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Martin Wolf

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DEFINING GLOBALIZATION

A SPECTER is haunting the world's governments—the specter of globalization. Some argue that predatory market forces make it impossible for benevolent governments to shield their populations from the beasts of prey that lurk beyond their borders. Others counter that benign market forces actually prevent predatory governments from fleecing their citizens. Although the two sides see different villains, they draw one common conclusion: omnipotent markets mean impotent politicians. Indeed, this formula has become one of the clichés of our age. But is it true that governments have become weaker and less relevant than ever before? And does globalization, by definition, have to be the nemesis of national government?

Globalization is a journey. But it is a journey toward an unreachable destination—"the globalized world." A "globalized" economy could be defined as one in which neither distance nor national borders impede economic transactions. This would be a world where the costs of transport and communications were zero and the barriers created by differing national jurisdictions had vanished. Needless to say, we do

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MARTIN WOLF is Associate Editor and Chief Economics Commentator at the *Financial Times*. This paper is based on "The Nation State in a Global World," presented at the Harry Oppenheimer Colloquium on Globalization, funded by the Ernest Oppenheimer Memorial Trust, in Stellenbosch, South Africa, in February 2000. Excerpts will appear in the winter 2001 issue of the *Cato Journal*.

not live in anything even close to such a world. And since many of the things we transport (including ourselves) are physical, we never will.

This globalizing journey is not a new one. Over the past five centuries, technological change has progressively reduced the barriers to international integration. Transatlantic communication, for example, has evolved from sail power to steam, to the telegraph, the telephone, commercial aircraft, and now to the Internet. Yet states have become neither weaker nor less important during this odyssey. On the contrary, in the countries with the most advanced and internationally integrated economies, governments' ability to tax and redistribute incomes, regulate the economy, and monitor the activity of their citizens has increased beyond all recognition. This has been especially true over the past century.

The question that remains, however, is whether today's form of globalization is likely to have a different impact from that of the past. Indeed, it may well, for numerous factors distinguish today's globalizing journey from past ones and could produce a different outcome. These distinctions include more rapid communications, market liberalization, and global integration of the production of goods and services. Yet contrary to one common assumption, the modern form of globalization will not spell the end of the modern nation-state.

THE PAST AS PROLOGUE

TODAY'S GROWING INTEGRATION of the world economy is not unprecedented, at least when judged by the flow of goods, capital, and people. Similar trends occurred in the late nineteenth and early twentieth centuries.

First, the proportion of world production that is traded on global markets is not that much higher today than it was in the years leading up to World War I. Commerce was comparably significant in 1910, when ratios of trade (merchandise exports plus imports) to GDP hit record highs in several of the advanced economies. Global commerce then collapsed during the Great Depression and World War II, but since then world trade has grown more rapidly than output. The share of global production traded worldwide grew from about 7 percent in 1950 to more than 20 percent by the mid-1990s; in consequence, trade ratios have risen in almost all of the advanced economies. In the United Kingdom, for example, exports and imports added up to 57 percent of GDP in 1995 compared to 44 percent in 1910; for France the 1995 proportion was 43 percent against 35 percent in 1910; and for Germany it was 46 percent against 38 percent in the same years. But Japan's trade ratio was actually lower in 1995 than it had been in 1910. In fact, among today's five biggest economies, the only one in which trade has a remarkably greater weight in output than it had a century ago is the United States, where the ratio has jumped from 11 percent in 1910 to 24 percent in 1995. That fact may help explain why globalization is more controversial for Americans than for people in many other countries.

Second, by the late nineteenth century many countries had already opened their capital markets to international investments, before investments, too, collapsed during the interwar period. As a share of GDP, British capital investments abroad—averaging 4.6 percent of GDP between 1870 and 1913—hit levels unparalleled in contemporary major economies. More revealing is that the correlation between domestic investment and savings (a measure of the extent to which savings remain within one country) was lower between 1880 and 1910 than in any subsequent period.

Historical differences exist, however. Although current capital mobility has precedents from the pre–World War I era, the composition of capital flows has changed. Short-term capital today is much more mobile than ever before. Moreover, long-term flows now are somewhat differently constituted than in the earlier period. Investment in the early twentieth century took the form of tangible assets rather than intangible ones. Portfolio flows predominated over direct investment in the earlier period (that trend has been reversed since World War II); within portfolios, stocks have increased in relative importance to roughly equal bonds today. And finally, before 1914, direct investment was undertaken largely by companies investing in mining and transportation, whereas today multinational companies predominate, with a large proportion of their investment in services.

Today's high immigration flows are also not unprecedented. According to economists Paul Hirst and Grahame Thompson,

> the greatest era for recorded voluntary mass migration was the century after 1815. Around 60 million people left Europe for the Americas, Oceania, and South and East Africa. An estimated ten million voluntarily migrated from Russia to Central Asia and Siberia. A million went from Southern Europe to North America. About 12 million Chinese and 6 million Japanese left their homelands and emigrated to eastern and southern Asia. One and a half million left India for Southeast Asia and Southwest Africa.

Population movement peaked during the 1890s. In those years, the United States absorbed enough immigrants to increase the U.S. population from the beginning of the decade by 9 percent. In Argentina, the increase in the 1890s was 26 percent; in Australia, it was 17 percent. Europe provided much of the supply: the United Kingdom gave up 5 percent of its initial population, Spain 6 percent, and Sweden 7 percent. In the 1990s, by contrast, the United States was the only country in the world with a high immigration rate, attracting newcomers primarily from the developing world rather than from Europe. These immigrants increased the population by only 4 percent.

As all of this suggests, despite the many economic changes that have occurred over the course of a century, neither the markets for goods and services nor those for factors of production appear much more integrated today than they were a century ago. They seem more integrated for trade, at least in the high-income countries; no more integrated for capital—above all for long-term capital—despite important changes in the composition of capital flows; and much less integrated for labor.

So why do so many people believe that something unique is happening today? The answer lies with the two forces driving contemporary economic change: falling costs of transport and communications on the one hand, and liberalizing economic policies on the other.

THE TECHNOLOGICAL REVOLUTION

Advances in technology and infrastructure substantially and continuously reduced the costs of transport and communications throughout the nineteenth and early twentieth centuries. The first transatlantic telegraph cable was laid in 1866. By the turn of the century, the entire world was connected by telegraph, and communication times fell from months to minutes. The cost of a three-minute telephone call from New York to London in current prices dropped from about $250 in 1930 to a few cents today. In more recent years, the number of voice paths across the Atlantic has skyrocketed from 100,000 in 1986 to more than 2 million today. The number of Internet hosts has risen from 5,000 in 1986 to more than 30 million now.

A revolution has thus occurred in collecting and disseminating information, one that has dramatically reduced the cost of moving physical objects. But these massive improvements in communications, however important, simply continue the trends begun with the first submarine cables laid in the last century. Furthermore, distances still impose transport and communications costs that continue to make geography matter in economic terms. Certain important services still cannot be delivered from afar.

Diminishing costs of communications and transport were nevertheless pointing toward greater integration throughout the last century. But if historical experience demonstrates anything, it is that integration is not technologically determined. If it were, integration would have gone smoothly forward over the past two centuries. On the contrary, despite continued falls in the costs of transport and communications in the first half of the twentieth century, integration actually reversed course.

Policy, not technology, has determined the extent and pace of international economic integration. If transport and communications innovations were moving toward global economic integration throughout the last century and a half, policy was not—and that made all the difference. For this reason, the growth in the potential for economic integration has greatly outpaced the growth of integration itself since the late nineteenth century. Globalization has much further to run, if it is allowed to do so.

CHOOSING GLOBALIZATION

GLOBALIZATION is not destined, it is chosen. It is a choice made to enhance a nation's economic well-being—indeed, experience suggests that the opening of trade and of most capital flows enriches most citizens in the short run and virtually all citizens in the long run. (Taxation on short-term capital inflows to emerging market economies is desirable, however, particularly during a transition to full financial integration.) But if integration is a deliberate choice, rather than an ineluctable destiny, it cannot render states impotent. Their potency lies in the choices they make.

Between 1846 and 1870, liberalization spread from the United Kingdom to the rest of Europe. Protectionism, which had never waned in the United States, returned to continental Europe after 1878 and reached its peak in the 1930s.

A new era of global economic integration began only in the post-war era, and then only partially: from the end of World War II through the 1970s, only the advanced countries lowered their trade barriers. The past two decades, by contrast, have seen substantial liberalization take root throughout the world. By the late 1990s, no economically significant country still had a government committed to protectionism.

Globalization can progress only as far as national policymakers will allow.

This historical cycle is also apparent in international capital investments. Capital markets stayed open in the nineteenth and early twentieth centuries, partly because governments did not have the means to control capital flows. They acquired and haltingly solidified this capacity between 1914 and 1945, progressively closing their capital markets. Liberalization of capital flows then began in a few advanced countries during the 1950s and 1960s. But the big wave of liberalization did not start in earnest until the late 1970s, spreading across the high-income countries, much of the developing world, and, by the 1990s, to the former communist countries. Notwithstanding a large number of financial crises over this period, this trend has remained intact.

In monetary policy, the biggest change has been the move from the gold standard of the 1870–1914 era to the floating currencies of today. The long-run exchange-rate stability inherent in the gold standard promoted long-term capital flows, particularly bond financing, more efficiently than does the contemporary currency instability. Today's vast short-term financial flows are not just a consequence of exchange-rate instability, but one of its causes.

Yet governments' control over the movement of people in search of employment tightened virtually everywhere in the early part of the last century. With the exception of the free immigration policy among members of the European Union (EU), immigration controls are generally far tighter now than they were a hundred years ago.

The policy change that has most helped global integration to flourish is the growth of international institutions since World War II. Just as multinational companies now organize private exchange, so global institutions organize and discipline the international face of national policy. Institutions such as the World Trade Organization (WTO), the International Monetary Fund (IMF), the World Bank, the EU, and the North American Free Trade Agreement underpin cooperation among states and consolidate their commitments to liberalize economic policy. The nineteenth century was a world of unilateral and discretionary policy. The late twentieth century, by comparison, was a world of multilateral and institutionalized policy.

TRADEOFFS FACING STATES

IRONICALLY, the technology that is supposed to make globalization inevitable also makes increased surveillance by the state, particularly over people, easier than it would have been a century ago. Indeed, here is the world we now live in: one with fairly free movement of capital, continuing (though declining) restrictions on trade in goods and services, but quite tight control over the movement of people.

Economies are also never entirely open or entirely closed. Opening requires governments to loosen three types of economic controls: on capital flows, goods and services, and people. Liberalizing one of the above neither requires nor always leads to liberalization in the others. Free movement of goods and services makes regulating capital flows more difficult, but not impossible; foreign direct investment can flow across national barriers to trade in goods without knocking them down. It is easier still to trade freely and abolish controls on capital movement, while nevertheless regulating movement of people.

The important questions, then, concern the tradeoffs confronting governments that have chosen a degree of international economic integration. How constrained will governments find themselves once they have chosen openness?

THREE VITAL AREAS

GLOBALIZATION is often perceived as destroying governments' capacities to do what they want or need, particularly in the key areas of taxation, public spending for income redistribution, and macroeconomic policy. But how true is this perception?

In fact, no evidence supports the conclusion that states can no longer raise taxes. On the contrary: in 1999, EU governments spent or redistributed an average of 47 percent of their GDPs. An important new book by Vito Tanzi of the IMF and Ludger Schuknecht at the European Central Bank underlines this point. Over the course of the twentieth century, the average share of government spending among Organization for Economic Cooperation and Development (OECD) member states jumped from an eighth to almost half of GDP. In some high-income countries such as France and Germany, these ratios were higher than ever before.

Until now, it has been electoral resistance, not globalization, that has most significantly limited the growth in taxation. Tanzi claims that this is about to change. He argues that collecting taxes is becoming harder due to a long list of "fiscal termites" gnawing at the foundations of taxation regimes: more cross-border shopping, the increased mobility of skilled labor, the growth of electronic commerce, the expansion of tax havens, the development of new financial instruments and intermediaries, growing trade within multinational companies, and the possible replacement of bank accounts with electronic money embedded in "smart cards."

The list is impressive. That governments take it seriously is demonstrated by the attention that leaders of the OECD and the EU are devoting to "harmful tax competition," information exchange, and the implications of electronic commerce. Governments, like members of any other industry, are forming a cartel to halt what they see as "ruinous competition" in taxation. This sense of threat has grown out of several fiscal developments produced by globalization: increased mobility of people and money, greater difficulty in collecting information on income and spending, and the impact of the Internet on information flows and collection.

Yet the competitive threat that governments face must not be exaggerated. The fiscal implications of labor, capital, and spending mobility are already evident in local jurisdictions that have the freedom to set their own tax rates. Even local governments can impose higher taxes than their neighbors, provided they contain specific resources or offer location-specific amenities that residents desire and consume. In other words, differential taxation is possible if there are at least some transport costs—and there always are.

These costs grow with a jurisdiction's geographic size, which thus strongly influences a local government's ability to raise taxes. The income of mobile capital is the hardest to tax; the income of land and immobile labor is easiest. Corporate income can be taxed if it is based on resources specific to that location, be they natural or human. Spending can also be taxed more heavily in one jurisdiction than another, but not if transport costs are very low (either because distances are short or items are valuable in relation to costs). Similarly, it is difficult to tax personal incomes if people can live in low-tax jurisdictions while enjoying the amenities of high-tax ones.

Eliminating legal barriers to mobility therefore constrains, but does not eliminate, the ability of some jurisdictions to levy far higher taxes than others. The ceiling on higher local taxes rises when taxable resources or activities remain relatively immobile or the jurisdiction provides valuable specific amenities just for that area.

The international mobility of people and goods is unlikely ever to come close to the kind of mobility that exists between states in the United States. Legal, linguistic, and cultural barriers will keep levels of cross-border migration far lower than levels of movement within any given country. Since taxes on labor income and spending are the predominant source of national revenue, the modern country's income base seems quite safe. Of course, although the somewhat greater mobility resulting from globalization makes it harder for governments to get information about what their residents own and spend abroad, disguising physical movement, consumption, or income remains a formidable task.

The third major aspect of globalization, the Internet, may have an appreciable impact on tax collection. Stéphane Buydens of the OECD plausibly argues that the Internet will primarily affect four main areas:

taxes on spending, tax treaties, internal pricing of multinational companies, and tax administration.

Purely Internet-based transactions—downloading of films, software, or music—are hard to tax. But when the Internet is used to buy tangible goods, governments can impose taxes, provided that the suppliers cooperate with the fiscal authorities of their corresponding jurisdictions. To the extent that these suppliers are large shareholder-owned companies, which they usually are, this cooperation may not be as hard to obtain as is often supposed.

It is also sometimes difficult to locate an Internet server. If one cannot do so, how are taxes to be levied and tax treaties applied? Similar problems arise with multinational companies' ability to charge submarket prices to their subsidiaries abroad (so-called "transfer pricing" within multinationals), which leaves uncertain the question of how and in which country to levy the tax. This scenario suggests that classic concepts in the taxation of corporations may have to be modified or even radically overhauled.

The overall conclusion, then, is that economic liberalization and technology advances will make taxation significantly more challenging. Taxes on spending may have to be partially recast. Taxation of corporate profits may have to be radically redesigned or even abandoned. Finally, the ability of governments to impose taxes that bear no relation to the benefits provided may be more constrained than before.

Nevertheless, the implications of these changes can easily be exaggerated. Taxation of corporate income is rarely more than ten percent of revenue, whereas taxes on income and spending are the universal pillars of the fiscal system. Yet even lofty Scandinavian taxes are not forcing skilled people to emigrate in droves. People will still happily pay to enjoy high-quality schools or public transport. Indeed, one of the most intriguing phenomena of modern Europe is that the high-tax, big-spending Scandinavian countries are leading the "new economy."

Governments will also use the exchange of information and other forms of cooperation to sustain revenue and may even consider international agreements on minimum taxes. They will certainly force the publicly quoted companies that continue to dominate transactions, both on-line and off, to cooperate with fiscal authorities. But competition among governments will not be eliminated, because the powerful countries that provide relatively low-tax, low-spending environments will want to maintain them.

The bottom line is that the opening of economies and the blossoming of new technologies are reinforcing constraints that have already developed within domestic politics. National governments are becoming a little more like local governments. The result will not necessarily be minimal government. But governments, like other institutions, will be forced to provide value to those who pay for their services.

Meanwhile, governments can continue the practice of income redistribution to the extent that the most highly taxed citizens and firms cannot—or do not wish to—evade taxation. In fact, if taxes are used to fund what are believed to be location-specific benefits, such as income redistribution or welfare spending, taxpayers will likely be quite willing to pay, perhaps because they either identify with the beneficiaries, fear that they could become indigent themselves, or treasure the security that comes from living among people who are not destitute. Taxpayers may also feel a sense of moral obligation to the poor, a sentiment that seems stronger in small, homogeneous societies. Alternatively, they may merely be unable to evade or avoid those taxes without relocating physically outside the jurisdiction. For all these reasons, sustaining a high measure of redistributive taxation remains perfectly possible. The constraint is not globalization, but the willingness of the electorate to tolerate high taxation.

Last but not least, some observers argue that globalization limits governments' ability to run fiscal deficits and pursue inflationary monetary policy. But macroeconomic policy is always vulnerable to the reaction of the private sector, regardless of whether the capital market is internationally integrated. If a government pursues a consistently inflationary policy, long-term nominal interest rates will rise, partly to compensate for inflation and partly to insure the bondholders against inflation risk. Similarly, if a government relies on the printing press to finance its activity, a flight from money into goods, services, and assets will ensue—and, in turn, generate inflation.

Within one country, these reactions may be slow. A government can pursue an inflationary policy over a long period and boost the economy; the price may not have to be paid for many years. What difference, then, does it make for the country to be open to international capital flows? The most important change is that the reaction of a government's creditors is likely to be quicker and more brutal because they have more alternatives. This response will often show itself in a collapsing exchange rate, as happened in East Asia in 1997 and 1998.

THE CONTINUING IMPORTANCE OF STATES

A COUNTRY that chooses international economic integration implicitly accepts constraints on its actions. Nevertheless, the idea that these constraints wither away the state's capacity to tax, regulate, or intervene is wrong. Rather, international economic integration accelerates the market's responses to policy by increasing the range of alternative options available to those affected. There are also powerful reasons for believing that the constraints imposed on (or voluntarily accepted by) governments by globalization are, on balance, desirable.

For example, the assumption that most governments are benevolent welfare-maximizers is naive. International economic integration creates competition among governments—even countries that fiercely resist integration cannot survive with uncompetitive economies, as shown by the fate of the Soviet Union. This competition constrains the ability of governments to act in a predatory manner and increases the incentive to provide services that are valued by those who pay the bulk of the taxes.

Another reason for welcoming the constraints is that self-imposed limits on a government's future actions enhance the credibility of even a benevolent government's commitments to the private sector. An open capital account is one such constraint. Treaties with other governments, as in the WTO, are another, as are agreements with powerful private parties. Even China has come to recognize the economic benefits that it can gain from international commitments of this kind.

The proposition that globalization makes states unnecessary is even less credible than the idea that it makes states impotent. If anything, the exact opposite is true, for at least three reasons. First, the ability of a society to take advantage of the opportunities offered by international economic integration depends on the quality of public goods, such as property rights, an honest civil service, personal security, and basic education. Without an appropriate legal framework, in particular, the web of potentially rewarding contracts is vastly reduced. This point may seem trivial, but many developing economies have failed to achieve these essential preconditions of success.

Second, the state normally defines identity. A sense of belonging is part of the people's sense of security, and one that most people would not want to give up, even in the age of globalization. It is perhaps not surprising that some of the most successfully integrated economies are small, homogeneous countries with a strong sense of collective identity.

Third, international governance rests on the ability of individual states to provide and guarantee stability. The bedrock of international order is the territorial state with its monopoly on coercive power within its jurisdiction. Cyberspace does not change this: economies are ultimately run for and by human beings, who have a physical presence and, therefore, a physical location.

Globalization does not make states unnecessary. On the contrary, for people to be successful in exploiting the opportunities afforded by international integration, they need states at both ends of their transactions. Failed states, disorderly states, weak states, and corrupt states are shunned as the black holes of the global economic system.

What, then, does globalization mean for states? First, policy ultimately determines the pace and depth of international economic integration. For each country, globalization is at least as much a choice as a destiny. Second, in important respects—notably a country's monetary regime, capital account, and above all, labor mobility—the policy underpinnings of integration are less complete than they were a century ago. Third, countries choose integration because they see its benefits. Once chosen, any specific degree of international integration imposes constraints on the ability of governments to tax, redistribute income, and influence macroeconomic conditions. But those constraints must not be exaggerated, and their effects are often beneficial. Fourth, international economic integration magnifies the impact of the difference between good and bad states—between states that provide public goods and those that serve predatory private interests, including those of the rulers.

Finally, as the world economy continues to integrate and cross-border flows become more important, global governance must be improved. Global governance will come not at the expense of the state but rather as an expression of the interests that the state embodies. As the source of order and basis of governance, the state will remain in the future as effective, and will be as essential, as it has ever been.