one quarter of the total population),
at least two-thirds of whom are extremely poor. The estimated cost was about 0.5% of Brazilian
GDP and about 2.5% of total government expenditure (Lindert 2005). The international
community has praised the Bolsa Familia program as being responsible for about 20% of the
drop in inequality in Brazil since 2001 and for a significant reduction in child labor exploitation
(Yap 2001). Its long run impact on human capital is also considerable. A World Bank report
indicates that the program has made significant "contributions to improved education outcomes,
and impacts on children’s growth, food consumption, and diet quality" (World Bank 2005).

The implication of the Bolsa Familia program is beyond poverty relief. The program has
important impact on the social welfare system. The success of the program marks a significant
shift away from a conservative tradition in Brazil in which poor families were excluded from
social services, particularly in form of in-cash programs. Since entitlements under these new
forms of social assistance are not dependent on occupational status, but are instead based on
households’ socio-economic profiles, the new forms of social assistance weaken the stratified
welfare provision across different sectors (Barrientos 2009). In other words, the program serves
to narrow the gap between the low-skilled and high-skilled sectors. The result is a gradual shift of the distribution of social protection expenditures. According to the official document (Governo Federal do Brasil 2005, cited from Barrientos 2009), the extension of Bolsa Familia has raised social assistance expenditure while reforms have reduced government subsidies to social insurance that is largely confined in formal sectors, suggesting a balanced distribution in welfare protection across sectors so that a social safety net can be created to accommodate the pressure from globalization.

In sum, the achievement of social welfare reforms in Brazil since the late 1990s can be considered significant, even though only in terms of the Brazilian standard relative to its previous performance. Globalization appears to be the underlying force to sustain the reform. Without the economic crises introduced by liberalization that shook up the established political system and changed the status quo, the reforms might have been further delayed. Once the reforms took place, the reformist Brazilian government since the late 1990s has been empowered by the urgency of accommodating globalization despite the strong political barriers. An overview of the reforms over the past two decades, from the early 1990s under Collor to the 1990s under Cardoso, and then to the past decade under Lula, suggests an acceleration of the speed and the widening of the scope of welfare transformation. As a result, the expansionary effect of skill
dependence has begun diminishing and the “move to the middle” has become faster as the
country becomes more exposed to international trade, as stated in Hypothesis 3.

6.6 CONCLUSION

Brazil’s social welfare reforms, though having made significant progress since the late 1990s,
have been through a difficult and protracted negotiation process, with mixed outcomes.
Coexistence of progress and obstacles suggests that a market-friendly social welfare system,
though inevitable, is difficult to accomplish in the short term. The particular difficulty in Brazil
has been the effort to reduce the welfare benefits in the formal sectors. This places Brazil’s
welfare transition in stark contrast to that in China. That is due to two factors. First, at the time
Brazil began the welfare transformation in the 1990s, the country’s economy had developed to a
stage that relied on much higher level of skill input. In other words, industrialization in the past
decades in Brazil has created a huge army of high-skilled labor that was overprotected and faced
much a higher level of risks once exposed to globalization compared to their counterparts in
China. This legacy remains a strong obstacle to transforming this part of the welfare system in
Brazil.

Second, since most firms in Brazil were overprotected under the ISI model, they were rarely
exposed to international competition. Once the country became exposed to a globalization
environment, the firms’ ability to take advantage of world markets to create jobs was rather limited compared to other developing countries such as China, where firms take full advantage of abundant low-skilled labor through exporting so they can contribute to the reduction of income and risk gaps among social groups. Lacking such an advantage contributes to the difficulty for the Brazilian government to reduce the welfare benefits in the formal sectors, because the risks for these sectors remain very high.

These obstacles have prevented the Brazilian government from making an effective effort to establish a balanced welfare state and an inclusive yet efficient social safety net. However, once globalization has fundamentally changed the status quo and made the welfare transformation inevitable, these obstacles may gradually be reduced over time, as suggested by the speedup of reform since the late 1990s. The transformation of the welfare regime will not be an easy and automatic process. The journey to an equilibrium welfare regime will remain a long and difficult one in Brazil. But the case of Brazil illustrates that globalization has been a powerful force to induce the country to join a great movement along with most other developing countries. Labor movements, political regime, political institutions and leaders, among others, may complicate this process. But it is globalization that dictates how this the process of welfare transformation evolves.
CHAPTER 7

WELFARE TRANSFORMATION IN SOUTH KOREA

7.1 INTRODUCTION

The welfare regime in South Korea has often been considered as a classic case of a residual welfare state – a “welfare laggard” (Rudra 2007:149), characterized by a low level of governmental financial responsibility for social protection. In a comparative perspective, the social security and welfare spending in South Korea is among the lowest in the developing world. During the 1970s, its spending on social security and welfare was at 0.82% over GDP on average. Not until 1989 had the welfare spending risen above one percent of GDP (1.13%). Though still increasing, the spending level during the 1990s and early 2000s was still a very low even by the standard of developing countries (see next section for detail).

Such an observation leads some scholars to claim that South Korea’s social welfare regime is a typical case of the “race to the bottom” in that social protection has been sacrificed by the need of supporting the capitalists and market competition. This argument, however, overlooks the dynamic of Korea’s welfare regime. As Mares and Carnes (2009) argue, such a static perspective tends to downplay the variation in social spending that occurred over time. Indeed, the
government spending on social security and welfare in South Korea has been more than doubled in the past decades.

Other scholars following the assumption in the power-resource theory argue that the welfare transformation in South Korea has been determined by the class struggle, which, in most part of the post-war history in South Korea, was in favor of capitalism. Political institutions, such as underdevelopment of the political party system, especially the absence of left-wing parties, are believed to determine weak labor movements. In addition, the authoritarian regime relaying heavy-handed tactics on labor helped maintain this process so that the bargaining power of labor was muted and firms were released from having to deal with problems such as collective action and other labor-management issues (Lee, 1995; Deyo 1989). As for the welfare expansion since the late 1980s, it is believed that that social policy since then has been developed as an instrument of social legitimation in the face of intensified confrontation between workers and capitalism (E. M. Kim 1997).

Another perspective argues that the transformation of social security system in Korea, as well as the changed power balance between the capitalists and the workers, was a result of the political transition from conservative and authoritarian to democratic regime. In other words, regime change has been the main dynamic for the welfare transformation (Deyo 1992; Wong 2003).
Though this perspective does not share the automatic assumption of the power resource model that “class struggle” is the engine of change, it echoes the assumption in the power resource model that the development of social policy in Korea has been primarily determined by the politics, in which political incumbents tried to use the power and resources of government to capture the allegiance of key constituencies at different historical periods. It was capitalists before 1988 democratization and labor after that were critical to the political coalition.

I argue that these theoretical perspectives, though important in understanding the particular characteristics of South Korea’s welfare regime and the process of transformation when comparing with other countries, overlook the importance of the structural factors that underpin the economic and political process associated with welfare transformation. They also overlook the dynamics associated with the change of these structural factors. In other words, the interaction between South Korea’s industrial structure and its integration to the international economy in the past decades determines the evolution of the welfare regime in South Korea.

More specifically, the process of industrialization has transformed the Korean economy from a low-skill dependent to a high-skill dependent one. At the same time, the country has been increasingly integrated into the world economy. Following the theory developed in Chapter 2, these two processes have conflicting effects on South Korea’s welfare state. This suggests that it
is necessary to divide the welfare transformation in South Korea into two different stages in order to fully understand how these two processes have interacted and affected the welfare regime. Before the late 1980s, the welfare state in South Korea was characterized by a low level of welfare protection, therefore, a residual welfare state. Since the late 1980s when the economy became more skill dependent, however, a residual welfare state is no longer applicable to South Korea, and welfare expansion became inevitable. Instead, the mechanism underpinning the Korean welfare expansion has increasingly resembled that in OECD countries, illustrating Hypothesis 2:

\[ H1: \text{Countries at higher levels of skill dependence are more likely to have a higher level of welfare protection, all else being equal.} \]

On the other hand, welfare expansion in South Korea has been a more complicated process in that South Korea faces tremendous pressures from international competition. The high level of economic integration therefore prevents South Korea from developing a generous welfare state compatible with its income level. For example, by the early 1990s, South Korea’s GDP per capita has become very close to some of the OECD countries and higher than Brazil’s. Its welfare spending, on the other hand, was much lower than OECD countries and Brazil. This is because that globalization has been a strong force to curb the expansionary dynamic of
industrialization in South Korea. From both temporal and comparative perspective, therefore, South Korea’s case helps to understand the future of welfare transformation in most developing countries as their industrialization proceeds, as both Hypothesis 2 and 3 suggest:

**H2:** *Countries with higher levels of international trade exposure are more likely to have a lower level of welfare protection, all else being equal.*

**H3:** *The expansionary effect of industrialization on welfare protection decreases as a country becomes more exposed to international trade.*

During the early stage of development, the residual welfare state in South Korea was the result of interaction between trade openness and its comparative advantage in low-skill labor. During the second stage, globalization effectively prevents welfare expansion from becoming excessive but instead imposes the principle of efficiency upon the new regime. At the same time, however, globalization also induces the government to expand welfare protection to previously marginalized social groups in order to maintain the long-run sustainability of the economy, thus achieving an equilibrium welfare model, as predicted in Hypothesis 4:
**H4:** As countries become more exposed to trade openness, welfare benefits that target skilled workers in traditionally strategic sectors decreases at a faster pace than those that target the general population.

This chapter is organized as follows. Section 2 describes the characteristics of the social welfare regime during the first stage of development. Section 3 explains the welfare regime in the early years from the perspective of trade and skill dependence, underscoring that the low level of welfare protection in South Korea during this period was a social choice due to the benefits resulted from the interaction of trade exposure and abundant low-skilled labor. Section 4 discusses the shift of industrial structure to a skill-dependent one since the 1980s and the impact on the mechanisms underpinning the demand for social protection. Second 5 discusses the new welfare regime since the late 1980s in the context of the South Korean economy that has been increasingly relying on a high-skill dependent industrial structure and has been further integrated into the world economy. It also highlights the role of the 1997 Asian financial crisis as a critical turning point that fundamentally compelled the country to adopt a balanced welfare regime compatible with a globalized economy.
7.2 CHARACTERISTICS OF THE WELFARE REGIME BEFORE THE EARLY 1980s

Like those in most developing countries during the early stage of development, the welfare regime in South Korea before the early 1980s was characterized by a hierarchical and stratified distribution of welfare benefits and protection. Only a very small portion of the population, mainly government employees and military personnel enjoyed the benefits of pensions, employment insurance, and health care. In terms of the structure of welfare spending, the government spent mostly on traditional social security and welfare programs but paid little attention to social assistance. For instance, the government took little responsibility in health care and poverty relief for those outside of the formal sector, which was by large left for families and societies. The ratio of public spending on health care to total government spending rarely exceeded 2%. In 1966 only 7 per cent of total health care services were provided by public institutions (McGuire, 2006:11). The primary beneficiaries appeared to be those in formal sectors.

What distinguished the South Korean welfare model from most developing countries was that the level of social welfare spending was very low. Welfare spending, as Figure 7.1 below shows, was between 5-6% of total government expenditures for the entire period before 1985. This level was well below the average of the spending in the developing world, where the average was around 15% during the 1970s and 10% during the early 1980s.
Overall, the social security and welfare programs in South Korea before the late 1980s were guided by the spirit of market dependency and self support. That spirit was proclaimed in President Park Chung-hee’s claim, “economy first,” as the country unveiled its outward economic development strategy in 1962. The 1963 Social Security Act stated that social policy should be issued “gradually as provided for by law in light of the economic circumstances of the state” (J.S. Kim 2004:150). This spirit set the tone for the South Korean welfare regime being considered as a residual one.

This observation, however, obscures the significant change over time. Since the mid-1980s, particularly since 1987, the spending level has increased steadily. By the mid-1990s, the welfare spending ratio reached to 10%, doubled from below 5% during the mid-1970s. This amount of increase may not suggest anything significant by the standard of some other countries – for example, Brazil. By South Korean standards, however, doubling in two decades is by no means trivial. After a significant increase around 2000 following the Asian financial crisis, the spending level decreased to the pre-1997 level. This may suggest that the impetus for welfare expansion has been significantly restrained by the pressure of globalization. As explained in the following sections, the changes occurred since the mid-1980s must be understood from a broader perspective of globalization and the changing economic structure that followed.
7.3 EXPLAINING THE WELFARE REGIME BEFORE THE 1980s

The following discussion explains why the interaction between trade openness and South Korea’s industrial structure allowed it to maintain a low level of welfare spending. The first factor is trade regime in South Korea. What distinguishes South Korea’s trade regime from most other developing countries is that South Korea has a much longer history of an open economy. This is particularly reflected in its trade openness. Figure 7.2 below compares the level of trade/GDP ratio in South Korea, China, and Brazil. It shows that South Korea has already heavily exposed to the world market almost two decades ahead of China and Brazil. Four years
after President Park launched economic reforms in 1962, the trade/GDP ratio in South Korea was already over 30%. A decade later, the ratio increased to over 60%. For the next three decades, the ratio has been well above 60% except for a few years during the early 1990s. In contrast, China’s and Brazil’s levels remained well below South Korea’s.

Figure 7.2: Trade Openness in Korea in Comparison: 1962-2004

Note: Trade openness is measured by trade volume (the sum of imports and exports) as a share of GDP.
Source: PWT 2006 (current price: 2000 base year)

This cross-country comparison may well support a “race to the bottom” argument. Indeed, scholars have repeatedly argued that the weak welfare state in South Korea is the outcome of labor repression in favor of capital interests in an open economy. However, such an explanation fails to explain why the welfare spending in South Korea could increase over time given its
upward trend of trade openness. Again, this must be explained by looking at the changing economic structure over time.

7.3.1 Trade Openness, Skill Dependence, and Industrial Structure

It has been widely acknowledged that foreign trade was a “leading” engine of growth in South Korea (Krueger, 1997), in which the export-led development strategy determined the pattern of the economic structure. An important factor that determines the rapid takeoff of South Korea’s trade openness is its industrial structure that was low-skill dependent in the early years. When President Park embarked an export-oriented development strategy in the early 1960s, Korea was a country endowed with abundant low-skilled workers but lacking both domestic and international capital as well as natural resources. Similar to China in the late 1970s as well as many other East Asian countries with similar factor endowments in their early years of development, Korea soon shifted its development strategy from Import-Substitution-Industrialization (ISI) – existing within a short period after the Second World War – to export-oriented-industrialization. Many have pointed out that Korea’s ability to exploit its comparative advantage and efficient use of its abundant cheap labor during the first two decades of development was a major contributing factor to its rapid growth (Kim 1997; Krueger 1995, 1997; Kuznet 1984; Perkins 1997).
In comparison, the industrial structure in South Korea during the early years of development somewhat resembles China’s industrial structure since 1978 but in striking contrast to Brazil’s. During the entire 1960s and early 1970s, Korea promoted labor-intensive industries to take its comparative advantage of a low-skilled labor force. This can be illustrated in its emphasis on light industries in exports, a similar approach adopted by China after 1978. Fully utilizing the abundant and cheap low-skilled labor, light industries accounted for 67% of manufactured exports and 56% of manufacturing output even by the end of this period, as shown in Table 4.2 below, only to be surpassed by high-skill dependent heavy industries in the late 1980s.

Table 7.1: Percentage of Heavy and Chemical (HCI) and of Light Industries in Korea’s Manufacturing Output and Exports: 1953-1988

<table>
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<tbody>
<tr>
<td>Manufactured export</td>
<td>HCI</td>
<td>19.9</td>
<td>24.2</td>
<td>33.1</td>
<td>45.6</td>
<td>55.5</td>
</tr>
<tr>
<td></td>
<td>Light</td>
<td>80.0</td>
<td>75.8</td>
<td>66.9</td>
<td>54.4</td>
<td>44.5</td>
</tr>
<tr>
<td>Manufacturing output</td>
<td>HCI</td>
<td>25.2</td>
<td>32.0</td>
<td>44.4</td>
<td>51.9</td>
<td>59.6</td>
</tr>
<tr>
<td></td>
<td>Light</td>
<td>79.2</td>
<td>68.0</td>
<td>55.6</td>
<td>48.1</td>
<td>40.4</td>
</tr>
</tbody>
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Source: modified from Moreira (1995:168), Table A.2

A comparison between Table 7.1 here and Table 6.2 in Chapter 6 on Brazil and Table 5.1 in Chapter 5 on China is suggestive. Where light industries only accounted for 49% of manufacturing output compared to 51% from HCI in Brazil in 1973, light industries in South Korea accounted for 76% compared to 24% from HCI in 1972. These data suggest that South
Korea’s industrial structure was at a much lower level of high-skill dependence compared to Brazil’s, and more similar to that in post-1978 China.

Another important element in South Korea’s development in these early years is the small size of the public sector. Because of the exposure to the world market from the outset of industrialization, the South Korean government avoided the common practice adopted by many developing countries that cultivated a large amount of state-owned enterprises in order to promote heavy industries through public finance. Unlike that in Brazil and China before reforms, economic development in South Korea has been entirely dependent on the private sector, famously in forms of chaebols, the family-owned business conglomerates. Compared to China and Brazil, this factor is important in affecting South Korea’s welfare regime in that the beneficiaries of welfare protection – primarily in the military and civil service – constituted a much smaller portion of the populace than in China and Brazil, thus contributing to the low level of welfare spending.

7.3.2 Low Level of Protection as Social Choices

Maintaining a low level of welfare protection did not seem to encounter much resistance in the early years. After all, it was precisely the interaction between the high-level exports and the low level of skill dependence of the industrial structure that made the rapid growth possible for the
entire period, which benefited both domestic firms and labor. As the economy rapidly advanced during the period of 1972 to 1983 with an average GDP growth rate above 10% and GDP per capita growth rate above 6%, the growth rate in real wages during this period was estimated around 9.8% (Amsden 1989:201; Moreira 1995:56).

The rapid growth of wages and living standards was accompanied by nearly-full employment during this period. This favorable condition explains why the welfare expenditure could be maintained at a low level during the 1970s and 1980s with minimum resistance from the labor. That is, South Korea fully exploited the opportunities of the world market using its advantages of abundant and cheap low-skilled labor. The opportunities from market activities reduced the market-induced risks for both high and low-skilled workers and therefore provided strong incentives for workers to lower their demand for state protection. This is very similar to what has happened in China since 1978. Compared to Brazil, South Korea before the 1980s and China after 1978 are better able to maintain a low level of welfare spending because both countries have a low level of industrialization at the outset of their openness, and both countries are able to fully take advantage of the world market in order to benefit the majority of the working force.

The discussions above explain why the weak labor movement in South Korea cannot be a primary explanatory variable for the low level of welfare protection in South Korea during this
period. Instead, the weak labor movement itself was the outcome of the interaction between trade openness and industrial structure. It is true that the government during this period was notorious in its repressive labor tactics. However, it must be noted that the gains from trade openness significantly muted the demand from labor for government protection. This is particularly true given the fact that labor movements during this period were mainly concentrated in sectors where the skill dependence level was relatively high and the workers in these sectors therefore were better organized. For the majority of the workforce, however, labor movements were much less attractive and less effective.

One example to illustrate why the low level of protection could be a social choice during this period is the wage bargaining system during the early years of economic development. Against the argument that the authoritarian state deliberately kept labor wages low in order to promote international competitiveness of their labor intensive exports (Deyo 1989), scholars find that the low labor wages during the early stage of development were actually driven largely by market logic and the state did not impose much restrictions, as the wage bargaining system was highly decentralized so that wages and benefits were decided at the enterprise level through annual bargaining, usually during the spring (Shin 2003:71, 73).
A weak welfare state during this period therefore was not the outcome of labor repression incentivized by market competition but a natural consequence of the low skill dependence of the workforce in an open economy. Given the industrial structure, a protective welfare regime would be politically unfeasible from the standpoint of both firms and labor. The majority of the labor force was concentrated in low-skill dependent sectors. Since low earnings incur fewer risks from the shift of labor markets, as explained by the model in Chapter 2, workers with low but stable wages would have less incentive to demand a high level of compensation. Thus, the symbiotic relationship between the state and business, which has often been seen as collusion against labor in its entirety (Deyo 1989; Rudra 2007), in fact was buttressed by the low-skilled workers. In other words, a cross-class alliance between business and labor supported a residual welfare state during the early years of development.

The labor movement and the reform of welfare regime that took place since the late 1980s could not occur without the change of the underlying industrial structure during the late 1970s and early 1980s, which altered the previous government-business relationship and provided incentives for the government to change their strategies in making social welfare policies.
7.4 SHIFT OF THE INDUSTRIAL STRUCTURE SINCE THE 1980s

7.4.1 The Shift of Industrial Structure

After two decades of rapid growth based on labor-intensive manufacturing export, a shift of industrial structure took place in South Korea during the 1980s. Figure 7.3 below shows the trend of skill dependence in South Korea from 1972 to 1995 in comparison to Brazil, the average of developing countries (LDC avg.), and the average of OECD countries. The skill dependence in South Korea started at a very low level of 36% in 1972, only slightly above the average of the developing countries. By contrast, the level in Brazil was 51% and the average level of OECD countries was 69%. A decade later, however, the level in South Korea became very close to that in Brazil, and surpassed the latter in 1989. During the 1990s, the level in South Korea further increased in a fast pace and even surpassed the level of OECD average in 1995, one year before the country became an OECD member.
During the 1980s, export share of skill-intensive products such as machinery and transport equipment increased significantly, while labor-intensive exports began to slow down. In 1988, as shown in Table 7.1, the share of manufacturing output from heavy industries was 19% higher than that from light industries, compared to 3.8% in 1980. The share of manufactured exports from heavy industries in 1988 was 11% higher than that from light industries. By 1990, electronics had overtaken textiles and garments, whose share of total exports had fallen from 41% in 1970s to 22.6% in 1990 (Krueger, 1997:325). In sum, the 1980s was an important transition
period in which high skilled exports began to surpass low skilled exports (Lee 1995) and the
industrial structure in South Korea has since become a high-skill dependent one.

The most significant consequence of this transition was the structural change of labor markets
from a state of labor surplus to one of limited supply. By the early 1980s, the demand for labor
began to outpace supply. The impact of the considerable shortage of skilled workers was
illustrated by the drastic increase of labor costs. The annual average growth rate of wages
reached 13.4% (Shin 2003). Between 1966 and 1980, the capital-labor ratio in manufacturing
increased by nearly three-fold (Hong 1987:314). Table 7.2 below puts the labor costs in South
Korea in perspective. The sharp decline of the average wage in two second-tier East Asian
newly-industrialized countries (INC), Indonesia and Thailand, compared to that in South Korea,
illustrates how fast the labor costs in South Korea had gone up during the 1980s.

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<td>Thailand</td>
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*Source: UNIDO*

When this shift of industrial structure was largely completed by the early 1990s, the South
Korean government actively pursued new development strategies in order to accommodate the
new international market environment. The New Economic Plan launched by the Kim Young-
sam government (1993-1997) aimed to reinvigorate the economy in the face of increasing international competition by encouraging high-value products and enhancing productivity. As the governmental statement clearly indicated, the Plan marked an important step of transforming South Korean product and factor markets from a growth-oriented economy with low skills, low wages, and life-long employment to a competitiveness-oriented economy with high skills (Economic Planning Board 1993, cited from Yi and Lee, 2005:153).

7.4.2 Changing Mechanism for Welfare Protection

The shift of industrial structure had significant implications for South Korea’s welfare transformation. The shift has changed the mechanisms underpinning the welfare regime, thus causing the South Korean welfare state to increasingly deviate from the standard developing country model and instead follow the upward trend similar to OECD counties. The comparative advantages of low-skilled workers have begun diminishing (see Figure 7.3), therefore putting these workers in a situation more resembling the low-skilled workers in OECD countries. To complicate the situation in South Korea, the competitiveness of the skilled workers has not yet reached the level that their western counterparts enjoy. The risks for high-skilled workers are still quite significant. It is therefore not surprising to observe a fast and steady increase of welfare spending in South Korea since the late 1980s.
At the same time, the pressure from the international market competition has accompanied the process of shifting industrial structure and underpinned welfare transformation in South Korea. Globalization affects the South Korean welfare transformation in two aspects. First, it induces the expansion of social protection to previously marginalized groups. Second, the transition in South Korea to a skill-dependent economy was guided by market principles of efficiency and competitiveness rather than decommodificating workers from the international market. The shift of industrial structure was therefore accompanied by further openness to the international market.

In the face of economic crisis at the end of the 1970s, the Korean government began in the early 1980s to pursue new policy measures towards economic liberalization, such as opening financial markets to FDI, deregulating financial systems, and removing the restriction on imported goods (Perkins, 1997; Krueger, 1997). During the early 1990s, another wave of liberalization and deregulation in financial systems and trade barriers was launched under the Kim Young-sam administration. As the South Korean economy became further integrated into global market, it expanded welfare spending. Even though its expenditures on welfare are increasing as Hypothesis 1 would predict, they remain much lower by the OECD standards due to the logic of globalization stated in Hypothesis 2.
7.5 NEW WELFARE REGIME IN A SKILL-DEPENDENT ECONOMY SINCE THE LATE 1980s

The welfare transformation in South Korea following the shift of industrial structure since the late 1980s has two important elements. First is the increase of welfare protection as the result of a high-skill dependent industrial structure. Second is the more balanced distribution of welfare protection among different social groups, thus a move to the middle. However, because of the conflicting forces of skill dependence and economic integration as discussed above, the process was not a smooth one. Though the incentives to expand welfare programs have been strong as the result of the rising skill level of industrial structure, the market pressure has successfully curbed the impetus. The 1997 Asian financial crisis was a critical turning point. Before 1997, the legacies from the previous regime still exerted strong influence on the new regime, reflected particularly in the biased distribution of welfare protection. However, the price of such a system was fully manifested in the 1997 crisis and forced the country to finally adopt a more balanced approach to compensate different social groups through a stronger social safety net system.

7.5.1 Changing Strategy for Political Support
The critical political constituency for the Korean government before 1980s was the cross-class alliance between business and workers at the low skill dependent sectors. The low impetus for government protection – even the hostility from business – from this alliance incentivized the government to repress the labor movements organized among the workers at the high-skilled sectors. Since the 1980s, the shift of the industrial structure began weakening this coalition primarily for two reasons.

First, business groups no longer had as strong incentives to resist worker protection. Business conglomerates such as chaebols have fundamentally shifted their products to capital-intensive and skill-intensive ones during the 1980s. Expansion of social welfare, under such a circumstance, became beneficial for chaebols themselves because a stable and skilled labor force were valuable. Another factor contributing to Chaebols’ recession to welfare expansion was the decline of the life-time employment practice among chaebols since the 1980s because of the changing managerial strategy under new business environments. That change gave businesses motivations to shift the welfare burden from firms to the state.

Second, the labor force had fundamentally transformed into a wealthy middle class, as the low-skilled labor became increasingly the minority. Due to the sheer pace of industrialization between 1960s and 1980s, the proportion of wage and salary workers in the workforce increased
from 31.5% in 1963 to 54.2% in 1985 (Bello and Rosenfeld 1992:33). The industrial workforce alone rose from 10% of the labor force in 1965 to 23% in 1983 (Minns 2001). As the result of this changing structure of the labor force, expansion of middle classes became associated with more risks from market fluctuation, thus more incentives for government protection.

These changes significantly reduced the importance of political support from the social groups that resisted welfare expansion. Instead, the government began to adjust their strategy in order to maximize their political support from a broader coalition. The new political calculation ultimately led to a series of reforms in social welfare programs in the 1980s.

An example to illustrate this change of government calculation for political support was its expansion of welfare benefits to the social groups that had traditionally been marginalized, for example, farmers and fishermen. In 1988, the government introduced the Medical Insurance Program (MIP) for farmers and fishermen, by which the government for the first time began to provide subsidies amounting to 35% of total costs needed for the program. This amount was soon raised to 50% (Shin 2003:127). On the surface, it seems that the government was yielded to the labor movement from farmers and fishermen. A deeper analysis, however, suggests that Korea’s labor movements have traditionally concentrated in wage workers in urban manufacturing sectors, rather than farmers and fishermen. The introduction of these subsidies,
therefore, was a response to riskier economic conditions facing the majority of the labor force.

During the first half of the 1980s, the average amount of debt among farming households increased more than fourfold. Under this circumstance, the government announced special measures for the farming and fishing villages beginning in 1986, focusing on industrialization and income increase in rural areas. A special loan with much lower interest rates was provided to replace private loans in order to reduce debts in farming and fishing households. Notice that these measures took place before democratization took place in 1987, therefore suggesting that the government had already actively begun to provide a series of special measures to help low-skilled workers to survive economic fluctuations. Welfare expansion to these groups was part of this process.

### 7.5.2 Welfare Expansion and the Principle of Market Dependence before 1997

The shift of the industrial structure during the 1980s and the new political calculation of the government in response to this shift resulted in a process of welfare expansion. The 1980s witnessed a series of social welfare policy adjustments. Democratization in the mid-1980s certainly accelerated the process of welfare expansion. However, the process started as early as the late 1970s, and many of the welfare programs were already legislated before the first presidential election in 1987, suggesting that democratization was part of the outcomes resulted
from the shift of the industrial structure. For example, The Medical Insurance Program (MIP) was introduced in 1973 but it only covered workers from large firms. In the early 1980s, the government expanded the coverage for all industrial workers. After democratization, other programs began to expand. The National Pension Program (NPP) was legislated in 1973 but not implemented until 1989. Both the medical and pension programs became universal schemes in 1989 covering all working population. The Minimum Wage Law was also put into effect in 1989 (Yi and Lee 2005; Shin 2003).

The implementation of pension, medical, and minimum wage programs was considered to be ground-breaking for Korea’s social welfare system (Choi and Kim 1997:550). Other reforms, including the introduction of the Employment Insurance Program (EIP) and expansion of compulsory coverage in the National Pension Insurance, took place during the early 1990s when the second wave of deregulation and liberalization were launched as a response to another wave of economic downturn.

It can be argued that South Korea since the late 1980s and early 1990s has departed from its tradition of being a residual welfare state that assigned almost entire welfare responsibility to individuals and the society. A closer analysis, however, suggests that such a claim is only partly true. On the one hand, these reforms expanded tremendously the scope and the coverage of
social protection. The steady increase of welfare spending since the early 1980s, as shown in Figure 7.1, clearly reflects the government’s attempt to secure its labor force who has become increasingly vulnerable to market fluctuation as the result of the higher level of investment and costs. On the other hand, however, such a transformation does not obscure the fact that the government had deliberately engineered the reforms towards a market-friendly welfare regime and avoided excessive protection.

During the early 1990s, the government remained conservative with regard to social protection. Under the label of the “Korean welfare model,” the reforms aimed to assist its competitiveness-oriented economic strategy. For example, all programs put a greater emphasis on non-state welfare providers, such as families, voluntary organizations, and other types of private provision. Strongly emphasizing welfare pluralism and the family welfare function, the welfare regime during the early 1990s gave priorities to efficiency and low cost in the provision of state welfare.

For example, one such market-confirming measure was the reform of the National Pension Program (NPP) and the introduction of the private pension scheme during the mid 1990s. The NPP was designed to be generous because of the small beneficiaries when the bill was initially introduced. The extension of coverage to farmers and fishermen in 1995, however, made the program financially unsustainable. Under mounting criticism with respect to its long-term
financial stability, reforms took place to reduce the existing income replacement rate of 70% to 40%. At the same time, the government also introduced a personal pension scheme as a measure of private welfare provision in order to compensate the NPP. The government provided tax deductions in order to attract people to the personal pension scheme (Shin 2003:160). Thanks to measures as such, South Korea was able to maintain its welfare spending at a relatively low level compared to most other developing countries, even if its skill level had reached to the average of OECDs by 1995.

7.5.3 The Cost of the Residual Welfare State

The reforms during the 1980s and early 1990s demonstrate that the increased skill dependence led to the expansion of welfare protection. The magnitude of the expansion, nevertheless, was maintained at a minimal level. The new welfare system was carefully designed to be complementary to the competition-oriented development strategy.

This strategy, however, did not come without costs. The welfare reforms before the late 1990s emphasized the enhancement of labor capacity of the active labor force but paid little attention to the risks of unemployment and income security. The result was the delay of the development of social safety nets that are critical for economic sustainability against market fluctuation. One reason for such a delay is that mass layoffs were not common in Korea before 1997. Korea since
1962 had never suffered from high unemployment. Government subsidies and the practice of life-long employment helped firms to avoid lay-offs even in financial difficulty due to business fluctuation (Yi and Lee 2005:152). In addition, the social welfare through extended families and the low level of income inequality that characterized the traditional Korean society in the previous decades made the government inattentive to the potential risks caused by market fluctuations, particularly for those lower on the social ladder. In fact, poverty relief never became a concern for the Korean state but was entirely left to the families and communities.

The 1997 Asian financial crisis has fundamentally changed the government’s – as well as the public’s – perception about appropriate forms of social protection. The economic crisis led to a social crisis that eventually called for further reforms of the social welfare systems. The underdeveloped social welfare system worsened the severity of the economic crisis. In the wake of the crisis, unemployment rates increased dramatically in 1997, from around 2.5% before the crisis, to an unprecedented 8.8% in February 1999, changing from a situation of near full employment to a level that threatened social stability. Life-long employment became unsustainable. The number of temporary and daily workers increased rapidly, accounting for more than 50% of total waged workers after 1999 (Yi and Lee 2005: 157; Shin 2003:179).
7.5.4 Asian Financial Crisis and Establishment of Social Safety Nets: “Move to the Middle” in a Globalized Economy

The new government under Kim Dae-iung, elected the end of 1997 in the midst of the financial crisis, began launching a series of new policies in order to deal with the new economic environment. The most urgent reform was to expand the coverage of the Unemployment Insurance Program to all workplaces, including part-time workers. The entitlement conditions for unemployment benefits were relaxed. The requirement of twelve months contributions was replaced by six months. The unemployment benefit was made more generous in terms of the minimum duration and the amount of unemployment benefits (Shin 2003:182).

In addition to the unemployment insurance program, other insurance programs such as the Industrial Accident Compensation Insurance, the Labor Standard Law, and the minimum wage system began to cover workers in all workplaces. The previously fragmented medical care program was integrated into a unified national health system in 2000 in order to improve efficiency of management. The pension program was expanded to cover the self-employed living in urban areas from 1999, realizing the objective of a comprehensive national pension system covering all of the economically active population over 18.
Another crucial step in the establishment of the social safety nets was the reform of the Public Assistance Program (PAP), which was later replaced by the Basic Livelihood Protection Scheme in 2000. Finally, the living allowance that had been provided only to those unable to work became available to all individuals covered by the PAP. Since 2000, the government began providing living allowances for any individual whose monthly income was less than the minimum living costs decided by the government. The government at the same time took other complementary measures to establish social safety nets, such as creating public jobs and providing job training and special loan programs for the unemployed. The Public Work Program became a crucial income source for daily workers who were not entitled to unemployment benefits.

Similar to what has happened in China and Brazil since the late 1990s, the process of welfare expansion in South Korea after the financial crisis has been dictated by the pressures of globalization, under which, politicians’ political support has been increasingly associated with the enhancement of aggregate social welfare. To survive globalization and maintain a sustainable economy in the long-term, a delicate balance between political contribution and aggregate social welfare, as argued in the endogenous protection theory (Grossman and Helpman. 1994), requires politicians to protect as many social groups as possible but only compensate each partially. All
three country cases illustrate that such a balance has been taken seriously under varying economic and political environments.

Some may argue that Kim Dae-jung’s pro-labor background was the key for the welfare expansion. Such an argument, referring back to the previous chapters, overlooks the structural dynamics underlying politicians’ particular policy choices. Populist and pro-labor leaders may have easier chance to be elected or grasp power under such a circumstance. But the policy orientation by Hu Jingtao in China and Lula in Brazil, both of whom were populist and left-oriented, did not depart from their pro-business precedents substantially. Neither did Kim Dae-Jung’s in South Korea. This is evident in his faithful implementation of structural adjustment programs as well as the reform of social welfare reforms that emphasized on social assistance in an effort to assist the structure adjustment. This also partially explains why the welfare spending since 1997 did not experience a linear increase despite the control of power by the pro-labor party, but instead, after reaching the peak in 2000, went back to pre-1997 level once the economy became stabilized. Rather than the major welfare cutbacks linked to globalization pressures (Rudra 2007:149-150), the reverse reflects a prudent response to globalization.
7.6 CONCLUSION

The welfare transformation in South Korea’s experience of transformation in social protection represents a classic case in which the social welfare system has evolved as an outcome of the interaction between the skill dependence of industrial structure and global economy. As the model has predicted, the South Korean state has experienced an upward trend of welfare protection as the economy has been upgraded from low-skill dependent to high-skill dependent one, with the 1980s being the critical period of transition of the industrial structure. Since the late 1980s, the country witnessed a series of important legislations and policy implementations that led to the expansion of welfare protection. With respect to the common assumptions in the literature about labor movements being the dynamic of the welfare state, the case of South Korea has illustrated that the same dynamics released from the shifting industrial structure also resulted in better organized labor unions and democratization that took place during the late 1980s (Minns 2001).

An important feature, however, sets apart the South Korean welfare state from many other developing countries. It opened its doors to the global economy early, before it could accumulate legacies of protected industries. This leaves a heavy mark on South Korea’s social welfare regime. On the one hand, the conservative side of this feature contributed to the
underdevelopment of certain welfare programs such as social assistance, poverty relief, and unemployment insurance, which are critical for building strong social safety nets to protect all social groups against market fluctuations. State dependency has been played down. This contributes to Korea’s image of a residual welfare state and to the low level of welfare spending from a comparative perspective.

On the other hand, being exposed to world markets from the outset does give Korea many advantages over most developing countries in transforming its welfare regime in the era of globalization. The most noticeable one is that fiscal discipline has been faithfully maintained and has seldom faced serious challenges even during economic and political crises. This fact partly explains the relatively low level of welfare spending that characterizes South Korea’s welfare regime in comparison to most other developing countries. Another advantage is that the shift of the industrial structure in South Korea from a low-skill dependent to high-skill dependent one has, for the most part, been firmly guided by market principles. This has helped the country avoid cultivating a large size of public sector and excessive welfare protection in the early years in order to accommodate the need for promoting heavy industries, which, in most developing countries, was driven by the urgency of industrialization. In both China and Brazil, by contrast, tremendous welfare burdens from the distorted public sector that was cultivated in a closed
economy in the early stage of development become serious obstacles later to the welfare
transformation once the country became integrated into the global economy. In other words,
South Korea has enjoyed low costs for transforming a previous hierarchical welfare system and
moving towards a balanced welfare structure.

In sum, being integrated into the international market proves to be vital in South Korea’s
economic and social transition that has taken place in a relatively smooth way compared to most
developing countries, for example, Brazil, where the costs for transition have been enormously
high, even though the two countries had reached similar level of skill dependence and income
during the late 1980s. The stark contrasts between the two countries in terms of their welfare
transformation and economic consequences suggest that countries have a high price to pay for
disengaging from the global market.
CHAPTER 8

CONCLUSION – “THE WELFARE STATE IN DECLINE?”

Developing countries everywhere today struggle to readjust their social protection systems in response to intensified international economic integration and market competition. Instead of following what the rich developed countries have done to expand the welfare state – a “race to the top” – in order to avoid the possibilities of “globalization backlash,” the general trend of welfare protection instead has appeared to be declining in the developing world. Many scholars and policy makers alike have warned that the governments in these cash-strapped countries are forced into a “race to the bottom,” in which, retaining “footloose” capital in their economies implies the sacrifice of certain social agendas such as labor protection. Has globalization gone too far, as Rodrik (1998) famously puts it?

Evidence, however, suggests that developing countries vary greatly in their behavior with regards to readjusting their social protection systems as they become integrated into the global market. We have seen in many cases that developing countries expand their overall expenditures on social welfare. But in more cases, governments have reduced their overall expenditures while at the same time expanding their welfare coverage to the entire population. As such, these varying policy choices present scholars with important puzzles about the effects of globalization, as well as about the nature of social protection in the developing world. In contrast to the
accepted wisdom of early globalization research, welfare expansion has been less extensive in the more open and capital-scarce economies. Nor is welfare retrenchment the result of heightened integration to the world market. If anything, globalization in these countries has induced governments to readjust their social protection systems so that the overall welfare expenditures can be maintained at a reasonable level that is compatible to the country’s need for market competition and efficiency, while nevertheless providing protection for the majority of the labor force in order to maintain long-run economic sustainability.

The task of this study has been to explain why, how, and to what degree such transformations of social protection occur in the developing world. This study argues that welfare transformation in the developing world must be explained through the interaction of these countries’ integration to global markets and their industrial structures. The skill dependence as a result of industrialization incurs risks that fuel the demand for state protection, which, as an instrument of social insurance, compensates those who are vulnerable to the sifting labor markets. In most developing countries, the most vulnerable social groups to the shifting labor markets are those workers in the sectors with a high degree of skill dependence, because these workers have higher stakes of income losses and transaction costs occurred during the job shifting process. Since skilled workers in most developing countries are a scarce factor, intensified globalization induces these countries to strengthen their comparative advantages with low-skilled labor, thus benefiting the majority of
labor. As a result, globalization produces an equalization effect on the risk distribution in the labor force and lowers the demand for protection. At the policy supply side, politicians seek the opportunities from this structural shift of social preferences to maximize their political support by bringing more social groups under social protection systems, thus resulting in a balanced structure of social spending without incurring excessive protection on any single group.

8.1 FINDINGS

I developed this analysis in Chapter 2 by specifying the important conditions under which globalization can equalize the risk distributions among the labor forces in the developing world. In addition, it specifies the conditions under which skill dependence as a result of industrialization produces an expansionary effect on traditional contributory welfare programs but eventually yields to the reducing effect of globalization as countries become further integrated in the world economy.

8.1.1 Evidence from Quantitative Analysis

The quantitative cross-national analysis in Chapter 3 revealed systematic patterns of variation in the movement toward balanced welfare protection. The findings demonstrate that skill dependence has an expansionary effect on traditional social security and welfare programs but also has a detrimental effect on certain social services such as health care that are critical for
human capital infrastructure. I argue that this occurs because industrialization in most developing countries has relied on a small group of strategically important sectors with high skill dependence. The excessive protection enjoyed by these privileged sectors has led to high levels of traditional welfare expenditures, but the system has been biased against the rest of the society because of financial constraints and political strategies. Globalization, on the other hand, exerts opposite effects. It produces a retrenchment of traditional welfare benefits but also induces governments to invest in human capital infrastructure and productivity. Consequently globalization promotes the transformation of the traditional welfare state into social safety nets that are inclusive and market-compatible. The findings from Chapter 3 also demonstrate that, over the long run, the expansionary impact of skill dependence on traditional welfare spending diminishes as countries become more exposed to the world economy.

Overall, the quantitative cross-national analysis lent significant support to the expectations developed in Chapter 2 that we must pursue a new approach to understanding welfare transformation in the developing world, where the interaction between factor endowments, labor markets, industrial structure, and comparative advantages in international markets place these countries in different positions in dealing with their social protection systems with the mechanisms different than those in the OECD. In Chapters 4 through 7, I test these causal
arguments in three developing countries that are under transformation of both economic and social policies.

8.1.2 Retrenchment of the Welfare State

In all three cases examined, the retrenchment of traditional social security and labor protection entered the political agenda in these countries as part of a general upsurge in confidence in the principles and promises of markets that in many instances followed in the wake of profound failures in the performance of traditional state-run welfare institutions. Market-oriented reforms were buoyed by potent visions of a promised land in which free markets would deliver citizens from the constraints and insecurity of the past, and where competition and entrepreneurship would underwrite sustained economic growth and prosperity. In the realm of social security programs, market-oriented reforms were deemed a gateway to financial and political freedom, higher returns of the contributions, and sustained macroeconomic growth.

The most visible evidence of this logic can be found in the case of the Chinese workers in high-skill dependent sectors, such as large-scaled SOEs and many public sectors. Since 1978, the retrenchment of the welfare benefits and labor protection on these workers has taken place but encountered a minimal level of resistance. The government’s strategies of dealing with the issue, such as gradual reform of labor markets and decentralized measures to cushion the shock of
reforms, certainly played a significant role. However, the job opportunities and prosperity of economic growth brought by China’s rapid integration into the world economy were the underlying forces that lured the workers in these sectors away from welfare protection to market places. Underlying this process has been China’s comparative advantages in its abundant low-skilled workers. The high speed economic growth driven by these low-skilled workers has benefited the high-skilled workers as well.

In Brazil, a similar process has taken place since the 1990s and the mechanisms have been similar. However, the process in Brazil has been much more difficult and protracted, with stronger resistance from skilled workers. In addition to the peculiar factors that characterize Brazil, such as the fragmented political institutions that often produced stalemates during reforms, fundamental problems lay in two factors. The first was the much slower pace of Brazil’s economic integration into the world market. Delayed reforms produced much fewer opportunities but caused more uncertainty. A related factor was the high skill dependence Brazil inherited from its previous industrial policies. This legacy from the “Big Push” has persisted in the new era and produced much costs for transition, thus preventing the country from transforming its industrial structure to a low-skill dependent one in order to take advantage of world markets.
In South Korea, the negative influence of the welfare legacies has been minimal due to the small size of public sectors. The early integration into the international markets helped the country to avoid the investment in high-skilled industries. Despite the attempt of catching up during the 1970s, the “Big Push” plan proved to be unsustainable and was quickly abandoned. The low-skill dependence and high level of trade openness, together, contributed to the residual welfare state in South Korea. For almost three decades from the early 1960s, South Korea was able to maintain a social protection system with a significantly low level of government expenditures while the income level in the country skyrocketed.

In comparison, it is striking to see how similar South Korea before the late 1980s and China after 1978 are in terms of the interaction between their high level of trade openness, low skill dependence, and low level of welfare protection. The comparison between these two cases with Brazil, on the other hand, also strikingly unveils a different scenario, in which high skill dependence and low trade openness, together, produce a high level of protection, which is consequential to the welfare transformation in a globalization environment.

8.1.3 Expanding Social Protection in Low-skilled Sectors

While the retrenchment in the traditional welfare protection is taking place, programs that were downplayed previously, such as social assistance, poverty relief, education, and health care, have
gained increasing emphasis and became the critical components of the strategies to maintain macroeconomic growth and political stability. Again, integration into the global economy is the same dynamic that has brought about stronger compliance with broadening coverage of social protection systems. In all the three cases under examination, the process of broadening coverage of social protection systems began taking place when globalization in these countries became heightened. In all three cases, urgency for such a process became visible since the late 1990s. In China, expectation for the WTO entry was a particular impetus for the change that finally brought large-scaled SOEs into reforms in 1998: lowering the demand for skills and increasing the need for social protection for low skilled workers in the new institutional framework. In Brazil and South Korea, globalization brought in financial crises that fundamentally changed the dynamic toward providing low skilled workers with welfare benefits.

During this period, the reforms of welfare systems for workers in formal sectors reached a stage where lacking a universal scheme of social security and welfare proved to be an obstacle. Workers attempting to fully grasp the opportunities of economic growth were unable to carry their welfare benefits to other sectors. This discourages labor mobility. Universal coverage has become perceived as an important instrument to bring low-skilled workers into a healthy and regulated labor market. The same dynamics promoted other programs such as poverty relief and
social assistance to cover the entire labor force so that macroeconomic growth could take place in a stable environment.

8.1.4 Low Welfare Protection as a Social Choice

All three cases demonstrated that the fundamental change of welfare systems in these countries was a social choice made by major social groups who sought the opportunities brought about by globalization. By inducing workers to adjust their skill levels and consequently lowering the risk gap between workers in different sectors, globalization restructured the social preferences of state protection among major social groups. A structural shift of social preferences signaled politicians the opportunities to adjust their strategies to maximize their political support by taking a balance between the aggregate welfare of the society and the interests of their political supporters.

Again, the interaction between the level of trade openness and the level of skill dependence determines the variations of countries in this aspect. South Korea was the first of these three countries to engage heavily in world markets. With high employment for low-skilled workers, its government found it easy to keep welfare expenditures low. In China, this shift of the structure of social preferences was quick due to the intensified trade openness that introduced low-skill dependent foreign investment; the previously low level of skill dependence quickened this
process. In Brazil, in contrast, this process has been difficult because of the high level of skill
dependence, which weakened the equalization effect of trade openness, though this weakening
effect diminished as the country became further integrated.

8.2 CONTRIBUTIONS TO THE LITERATURE AND THE AGENDA FOR FUTURE RESEARCH

This study contributes to various debates in the literature of both globalization and the welfare
state. By expanding the focus beyond a small number of advanced industrialized countries and
examining the unique experience of welfare transformation in the developing world in the
context of globalization, this study has exposed the limitations of conventional wisdoms in
unveiling the complex relationships surrounding globalization, skill dependence, and welfare
policy choices in the developing world. The findings in this study have pointed to a rich research
agenda for further exploration of the nature of globalization, social protection, and, more broadly,
the relationship between politics and markets in a new environment.

8.2.1 Globalization and Future of Social Protection

The findings in this study have demonstrated that traditional welfare systems have been under
significant challenges from the pressures of globalization. Welfare regimes in countries with
various backgrounds have been under overhaul and readjustment. And cutback on social security and welfare expenditures seems to be a common practice for most developing countries. The current literature suggests that social protection in the developing world is unsustainable in a globalized economy that enhances business power at the expenses of workers. In contrast, this study contends that as developing nations expand their foreign trade in manufacturing goods, their government social safety nets actually grow wider, but flatter. Indeed, former approaches to social protection are often given fewer resources. But other programs of protection become enriched.

In exploring the changing nature of social protection in the new global economic environment, this study suggests a significant refiguring of the so-called globalization-welfare nexus, which is critical for our understanding of the nature of social protection and globalization in the new market environment. It suggests that neither a “race to the top” nor a “race to the bottom” regarding social protection took place in the developing world. It is rather a “move to the middle” in which governments make efforts to adjust their policies in order to maintain a reasonable level of spending and achieve a balanced structure of social spending.

Underlying this movement is the re-conceptualization of the traditional welfare state from an instrument for political privilege to a social safety net. This conceptual leap appears to have
taken place among scholars and practitioners (van Ginneken 2003; Frye 2005). Under this conception, new developments in the international economy have fundamentally changed the social foundations of traditional welfare states both in developing countries and in the developed ones. For example, Esping-Anderson (1999), in his discussion of OECD welfare states in a new economic environment, acknowledges that “[T]he real ‘crisis’ of contemporary welfare regimes lies in the disjuncture between the existing institutional configuration and exogenous change. Contemporary welfare states . . . have their origins in, and mirror, a society that no longer obtains.” In the cash-strapped developing countries, this movement to the middle produces a “miserly” social protection system in terms of benefit levels. This system may have tremendous difficulties fully serving the purposes of protection. However, it nevertheless serves the right purposes of sustainable development.

This “move to the middle” results in the retrenchment of certain welfare programs. However, welfare retrenchment in the developing world should not be viewed through the lenses of the conventional theories based on the experiences of OECD countries. The findings suggest that, the retrenchment is not so much about the retreat of state from its social responsibility, but about the restructuring of the welfare state institutions, and about the structural transformation of social protection from an instrument of decommodification to market governance. That is, the
retrenchment is more than simply a process of taking away benefits and state protection. It revolves around the establishment of new forms of market relations and property rights (Brooks 2009:10). In doing so, welfare retrenchment serves certain purposes which are not entirely detrimental to aggregate wellbeing in these nations.

This certainly does not rule out other factors that render current studies pessimistic about the future of welfare states in these countries, such as budget constraints, which have indeed contributed to state contraction. However, these factors are not the primary driving forces and cannot fully capture the dynamics of social protection in developing countries. Most importantly, the pessimistic predictions associated with these factors fail to explain why developing nations jump on the so-called “free trade bandwagon” (Gruber 2001) if their governments find that such actions are entirely detrimental to the living standards of their population.\textsuperscript{10} The incentives for protection are hinged on the prosperity and market opportunities produced by openness. In fact, the retrenchment of certain types of welfare benefits may, as Brooks (2009) argues with regard to pension privatization, “constitute real possibilities for reward and distributive advantage for those who can benefit from ‘going alone’ rather than from sharing broadly the risk of mischance

\textsuperscript{10}Gruber (2001) argues that many countries, without being bullied or coerced, join international trade agreements that they dislike simply because “going alone” is a worse alternative that would incur higher political costs of exclusion. For a counterargument, see Rodrik (1992).
and poverty in a market economy” (2009: 10). In other words, moderating and adjusting welfare expenditures benefits broader segments of society in developing countries.

This important point sheds new light on the conventional understanding of the future of social protection in a globalized world. Welfare retrenchment has become a general recurring theme in the literature of the welfare state in recent decades. However, the studies have been occupied to a large degree with the question of whether welfare retrenchment has taken place. Instead, the question should be how welfare restructuring has taken place. Welfare is not breaking down or disappearing. It is evolving. Researchers need to break down welfare into its component parts and examine how budget allocations change among them over time. Different parts of welfare budgets have key constituents, and serve different purposes in the globalization process. Changes in the need for high-skilled labor, opening and closing of factories, and many other factors relating to globalization will affect those budget allocations. Globalization inherently needs welfare to remain flexible and viable. Researchers need to focus on such dynamics as they examine the changing nature of social protection in today’s new environment.

8.2.2 Politics and Markets in a Globalized Economy

The structural shift of risk protection from government protection to market governance takes place in a new environment in which the relationship between politics and markets has been
under reconfiguration. Consequently, such reconfiguration calls for the readjustment of our scholarly understanding about this relationship. A substantial number of studies influenced by neo-liberal thinking have argued that state intervention has become increasingly an obstacle or even a damaging force for market operations in a new economic environment. Globalization, in this view, leads to a retreat of state from market intervention. This argument, once again, brings back the old zero-sum assumption in the power resource theories about the relationship between politics and markets. In reality, governments today are actively engaged in market activities in response to pressures introduced by globalization to ever-heightening levels, often with varying degrees of success. Today’s welfare involves the combination of private and public financial commitment, but in every situation, some portions much be paid by government, and even private programs require government regulation. An efficient and balanced spending pattern requires stronger government involvement, commitment, and better skills for handling the complicated situations. In doing so, states are adjusting their role in managing markets and turning their focus on “core activities” that address those problems dictated by major market failures (Barr 2001; Glennerster 1998). State intervention, in this sense, is not being weakened, but rather strengthened, by greater economic integration. However, today’s intervention reflects a new relationship between “politics with markets” produced by globalization, a relationship in which institutional complementarity (Hall and Soskise 2001) becomes pivotal for governments
to redesign and readjust their social and political institutions in order to facilitate their handling of markets.
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