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GLOBALIZATION, INTEGRATION, AND THE EUROPEAN WELFARE STATE

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This paper considers three challenges to the mature European welfare states posed by economic and social integration, demographic changes, and the alleged decline of state capacity in the form of fiscal extraction in an era of globalization. I argue that the experiences of the older member states in the European Union are difficult to reconcile with the common assertions that globalization necessarily leads to a "race to the bottom" where welfare spending is downsized to the lowest common denominator. I develop a set of hypotheses on plausible linkages between demographic challenges, globalization, political capacity, and welfare spending, and test the propositions in an empirical analysis of 14 European Union member states from 1983 to 1998. My empirical results suggest that economic integration does not pose a threat to European welfare states. Rather, demographic changes such as low fertility rates and the aging of the population and their political implications for political leaders' incentives are more serious challenges for the continuation of the welfare state in Europe.

Keywords: Welfare state, European integration, globalization, state capacity

The welfare state presently faces a number of challenges to its continuation, at least in its present form. Many current studies on welfare states agree that many governments have been forced to adopt austerity measures in their economic and social spending in the wake of economic recession. Researchers have identified a variety of reasons, both external and internal,

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that contribute to the stagnation and possible rolling back of the welfare state.[1] In this paper, I discuss some of the main international and domestic challenges confronting the welfare state, and evaluate the ability of states to face these challenges.

Globalization has arguably weakened the nation-state as an economic and political unit, while at the same time increased the power of other alternative political units, such as smaller regions within the nation-states, and the political impact and role of "non-political" actors with purely commercial interests (Cerny, 1999). Likewise, European integration aims to create supranational political and economic institutions that seem to challenge the primacy of the nation state and its effectiveness to regulate the welfare of its citizens.

The ability of states to respond to a changing economic environment is constrained or enhanced by a state's *political capacity*, or a state's ability to implement and enforce policies. Although state capacity in principle could be envisioned and measured along many different dimensions, Arbetman and Kugler (1997, p. 12) hold that revenue extraction is a particularly important aspect of state capacity, as this measurement indicates a government's political reach or power to influence its citizens. States that have greater extractive capacity are more efficient in implementing their chosen policies. These states can clearly assemble and command more resources, the higher the actual tax raised. The actual level of extraction relative to the potential will also tap whether a state has effective means of influencing the life of its citizens and the ability to enforce its policies.

At the domestic level, a rapidly aging population and a shrinking labor force augur markedly higher future costs for maintaining welfare benefits at current levels for most European states. The extended longevity of the populations combined with lower fertility rates in most European countries will increase the number of people over the retirement age entitle to costly pensions and care services, while the economically active population is shrinking, both in absolute numbers as well as a relative proportion in relation to the size of the nonworking population. The growth in the number of entitled will clearly increase the economic and social burden that must be carried by tax contributions from the economically active population.

[1] In this study, I used the terms welfare programs, welfare transfers, and welfare state interchangeably to denote state intervention in the distribution of social and economic and social resources to enhance equity or guarantee a minimum level of income. Welfare transfers include either direct re-allocation of resources such as pensions and direct transfers for segments of the population in need, or financial transfer to provide for unexpected contingencies such as unemployment and sickness. The welfare transfer variable that I apply in the empirical analysis in this paper includes different types of social protection, as defined by the European Commission (2000), Eurostat (2000) and OECD (2000), encompassing pensions, sickness benefits, and unemployment benefits, but not health benefits.

The domestic and international challenges that European countries currently face, also in turn, alter the policy options available to governments for maintaining the current levels of welfare provisions. Many observers fear that increasing financial and trade integration among states coupled with these demographic trends combine to pressure these European governments to downsize welfare provisions, leading to a "race to the bottom" where states cut spending to complete with states offering less generous welfare benefits. Abundant evidence suggests that many of the traditional European welfare states such as France, Germany, and Italy are in the process of shrinking the range and scope of their institutions to remain competitive with other non-European states with fewer such constraints.

Most recent studies on the welfare states have focused exclusively on a single set of challenges to the welfare state—either consequences of globalization or domestic challenges, such as demographic changes. As a result, existing studies have not to date examined how the different internal and external challenges to the welfare state relate to one another, and how they impact the political ability of governments to enforce public policies. To evaluate accurately the future prospects of the European welfare states, one must take into account both the direct and indirect effects of "internal" and "external" constraints on welfare provisions and their impact on the capacity of states. In this paper, I try to address this issue by exploring the impact of both external and internal factors on welfare state provision and simultaneously accounting for their impact on state capacity and political stability, measured as the probability of a constitutional change in executive government.

Despite the common view that globalization poses a major challenge to the welfare state, my analysis suggests that the experiences of states in the European Union countries is difficult to reconcile with the assertions that globalization necessarily must lead to a "race to the bottom" in welfare provision. I find evidence suggesting that neither increasing financial integration nor trade openness must fundamentally undermine state capacity, but actually can give state more leverage in devising social and economic policies to respond to changing social demands. The main challenges to European welfare programs are primarily domestic in nature. Demographic changes such as an aging population can indeed impose severe constraints on the ability of European states to maintain their current levels of welfare spending. However, resources and gains from globalization can help counteract these consequences, and help states enact policies to maintain welfare provisions such as increasing the active population base to finance government services.

The paper is organized in four sections. In the following section, I develop the theoretical argument that motivations this paper. I first discuss in greater detail the internal and external challenges that welfare

states face, focusing on the old member states the European Union. I then relate the welfare state to its broader political dimensions and purposes, and discuss the relationship between state capacity and the future of the European welfare state. The subsequent section develops the research design for testing these propositions empirically, and describes the specific variables and data sources used in the empirical analysis. The next section gives an extended discussion of the empirical results and their implications for the theoretical propositions. The final section concludes the paper and provides some suggestions for future research.

WELFARE STATE IN THE EUROPEAN UNION

Outside the role of economics markets, in most contemporary capitalist economies there are a variety of government services and programs that have a substantial additional impact on the welfare of individual citizens.[2] Welfare spending has been an integral component of the development and consolidation of the states in the developed economies in the world. Pierson (2001a), Manow (2001), and Rhodes (2001) argue that the modern welfare state is not just a protective mechanism against certain particular market failures in capitalist economies, but rather must be considered an integral component of modern capitalism and the social fabric of developed economies[3].

Western welfare states have three primary goals: redistribution, efficiency, and social cohesion. The welfare state distributes either direct funds or services in-kind to secure the working population from contingencies such as involuntary unemployment, sickness and injuries, maternal leaves, and old-age retirement.[4] Welfare programs correct market imperfections (e.g. adverse selection and externalities), while contributing to social cohesion and facilitating political consensus.[5]

[2] In this paper, I use the term "welfare" to denote the specific policies and services provided by the state.

[3] Historians usually credit imperial Germany as the forerunner of modern welfare programs. In the late nineteenth century, Chancellor Bissmarck instituted the first social security legislation in an efforts to shift the loyalties of the working class away from socialism and communism and the labor movement. The provision of social insurance helped maintain political stability and greatly strengthened the German state (Flora and Heidenheimer, 1981 pp. 18–19). On the political factors that shaped the welfare institution, see Korpi (1989), Usui (1994), and Shalev (1987).

[4] The primary recipient of welfare transfers and social security tends to be middle class, which carries significant political weight (Mucller, 2000).

[5] John Mucller (2000), a senior economic advisor and a Reagan Republican conservative, applied simulation and forecasting models to study who does benefit and lose if the Federal Government were to privatize Social Security. To his surprise, the analysis showed that private institutions could not efficiently provide the same degree of stability and security as state supported social security. Single men were the only group who stood to benefit from privatizing social security because they tend to have higher incomes and lower life expectancy.

Governments redistribute resources for two main reasons, either to remain in power or to facilitate the participation of certain segments of the population in economic and social life. In this paper, I argue that the former reason (social cohesion) tends to be more important than the latter (redistribution) for governments, unless there are exceptional political and private benefits involved.[6] This assumption is consistent with Bueno de Mesquita and Root (2000) argument that governing elites redistribute wealth to secure a winning coalition and remain in power. In autocracies, winning coalitions are small, making the redistribution of wealth a private good and an alternative to secure political power. In democracies, by contrast, the larger size of the electorate forces governments to secure winning coalitions through public goods such as comprehensive insurance systems and extensive unemployment benefits. Redistribution can in this context reduce the likelihood that governments will lose power without necessarily reducing income inequality.[7]

Although governments redistribute resources to maintain political stability, they must also ensure that redistribution does not undermine the long-run viability of the political system. Policies to remain in power in the short-run may have adverse long-run effects if welfare programs constrain economic growth. More intense redistribution of resources involves the greater taxation of wealth. Consequently, redistribution causes disincentives to investment, and has a negative impact on economic growth through lower levels of investment (Alesina and Rodrik, 1991, 1994; Perotti, 1993, 1996; Persson and Tabellini, 1994, Meltzer and Richard, 1981).

Welfare states are efficient and viable when the short-term goals of redistributing resources among the members of the winning coalition do not undermine longer-term goals of equity and political stability. The

[6] Goodin and Le Grand (1987) emphasize that some welfare programs function as "redistribution over life cycle." That implies that transfers are not always from the well-off to the less fortunate, but rather transfers that offer security to the well-off. The best example is contributions to pensions where government transfers resources to employees after they retire usually in proportion to their salaries.

[7] An extensive study by the International Labor Office shows that benefits from public expenditures are not equally distributed in developing countries. The decision-making process is remote from most of the rural population, leading to larger differences within countries. The majority of poor households is located in rural areas and receives little support (Lecaillon et al., 1984, pp. 128–130). A more detailed analysis of itemized public expenditures in various countries shows that not all public expenditures enchance redistribution (Lecaillon et al., 1984). Social welfare expenditures may seem progressive, but upon examining the composition of expenditures taken, it is clear that most of social welfare expenditures are pensions. Most recipients of pension in developing countries are civil servants from middle or higher income groups, and poor segments of the population received little of the social welfare transfers. Health expenditures display similar tendencies. Moreover, expenditures on higher education tend to be regressive (Lecaillon et al., 1984, pp. 166–168).

development-path of country's political and economic dynamics determines the policy choices between equity and consensus building. Social cohesion implies that a critical proportion of the population supports the political system that governs the interaction between state and society and provides the political system with legitimacy. Greater popular approval can reduce the risk of political conflict and disruption.

In developed countries, short-term and long-term goals are coordinated by welfare programs combining a more egalitarian income distribution with stable political system and economic development. Welfare transfers are a combination of selective private transfers, targeting politically important segments of the population, and universal transfers. Demographic changes, such as an increasing share of elderly dependents, will alter political demands and "who gets what" within a society. Similarly, unemployment and the growth of female labor modify the composition of welfare recipients and create opposing demands to those of the older population. Whereas much of the existing literature focuses on these tends in isolation, I will consider the overall effects of economic integration, demographic, and social changes jointly on demand for welfare programs, and assess the ability of the European states to respond to such processes. It is pertinent to study the effects both of an aging population and increasing numbers of female labor in European markets to understand the competing interests and pressures that the electorate imposes on the governments. Since the *raison d' être* of the European welfare states has always been political and social cohesion, I cannot evaluate the constraints on welfare programs unless I assess the leeway governments have to strike legislate bargains and build political coalitions before social cohesion erodes.

Economic and Demographic Trends

Aging European Population

Despite the significance of demographic factors on welfare costs and demands, few research designs have taken into account their impact on governments' expenditure patterns and/or have focused on the aging of European populations.[8] Two fundamental demographic changes affect welfare expenditures. The first major social and demographic change is the increasing paticipation of women in the labor force. Barring extensive immigration, women currently constitute the only sources for growth in the labor force for the near future. The second factor is the extended longevity of the European populations, combined with lower fertility

[8] For more on the significance of demographic factors to determine the level of public expenditures and the types of programs and services that the state provides, see Pampel and Williamson (1989, pp. 165–168).

rates. The share of the population under 15 has fallen by one fifth over the last three decades, according to Eurostat. Increasing longevity and low fertility rates combine to increase the demands on the welfare state by both the increasing numbers of retired and pensioners, and shrinking the absolute and relative size of the working population in the long run.[9] These demographic changes and the changes in social norms permitting nontraditional forms of households, e.g., single parent households, cohabitations, challenge the initial structures on which European welfare states were built. As a result, household structures in European countries have undergone a major transformation from a traditional nuclear family of 3–4 members to single-member households. The premise of nuclear families, with husbands as principal breadwinners and women as the principal care providers for elderly and children, still remains the general foundation of the welfare institutions.

Long-term Unemployment

Europe has historically had much less unemployment than the United States. However, beginning in the mid-1980s, most European states saw a dramatic increase in the rates of unemployment, in many states leading to rates well above the U.S. average of 6.21% (Sjöberg, 2000, p. 59).[10] Changes in the institutional structure of labor markets in the late 1960s and early 1970s, motivated by concerns of equity and income distribution, led to more rigid labor markets and increased unemployment in the major European economies (i.e., France, Germany). New rules on working time, more generous and accessible unemployment benefits, and restrictions on lay-offs reduced the difference between the lowest wage and unemployment benefits in many European countries (Siebert, 1997). These institutional changes affected the cleaning capacity of labor markets, as the demand for labor weakened and labor supply was distorted (Siebert, 1997). The long-term effects of the labor market rigidities were twofold: a failure to meet global competitive standards, and rising long-term unemployment in many European countries. Without greater wage flexibility and institutional structures that are supportive of job supply, unemployment is likely to remain high with devastating social consequences. Long-term unemployed people generally lose their skills and qualifications relative to those recently employed (Siebert, 1997, p. 53).

Despite the common belief that welfare programs are the "usual suspects" in rising unemployment, empirical studies lend little support to that argument. The direct effect of welfare benefits on unemployment is rather marginal, while the institutional structure of unemployment benefits might contribute to labor market rigidities (Sjöberg, 2000, p. 71). Many

[9]Fertility rates also decline due to the increasing numbers of divorces and lower rates of marriage.

[10]Nevertheless, not all of the European countries follow the same patterns in unemployment rates and some of them actually have much lower rates than the United States.

European countries, in particular the Mediterranean countries Italy, Greece, Spain, and Portugal, face problems of high unemployment among people under 25, even though welfare programs in these countries are rather limited compared to Northern Europe.

Female participation in the labor force compounds the problems of increasing unemployment. Female labor is of particular interest, as the majority of women continue to be employed in occupations that are low-paid and lack job security. Even in the most developed European welfare states, women have to balance the dual roles of family and career. Higher levels of unemployment among young people and women can create political pressures on governments and their choices regarding welfare programs. Future changes in labor supply can dramatically alter demographic structures in European countries and vice versa. The linkage between changes in the European labor force and demographic structures attest to how any examination of welfare programs in the European labor market must include not only each of the forces but also how they interact simultaneously (European Commission, 200, p. 63).

Globalization and Economic Integration

Globalization is widely believed to threaten the survival of the welfare state Rodrik (1997) argues that globalization in its economic expression makes it more difficult for governments to maintain social integration and social cohesion through welfare policies. Schwartz (2001, pp. 43–44) argues that even though the formal structures of welfare programs remain intact, new strategies and global methods of production have eroded traditional political and property rights and put pressures on firms to outsource production outside of the European markets. Schwartz's argument does not postulate a dichotomy between "internal" and "external" causes of welfare decline, and it does not point at globalization as the main culprit of the decline of the welfare state. Rather, Schwartz argues that market pressure and competition erode traditional property rights, which emerged after the industrialization period, and favor new actors with different kinds of property rights and different policy preferences (Schwartz, 2001, p. 44).

In principle, globalization allows for greater labor flexibility, where the unemployed can relocate to different regions, and competitive markets will clear unemployment.[11] The movement of labor undermines social cohesion

[11] In the 2000 opening of the World Economic Forum in Davos, Switzerland, Swiss President Adolf Ogi states that ordinary people's "feelings have been evident in Seattle and, if we are honest with ourselves, we all know that this is not the last we have heard of it. There is no longer any possibility for economists to escape social responsibility"(Higgins, 2000). The large demonstrations in Gothenbrug and Geneva in 2001 and Barcelona in 2002 similarly attest to the widespread dissatisfaction with globalization.

and the foundation of the national welfare programs. This labor mobility remains an issue of contention within the European Union where the states maintain their exclusive rights in administering the national welfare programs. Moreover, the alleged effects of globalization on state capacity contribute to the weakening of the welfare state. The effects of globalization suggest the presence of a "race to the bottom" and retrenchment in welfare programs in developed capitalist economies as an adjustment to compete in the global economy (Pierson, 2001b; Schwartz, 2001; Iversen, 2001).

Despite the pressures from both the international markets and conservative regimes such as the United States under Reagan and Great Britain under Thatcher, the institutions of the welfare states have remained surprisingly resilient. Pierson (1996, p. 179) attributes the survival of the welfare states to cautions government policies that have tried to avoid direct confrontation with relevant actors. Some hold that the detrimental consequences of globalization for the welfare state have been greatly overstated. Swank (2001) focuses on how preexisting domestic institutions have been able to respond to market actors who promoted deregulatory policies and privatization. Pierson (2001a) and Iversen (2001) point out that the halt of deindustrialization process and domestic pressures on mature welfare states explain the stagnation observed since the 1970s.

The ability of European states to respond to the changing social and demographic environment is constrained by a state's political capacity or its ability to implement policies. The current domestic and international challenges European countries face alter the available governmental policy choices. Increasing financial and trade integration and demographic trends create both new pressures as well as policy options. As European democracies maintain political power through democratic electoral procedures, increasing economic integration may also alter the political capacity of the European governments to carry out welfare state programs. Similarly, competing demands from local groups lead to structural changes in welfare programs, but not necessarily to "a race to the bottom." As long as European states maintain their control over domestic social cohesion will also remain the fundamental goal behind welfare programs.

HYPOTHESES AND RESEARCH DESIGN

Hypotheses

In this study, I explore the impact of both external and internal factors on welfare state and simultaneously account for changing levels in state capacity and probability of a constitutional government change.

Figure 1 illustrates and suggests that the two indicators of globalization—trade openness and foreign direct investment—should have a dumping effect on welfare transfers, as it is expected by the literature that supports a "race to the bottom" effect. Similarly, increasing economic integration and globalization of production are expected to reduce state capacity, the ability of states to respond and adapt to the external challenges.

H1: Higher levels of trade openness and FDI reduce welfare transfers.

H2: Higher levels of trade openness and FDI reduce state capacity.

The decline in state capacity due to increasing integration has a spiraling negative effect on welfare transfers as the countries have less policy option to implement economic policies (e.g., the European countries loose all their monetary policy instruments). Most importanty, a decline in state capacity threatens the ability of governments to remain in power, unless the government can satisfy the demands of various political and economic interest groups.

H3: Lower levels of state capacity reduce welfare transfers.

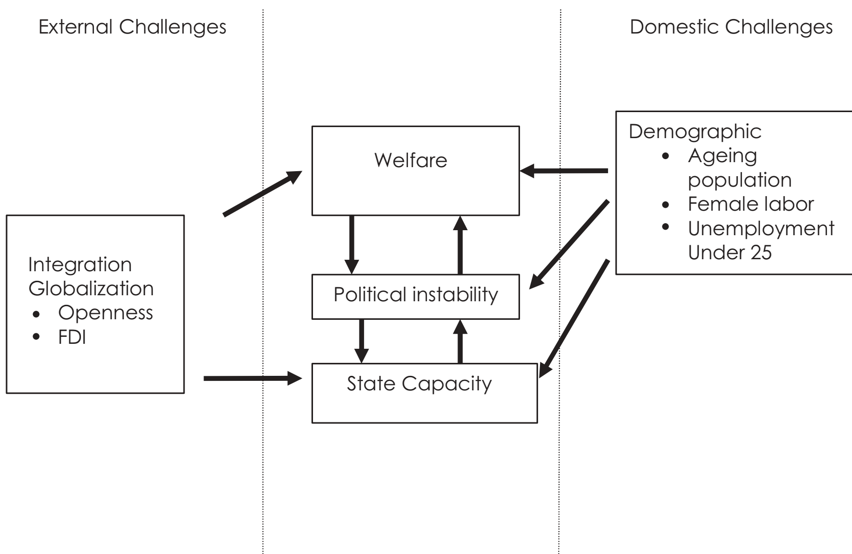

Figure 1. External and internal challenges to welfare, state capacity, and instability.

H4: Lower levels of state capacity increase the likelihood of government change.

Following the line of through that European governments still need to be responsive to the demands of the electorate, H5 and H6 link the demands of specific groups to an increase in welfare transfers. If in the European labor market labor growth comes from women, then the demands for easier access to child care and family leave will expend and increase. The same goes for levels of unemployment, especially in the Northern European welfare states, where the family does not play a very active role in providing income security. The pressures of unemployment might be lower in Southern Europe where families still protect the individual members of the family.

H5: Higher levels of total unemployment and female labor increase welfare transfers.

The population over 64 is the largest recipient of welfare transfers, either in the form of pensions or in the form of medical and health insurance. So the expectation is that demands on European welfare states will increase as the European population ages. The increasing demands from the older segments of the population will compete, though, with the demands of female labor and unemployed as each group has different needs to satisfy. Hence, even though the direct effect of the aging of the population might be positive on welfare transfers the type of programs can vary, according to which group has higher electoral power. In this paper, I only deal with the direct impact on the overall level of welfare transfers rather than specific programs.

H6: Higher percentage of people 64+ increases welfare transfers.

This paper postulates that political stability and social cohesion are the two most prominent motivating forces behind the establishment of the European welfare states. Unless we can make an argument that the relationship between citizens and the national state has eroded in the European countries, the political calculus of the governing elites will include welfare transfers. Hence, I expect that a government at risk of losing power will increase welfare transfers, at least toward their support groups. Reversing the argument the expectation is that higher level of welfare transfers will reduce the likelihood of government change and will increase state capacity, as the state maintains an active role in the redistribution of resources.

H7: Higher levels of welfare transfers reduce the likelihood of government change.

H8: Higher levels of welfares transfers increase state capacity.

H9: Higher likelihood of government change increases welfare transfers.

H10: Higher likelihood of government change reduces state capacity.

Estimation Method and Data Description

To test hypotheses 1–8, I estimate the following set of simultaneous equations on pooled data on 14 European countries from 1983–1988.

$$
\begin{aligned}
W &= \gamma_w P + \zeta_w SC + \alpha_w X_w + \varepsilon_w \\
P &= \gamma_p W + \zeta_p SC + \alpha_p X_p + \varepsilon_p \\
SC &= \gamma_{pc} W + \zeta_{pc} P + \alpha_{pc} X_{pc} + \varepsilon_{pc}
\end{aligned}
\tag{1}
$$

Where
W = level of welfare transfers,
P = probability of major regular government change,
SC= state capacity,
X = other predetermined variables, which include ratio of population over 64, economic growth; levels of female employment, levels of unemployment among the under 25, degree of financial integration (globall), trade openness, contract intensive money (CIM) which accounts for property rights, and percentage of electoral votes for leftist parties (leftv).
ε = error terms.

Although Austria, Finland, Portugal, Spain and Sweden became members later than 1983, I assume that either they were already undergoing social and economic convergence, or they were in comparable levels of development to the existing members, prior to joining the European Union. Being an outlier, Luxembourg is excluded, due to the combination of its small size and population and the highest GDP per capita in the European Union

To estimate the interactive effects between welfare transfers (W), state capacity (SC), and political stability (PS), I use three-stage least-squares (3SLS) estimation, which allows the error terms of the three equations to be correlated. The procedure requires three steps: 1.) calculate the 2SLS estimates of the identified equations; 2.) use the 2SLS estimates to estimate

the structural equations' errors and then use these to estimate the contemporaneous variance-covariance matrix of the structural equations' errors; 3.) apply GLS to the large equation representing all the identified equations of the system.

The 3SLS estimator is consistent and in general is asymptotically more efficient than the 2SLS estimator. If the disturbances in the different equations are uncorrelated, so that the contemporaneous variance-covariance matrix of the disturbances of the structural equations is diagonal, 3SLS collapses to 2SLS (for more details, see Greene, 1990). Since data on relative political capacity and political instability were not available for 1995 to 1998, I extrapolated estimates for 1995 through 1998, based on country-specific trends.

Any simultaneous equations model is sensitive to specification problems. The choice of exogenous variables was based on previous research (Feng and Gizelis, 2002; Feng et al., 2000; Iversen, 2001; Pampel and Williamson, 1989; Swank, 2001; Siebert, 1997; Sjöberg, 2000) that identifies variables and competing hypotheses on political stability, state capacity, and welfare transfers. The proposed theoretical model tries to capture the key socioeconomic and demographic process currently evolving in European states. Most of these processes are interconnected and influence governmental policies. It makes sense, both theoretically and empirically, look at how these variables are interrelated and determine the policy choice of the European countries. Using simultaneous equations, I can identify the cross effects of state capacity and political stability on welfare transfers and vice versa controlling for degrees of economic integration, demographic changes, and unemployment levels.

Welfare Transfers (W)

Various indicators have been adapted to measure welfare programs. Some studies use government expenditures, exclusive of military and educational expenditures. Other studies focus on health care, social insurance transfers, and pensions. The IMF's *Government Finance Statistics* defines welfare transfers, based on a narrow definition of welfare expenditures and social security as transfer payments compensating for a reduction or less of income. While social security expenditures consist of pensions and retirement benefits, by far the largest component of welfare state transfers, welfare payments are provided as assistance to groups with special needs, such as old people and the handicapped (*Government Finance Statistics*, 2001, pp. 71–72).

Eurostat uses a far more integrative definition of welfare expenditures that includes both private and public institutions. The Eurostat data include "all interventions from *public and private bodies* which intend to relieve households and individuals of the burden of a defined set of risks

or needs provided that there is neither a simultaneous reciprocal nor an individual arrangement involved. The list of risks is fixed by convention as; sickness/health care, disability, old age, survivors, family/children, unemployment, housing, social exclusion not elsewhere classified" (*European Social Statistics*: *Social Protection*, 1980–1998; European Commission, 2000, p. 7). Social protection expenditures can be broken down into social benefits, administration costs, transfers to other schemes, and other expenditures. In the context of this study I use the Eurostat measurement, since it is the primary statistical service for the European Union.

State Capacity (SC)

State capacity consists of two related concepts; a) political extraction and b) political reach (Arbetman and Kugler, 1997, p. 12). Political extraction involves ability of a government to gather necessary resources to implement its policies. Political reach pertains to government's ability to influence its population. Developed countries will already have high levels of state capacity. Hence, higher level of welfare transfers may in some sense indicate a decline in political extraction, since developed countries have reached their maximum level of extractive abilities (Willett, 1997). Kugler (Kugler et al., 1998–2001) has developed a measure of state capacity, Relative Political Capacity (RPC), and it is based on the ratio of a state's actual government revenue to the predicted revenue.[12] The RPC ratio is a measurement of the ability of governments to penetrate society and to extract resources. States that have higher levels of RPC are more efficient to implement policies, not only because they acquire more resources, but also because state mechanisms are more efficient in accessing the population.

Probability of government change (PS)

Feng (1997) provides estimates for several patterns of political instability. The first is regime change, which alter the norms and the institutional structures of the political system. The second pattern is political realignments, which reflect changes in the political parties or executive in control, but not fundamental changes in the political system. Feng (1997) has estimated the probability of government change, which takes a value of one if a change occurred in the control of the executive, and zero otherwise, using limited dependent variable model (logistic regression) over pooled

[12] The predicted revenue is estimated using the following regression equation:

$$Tax/GDP = \beta_0 + \beta_1(time) + \beta_2(mining/GDP) + \beta_3(agricultural/GDP) + \beta_4(Exports/GDP) + \varepsilon$$

(Kugler, et al., 1998–2001).

time-series cross-national data. The probability of government change is a function of a group of economic variables (inflation, previous levels of consumption, income); political variables (coups, riots, assassinations, strikes), and political structure variables (executive selection, selection of legislature). All of these variables capture different sources of political instability. In the estimation of the political stability, the economic variables reflect the overall economic performance of the government, whereas the political variables are indicators of imminent dissatisfaction with the political system (or the government). The political structure variables capture systemic instability (Feng, 1997). The fitted values of the logit model are used to estimate the probability of government change for each country. To explore the dynamics between the welfare state and likelihood of government change for the developed and stable democracies of the European Union, Feng's typology provides a useful measurement to capture major government change, where succession is determined by clear and widely respected electoral rules

Control variables

Globalization, Economic Integration, and Demographics. The ratio of exports plus imports to nominal GDP is often considered as an indicator of interdependence. Data on trade openness are available from the World Penn Tables and the Eurostat. However, this measure of economic integration and globalization cannot capture the effects of capital flows across national borders, such as the surge in communications and interactions, which is perhaps the major trait that distinguishes contemporary globalization from the high levels of trade and interconnectedness in the period before World War. Foreign Direct Investment within each country is the best available proxy, in time-series for all of the 14 European countries, as it indicates the freedom of transferring resources form one country to the other. Data on FDI are available from both the IFS and OECD.

The demographic variables (percentage of population over 64, percentage of female labor, and unemployment under 25) come from the Eurostat *Statistical Yearbook* (1989 and 2000 editions).

Additional exogenous variables. Besides the exogenous variables that are derived from the theoretical argument (e.g. globalization and demographic variables), the remaining exogenous variables (economic growth, CIM, Left Government, and total population) estimate competing hypotheses regarding changes in the levels of welfare and state capacity. The socio-economic data are available from the Eurostat *Statistical Yearbook* (1989 and 2000 editions), the *International Labor Statistics,*OECD, and the *World Development Indicators*, World Bank.

The Left variable (leftv) is the left party vote proportion of total votes, compiled by Swank (1998).[13] The inclusion of this variable is relevant, since the common assumption is that social democrats and leftist parties have stronger attachments to labor unions. As a result they will be more receptive to pressures to increase unemployment benefits, and even improve child care. Contract Intensive Money (CIM) is a measurement of property rights and reliability of governmental policies. Data on CIM can be found in Clague, et al. (1999). CIM= (M2-COB)/M2, where COB is currency outside banks. Generally, individuals keep a larger portion of their assets in currency if they do not rely on contracts and banking institutions. I use CIM to capture institutional constraints that can explain the reduction or increase in the state capacity variable and the ability of the state to extract resources from society. Clearly, if people have concerns regarding the reliability of governmental decisions, they will maintain their assets in currency, which is harder to be assessed and taxed by the governments.

ANALYSIS AND DISCUSSION

The core argument in this study is that social protection is critical for effective governance even under the stress of intensifying economic integration. In Europe, welfare states were essential in building political consensus and sustainable economic growth. The issue that arises from the integration process within the European Union is whether this political perspective is going to persist in the twenty one century or the pressures of economic globalization, demographic changes, and withering state capacity are going to alter the policy choices available to the governments. This study provides an explanation of why arguments of "social dumping" and "race-to-the bottom" do not apply in the case of the European welfare states. Moreover, the empirical analysis shows that the process of economic integration, even on the eve of the introduction of the Euro, has not been a threat to the social and economic rights of European citizens so far.

EXTERNAL CHALLENGES: GLOBALIZATION

H1 and H2 postulate that globalization has a dumping effect on welfare transfers and state capacity. The empirical analysis of the 14 European

[13]Some studies—notably Hicks and Misra, 1993—show that the ideology of the governing party accounts for differences in the levels of welfare spending. The most common argument is that social democrats favor welfare institutions, while conservative governments try to minimize the size of the government. However, welfare programs have been established not only by social democrats, but many conservative governments as well, as in the UK after World War I and the fascist regime in Norway during World War II. It is important to note that the very first welfare institutions were established by Bismarck.

countries shows that the reality is more complicated. The "race to the bottom" effect is actually refuted by the empirical analysis.

Increasing economic integration has no direct negative effect on welfare transfers. Trade openness has even a positive and significant effect on welfare transfers and F.D.I. has a positive and insignificant effect. The lack of evidence of any negative impact of globalization indicators is also evident in equations 2 and 3 (Constitutional Government Change and State Capacity respectively). This might seem a puzzling result, given the common beliefs that increasing integration reduces both the levels of state capacity and the size of welfare transfers, but confirms the argument of this paper that welfare programs in the European countries have a clear political goal. It is hard to imagine that even under the increasing pressures of globalization European states will give up welfare states and through welfare states the ability to intervene in society.

Despite the introduction of the European Monetary Union (EMU) and policies such as the Stability and Growth Pact, Rhodes (2002), examining the raw data on welfare expenditures as a percentage in the Eurozone for the period 1990–1997, argues that there is no retrenchment process of the continental model of European welfare state (*vis-à-vis* the Anglo-American model). While European countries, such as Sweden, Netherlands, Belgium, and even Italy, reduced governmental expenditures, they were careful not to touch their elaborate welfare programs. In the period 1990–1997 there was a convergence of nonwelfare expenditures for all European countries, while large welfare programs remained intact. Even the poorer Southern European countries, such as Italy, Greece, and Spain, have steadily increased their welfare spending as a proportion of total benefits, while the governments were careful to shape up the economies to meet the stringent "Maastricht criteria" (Rhodes, 2002, pp. 316–317). The case of Greece, which joined the EMU in the eleventh hour, is interesting since there has been a clear upwards trend in social expenditures at least for the period 1993–1997.

The ability of the European states to maintain their welfare programs can be attributed to the autonomy the states have over national taxation and fiscal policy (for more details see Lesage (2001), even controlling for higher levels of financial and trade integration. Moreover, trade openness can provide governments with additional income to finance welfare programs that suffer from the increasing burden of their ageing populations.

It is also interesting that neither trade openness nor increasing levels of F.D.I. has a significant direct impact on state capacity. Given the positive impact that trade openness has on the levels of welfare transfers, the net impact of trade openness is positive for the European states' state capacity. Property rights (CIM) do not seem to account for levels of state

capacity in this system of simultaneous equation, refuting previous argument by Schwartz (2001) that under the pressures of globalized markets groups lose their property rights, and the income stream attached to these rights.

Hypotheses 3–4 and 7–10 postulate the effect of the endogenous variables on one another. Consistent with Hypothesis 3, the empirical results reveal a direct relationship between state capacity and welfare transfers, as state capacity has a positive direct effect on welfare state provision. Similarly, welfare transfers increase state capacity (consistent with Hypothesis 8) and decrease the likelihood of government change (as suggested by Hypothesis 9). This empirical result is clearly consistent with the argument presented in this paper that welfare transfers are an important component for political stability and social cohesion in European states. However, contrary to Hypothesis 4, I find that a positive and significant effect of state capacity on the likelihood of the government change. Likewise, the results do not support Hypothesis 10, which postulates that the likelihood of government change should reduce state capacity, as the empirical analysis suggests a positive and significant effect of higher probabilities of government change on state capacity.

DOMESTIC CHALLENGES TO EUROPEAN WELFARE STATES

If the external challenges are not a real threat for European welfare states, demographic and social changes should be the real concern for policymakers. Per H5 and H6 higher numbers of female labor and older people will increase demands on welfare states. As Table 1 shows, the empirical analysis confirms H5 regarding female participation in the workforce. During the last twenty years, there has been a constant increase of women entering the workforce even among women of childbearing age. This social change is not uniform among all the European states; marital status and number of children are still deterring factors for women to participate fully in the economic life in Southern European countries, where interestingly enough fertility rates are the lowest ones in the European Union.[14] Yet, the overall increase of female labor is evident even in those countries. The economic participation of women creates an additional demand for child care policies. Clear evidence that care is a major contributing factor for women's lower participation rates is provided by the percentage of single mothers who

[14]Integrated welfare institutions are not developed either in the southern European states, where families used to have the primary role of caretakers, or the United Kingdom. As more women enter the workforce, the ability of families to provide care to the elders will be reduced, creating an urgent necessity for the welfare states to provide decent living conditions for those 65 and over.

Table 1. Joint Estimates of Welfare Expenditures, State Capacity, and Government Instability

Welfare expenditure	**Coefficient Estimate**	**Stand Error**	**Z**	
Foreign direct Investment	0.565	0.503	1.120	
State Capacity	34.473	8.717	3.950	
Constitutional Govt Change	30.229	34.160	0.880	
Unemployment 25 (%)	0.116	0.058	2.000	
Female Labor (%)	0.724	0.236	3.070	
Population over 65 (%)	0.141	0.544	0.260	
Left Gvt	0.192	0.120	1.600	
Trade Oppenness	12.890	5.197	2.480	
Population	–0.029	0.028	–1.010	
Constant	–73.739	27.580	–2.670	
Constitutional Govt Change				
Welfare Exp	–0.015	0.004	–3.710	
Foreign direct investment	0.002	0.006	0.280	
Trade Oppenness	–0.004	0.025	–0.150	
Economic Growth	–0.006	0.005	–1.070	
Unemployment 25 (%)	0.000	0.001	–0.730	
State Capacity	0.244	0.130	1.870	
Population over 65 (%)	0.017	0.006	3.050	
Population	0.000	0.000	1.450	
Constant	0.097	0.250	0.390	
State Capacity				
Welfare Exp	0.030	0.008	3.720	
Population over 65(%)	–0.042	0.014	–2.880	
Constitutional Govt Change	3.182	0.702	4.530	
Foreign direct investment	–0.014	0.016	–0.830	
Trade Oppenness	0.069	0.083	0.830	
CIM	0.782	0.741	1.050	
Population	–0.002	0.001	–1.530	
Constant	–0.405	0.817	–0.500	
Equation	Obs	RMSE	Chi2	P
Welfare Exp	266	7.690	73	0
Constitutional Govt Change	266	0.121	92.21	0
State Capacity	266	7.395	63.59	0

remain economically inactive. This situation is the case particularly in the UK and Ireland, where only half of the single mothers with children under the age of five are employed, a figure that is much lower even among married women who have children (European Commission, 2000, p.11). Women overwhelmingly occupy part-time jobs. Part-time employees do not participate in welfare state contributions and are not entitled to have social benefits;

therefore, they do not contribute to the financing of the welfare programs. As more women enter the work force, the pressures for welfare programs catering to their needs will also increase. Similarly, unemployment among young people increases demands on unemployment benefits.

The most interesting and counterintuitive result is that H6 (impact of population over 64 on welfare transfers) is not confirmed by the empirical analysis. Unlike the results of most of the previous studies, the higher number of older people has no significant direct impact on welfare transfers, but there is evidence that the aging of population is a burden on European welfare states. The aging of population reduces state capacity and increases political instability. Older people have stagnant or shrinking incomes, reducing the available tax basis for governments. Hence, higher numbers of citizens over 64 have adverse effects on how much the government can offer to citizens, while the burden of supporting the state and its programs is shifting to the shrinking working population (the ratio now is one person over 64 to four people of working age, while the projection for 2020 is going to be a one to three ratio and by 2040 it will be a one to two ratio). Moreover, as Table 1 shows, older people tend to be active participants in the electoral process and are willing to vote out governments that do not satisfy their demands (see in Table 1, the positive and significant coefficient of population over 64 on Government Change). The projection is for higher numbers of older voters who will favor programs that cover their needs rather than those of unemployed or female labor.

The problems of the European welfare states are getting even worse due to early retirement programs for specific professions and a large portion of population that remains unemployed during the productive years of 15–64. Aside from women who either do not enter the workforce or exit quite early (in some European countries like Greece, married women with kids have until recently had substantial benefits and an early retirement age), there is a portion of men who are also unemployed of exit the workforce at quite a young age. In the European countries, only 60% of the working age adults are fully employed, and although women consist of the majority of nonactive economic population, one third are men, and 7% are unemployed (European Commission, 2000).

The real challenge for European welfare states comes from within as they will be forced to restructure and reshape the existing welfare institutions to meet the future demands of the population. The competing interests and demands of younger people and women vs. the older and retired population, along with the shrinking of economically active populations, poses the real threat for the future of European welfare states. In this process increasing economic integration can be an asset rather than a liability for the European governments.

CONCLUSION

The notion that European welfare states have become obsolete seems premature given the empirical evidence presented in this study. I postulate that the process of European integration has not altered the basic political calculus of governments to use welfare states to maintain political power and enhance political stability. To test the hypotheses empirically, I apply a simultaneous equations' model. The first major finding is that the globalization indicators either have no direct impact on welfare transfers (Foreign Domestic Investment), or the direct effect is positive (trade openness). This result suggests that currently there is no "race to the bottom" among the European welfare states. The second major finding is that the real constraints for policy-makers come from domestic challenges, primarily demographic changes. The aging of the European populations crates a burden on welfare states since it reduces state capacity. Moreover, as the demand for additional labor is increasing and women become the target group, governments face competing demands over welfare programs that increase social and political tensions. Ironically, further economic integration can provide governments with additional resources to face off some of the future constraints on welfare programs. A policy option is to facilitate the active participation of women in the labor force, restructuring the welfare programs away from the traditional model, which has been based on a nuclear family with the father being the primary breadwinner.

The introduction of the Euro in 12 out of the 15 European members of the European Union and the admittance of 10 new member countries in December of 2004 will bring unprecedented turbulences in European social systems. Of primary importance are the differences in economic and political structures between the original 15 members and the 10 newly admitted ones, most of which are former Communist economies. The implications of such processes in the long-term viability of the European welfare states need to be assessed.

As this study points out, welfare transfers remain a political choice controlled very much by domestic factors, such as unemployment, ageing of population, and female labor. The study can be improved by separately looking at different components of welfare programs and health expenditures and identify the impact that demographic trends have on their future. Even though simultaneous models can be very sensitive to specification, the presented empirical results indicate that the interaction of demographic factors with the ability of the states to reach the populations should be an important component in the study of welfare states in the face of increasing economic and political integration.

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