

ECONOMIC ROLE OF THE STATE IN THE ERA OF GLOBALIZATION

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ABSTRACT

This paper examines the economic role of the state in era of globalization. The major findings of this study are that (1) the role of government in reducing volatility and minimizing potential financial crisis becomes essential; (2) the rise of a knowledge-based economy requires less societal control and more governmental help in reducing the digital divide; (3) privatization and deregulation moved the governmental role from that of a provider of basic utilities to the regulator of these utilities and from monopolist to an advocate of consumer interest through the promotion of competitive environment; (4) the state=s new roles are designed to improve human capital for employment since the main asset of the poor is labor; (5) physical capital is still important for economic growth but its relative value is declining while the relative importance of social and human capital is increasing; and (6) governments played important roles in globalization by adopting policies that increased integration and interdependency.

Key words: Privatization; Institutional Reform, and Mobilization of Resources.

Introduction:

The question is no longer big or small government but enough and efficient government to accomplish maximum welfare of society. Only government can create rules of laws, security, setting policies, enforcement of contracts, wider participation of civil society, reducing discrimination, a provider of education and health to prevent anarchy and social upheaval. Larger government than necessary may lead to intrusive state that destroys wealth rather than creating it. Smaller government than is needed may create instability and chaos. Government role now is considered an enabler of growth and progress rather than an obstacle to it. Despite the free market and knowledge-based economy, the need for government has still not been diminished. Combining ideas from private and public sectors will strengthen both sectors and enhance the changes of society's success.

THE TRANSFORMATION OF THE STATE ROLE

The traditional role of government was to provide public goods such as

education, defense, maintenance of order, and an engine for economic growth. But globalization expanded the government role into other areas such as playing a pivotal role in economic integration, financial capital flows, and productivity growth. Economics became a powerful force in governance. Currently, fiscal liberalism is replaced with fiscal conservatism and government plays the role of facilitator for individual entrepreneurship. State owned companies have been privatized and the welfare state is no longer a viable political option. In most developing countries, the extended family and the community played the primary paternalistic role of providing welfare rather than the state. Ohmae (1995) argued that nation states used to be a means to create wealth in the past but a means to destroy wealth currently. People are demanding more information to make their own decisions, freedom to be entrepreneurs, and access to quality products and services at the lowest prices. The creation of wealth has become more important than social equity.

The government role changed from guardian of local industry to a gradual promoter of competition that allows companies with negative profit to fail or be acquired by better managed corporations. Tariffs were used in developing economies for revenue purposes and not for the protection of domestic producers as in the case of advanced industrialized countries. The developing countries replaced tariffs with sales taxes, which are regressive in nature, in order to compensate for the loss of revenue from tariffs. According to Fréchette (June 2002) governments across the globe cut corporate taxes to induce investment and to prevent global corporations from leaving which led to the reduction of the percentage of corporate sector contributions to total government revenues. The reduction of tariffs and corporate taxes robbed governments in developing countries from needed funds for investment in education, health, and other infrastructures.

Interdependence of people, ideas, products, and information required to think globally because local solutions may not be possible or efficient. A state's power to use fiscal and monetary policies effectively is limited due to the ease of financial capital mobility. The government no longer can formulate economic policy based purely on national interest when its country wants to be a member of the World Trade Organization (WTO) and the International Monetary Fund (IMF). Purely national fiscal, monetary, and trade policy are no longer viable and enough instruments to deal with all kinds of economic problems since many factors are beyond its ability to control. Globalization was of benefit to most countries, but the countries that benefited the most were the countries that invested in their own human capital and infrastructure. The lack of heavy investment in the human capital and physical infrastructure in developing countries led to smaller benefits from globalization. Also, globalization brought many ills and crises that developing countries could not afford or manage. Financial crises led government and private sectors in developing countries, especially in East Asia, to the structural reform of their regulations, foreign reserve, and new rules affecting financial capital mobility which is intended for

sustainable future economic growth. The future competitive advantage will continue to be dependent on national stability, level of economic and social development, regional cooperation, and international environment.

Globalization has changed but not ended the role of government. Incentives, rules and limited resources will continue to be essentially national where government can be instrumental not only on the above aspect but also on its ability to create a favorable environment for foreign investment.

The Role of Government in Privatization

During the last 25 years, governments used their power to change labor laws, opened their economies for foreign trade and investment, and established privatization. According to Mahboubi (2001), privatizations of public assets were close to one trillion dollars during the period of 1990-2000 around the globe. Some argued that the privatization of public firms would promote and increase the ordinary people's shares and stocks in the privatized firms. The privatization improved efficiency, but much of this privatization led to the fire sale of valuable assets. These failures led to public frustration and the creation of large regulatory bodies. Also, government thought the private sector could be the engine for economic growth rather than government.

The proper privatization process could energize the private sector and be an engine for economic growth when the proceeds from privatization are reinvested in its infrastructure in the form of ports, roads, telecommunications, and power plants as was the case for Malaysia. According to Mohamed (2001) Malaysia started its privatization process in 1983. The privatization energized the private sector during the 1990s and moved the economy from a public deficit of 21.8% of the GDP in 1983 into surplus of 6.5% by the eve of Asian financial crisis in 1997. Without privatization the external debt of Malaysia would be double the amount of their 1999 external debt of 72.5 billion RM. Also, privatization gave Malaysian government the ability to reduce its top personal income tax rate and corporate income rates to 29% and 28% respectively by year 2000. The government of Malaysia gave the privatized entity employee the AEmployee Share Option Scheme@, where workers received 5% to 13% of the shares offered, expanding a capital owning democracy. Privatization decreased government spending in the economic sector and increased its spending on the social sector from 20.6% in 1983 to 31.6% by 1997.

The convergence of the pro-growth government policies, privatization, and high savings rate in South East Asia when the Japanese industries were expanding abroad helped fuel the economic miracle of South East Asia during 1980's and 1990's. The Japanese industries were trying to keep their competitive advantage in terms of labor cost which brought jobs and a model for emulation to the South East Asian countries.

Government Role and Civil Societies:

Government can be a promoter or inhibitor of civil society. Civil society can be described as the network of organizations, associations and citizens that are not subject to the state influence or marketplace but may be based on similar interests, religion, professions or a given ideology. These civil societies may have global interests such as concern for the environment, micro-credit, human rights, and peace. London (2004) argued that some of these civil societies are opposed to economic liberalization due to its negative impacts on a given sector of the economy or on the distribution of income. These may represent a growing and emerging countervailing power to the power of global corporations, the state, and multinational organizations such as the IMF. Even though civil society as a grass roots movement is not yet a match for the influence of global corporations, but civil societies may become an instrument for creating a global common ethics.

The State, market, and civil societies need an integrated approach in dealing with development and not a hierarchical or separate approach to development. Unfortunately, civil society is very weak in most developing countries. Transparency, integrity, accountability (financial, political and administrative), access to information, enforceable codes of ethics and the media in a proactive role are essential elements of a successful public, private, and civil social organization in a democratic society (for more details see Cheema 2003).

Modern age civilization globalizes the appearance of human activities and how we live but does not address the inner differences between cultures and individuals. Also, globalization fails to harmonize the morality with technical ability (for more details see Havel 1994.) Civil societies, labor unions, universities, professional associations, religious communities, and non-governmental organizations can be more effective in solving issues that the state used to believe were completely within its domain, such as the social and economic problems facing society. These civil societies can contribute volunteers, ideas, and financial resources to solve social and economic problems. Government needs to improve the relationship between citizens and their civil servants by making sure that the public institutions work for all without favoring the rich and influential at the expense of the poor. Government can be an instrument to promote peaceful coexistence, which is an essential ingredient for economic growth.

Government Role in the Globalization Process

Governments played important roles in globalization by adopting policies that increased integration and interdependency. These policies are reflected in the promotion of freer trade in goods and services, freer mobility of financial capital, and changing laws governing labor. Poverty, negative externalities, financial, and economic crises due to globalization require government programs,

social regulations, and economic regulations to improve the welfare of society. The restructuring of the economy, especially in developing countries, requires government to deal with the rise of unemployment.

Globalization created a shift of some decisions from national government to international due to interdependence. On the other hand, the need for regulations and cooperation with outside entities shifted some decisions from a national to a local level. These two trends led some to believe in an end of the power of national state. The increase in the size of trade relative to the GDP and the free movement of financial capital did not reduce the value of the state or the need for cooperation between governments to deal with market failures in the form of financial and economic crises. Also, governments still have influence in setting the international agenda based on their economic size. This is why developed countries have large roles and influence in setting the rules and policies that are shaping global social and economic activities.

Some of the potential benefits of globalization could be greater consumer and producer choices in consumption and investment, greater benefit from comparative advantage, economies to scale, lower prices and lower cost of financial capital, and transfer of technology. The potential problem of globalization is that the benefits are not distributed equally between countries and within each country, market and policy failures in the form of financial crisis and mass liquidation could produce devastating social and economic consequences (for more detail see El-Mefleh 2002 and 2003) and the firms' exploitation of natural resources without taking into consideration the long term impact on society and without paying the full cost, where the social cost exceeds private cost. Also, deregulations and liberalization policies were discriminatory because they exclude given industries or sectors. Therefore, the use of state authority to take advantage of the benefits and reduce the potential problems of globalization is essential. The state continues to play an important role in reducing negative externalities, reducing poverty, and insuring security and property rights. Also, the state can play an important role in improving health care, education, and eliminating absolute poverty, fighting corruption, improving financial regulations, applying knowledge and know-how, mobilizing financial reforms, and improving its own accountability in tax collection and government spending. Rondinelli (2003) argued that problems attributed to globalization may be the result of the state's failure to create and develop proper and effective institutions and regulations to stimulate investment, trade, and productivity. The standard measures of a country's competitiveness are based on economic performance (growth, employment, prices, investment and trade), efficiency of government (fiscal policy, monetary policy, public finance, education, and institutional structures), efficiency of business (productivity, financial sector, and management practices), infrastructure (basic, scientific, and technology), and financial market development. A country's competitiveness can be improved by government policies that enhance the ability of private enterprise to compete globally, reduce the potential cost for market failure, and provide public goods

that are socially valued.

Under the new era of globalization, government functions became more focused on strategic objectives and planning, maintaining attractive environments for the private sector, privatizing its role in producing goods and services, and creating enough regulations to limit the market failure potential.

Reaction to Globalization and Financial Crises:

Globalization in the form of market integration and competition between countries to attract foreign investment led governments to take major steps toward economic reforms. The market reforms rely on freer movement of financial capital, freer trade, and an export oriented approach to achieve sustainable economic growth for developing economies. The financial crisis led to not only addressing the issue of prioritization of the liberalization process but to the workability and credibility of open macroeconomic policies. The financial crisis led to stagflation in the form of steep increases in prices, substantial declines in real GDP, a rise in unemployment, and an increase in poverty by 10% of the population as was the case for Indonesia (for more details see El-Mefleh (2003) and Soesastro (2004)). The financial meltdown of many economies due to globalization and freer mobility of financial capital led to two schools of thought. The first school of thought advocated for an industrial policy of the past by selectively targeting and import substitution. However, relying on an export strategy for the economic growth of developing economies can be a risky strategy. The risk comes from a recession in the major trading partner of the industrialized country which then produces a recession in the developing country. The second school of thought advocated the development of internal capabilities where government can facilitate competition and provide training for public administrators in the sophisticated skills needed for the new era. It seems that at least for now, the second school of thought has won the debate.

Government as a Coordinator for Negotiation and Decision-Making

The government in the new era of globalization acts as a coordinator for negotiation and decision-making by different governments, regions, occupations, and governmental organizations. Also governments establish social safety nets, democratic institutions, maintain justice departments to mediate conflicts, protect the weakest groups of society such as the women, elderly, the sick, children, and minorities, and ensure that the benefits of globalization are fairly distributed across different groups of society, reducing the negative impact of globalization on a given segment of society and establishing a fair tax system, safety nets in the form of programs for the unemployed, the poor, health, education to combat poverty and invest in human capital and public infrastructure. Government in the new era of globalization should not reduce the size of government without looking at the secondary effect. Lack of proper study of the secondary effect led to terrible consequences for some developing countries. So, being a small-sized

government does not mean the elimination of the welfare state, but could change its role. The welfare state of the past contributed significantly to economic and social development even though it produced inefficient use of resources and large national debts.

CHALLENGES FACING GOVERNMENT

Globalization and privatization significantly weakened the ability of the state to exercise its influence on social and economic development as well as the ability of the government to be the major provider of essential goods and services such as health, education, utilities, etc. But the state continues to be needed to provide necessary infrastructure and services so the economy can compete internationally. The above weakness did not reduce or eliminate the roles of the state but changed its emphasis in the era of globalization. The state's new roles are intended to create economic incentives, a favorable political environment, and social attitudes conducive to economic expansion of the private sector, efficient use of resources, and increased productivity. The state's new roles are designed to improve human capital for employment (the main asset of the poor is labor), increase the openness of the economy to stimulate foreign investment, and provide a costly social safety net to alleviate poverty, especially for the poorest segment of the population.

According to Bertucci and Alberti (2003) there are four areas of the public sector that need to be reformed for economic, political, and social development. These four areas are institutional reform, information technology, human resources, and financial management.

Institutional Reform

Democratic reform at the national and local level where elected members of parliaments, legislatures, or councils will be informed, independent, and accountable can play the main forum for solving major problems. Reforming the judicial system where the individual and the minority rights are preserved, an impartial judicial system can be an effective instrument for reducing corruption and the abuse of public office. The executive branch needs to be reformed to deal more effectively with new challenges of globalization. Governments need to promote partnerships with both civil society and the private sector while pursuing development. Also, government needs to create policies that are helpful for investment, helpful for the adoption of new technology, and collect accurate data for policy makers.

Information technology (IT)

Information technology provides adequate, accurate, relevant and timely data for policy makers and the public. Therefore, information technology is capable of improving services, accountability, and wider participation by

stakeholders. Government needs to formulate policies that improve technology training, affordable access to information technology and reduce the externality cost of introductory information technology by providing retraining and safety nets for those workers who lose their jobs due to information technology.

Human Resources

Efficient institutions need competent people as much as competent people need efficient institutions. Government in the new era of globalization needs to constantly improve leadership skills. Public employee recruitment and promotion are based on merit. Also, negotiating with other countries or international agencies, and navigating international treaties and laws require improved skills on the part of government representatives. The information technology (IT) requires skilled government employees. Strategic planning requires sophisticated analytical skills, understanding of emerging opportunities and constraints and the ability to create a support for organizational restructuring. All of the above will not be achieved without governmental help in building a culture of dialogue, promoting consensus, accepting diversity, and implementing change peacefully without violence.

Financial Mobilizations and Management

Competent people and acceptable rules are necessary conditions for a well-functioning institution, but are not sufficient. Financial resources and the political commitment to use these financial resources for society's welfare are needed. Efficiency of government fiscal policy and simple forms require a tax structure that is fair and simple, to achieve the highest possible degree of voluntary payments by tax payers.

Economic growth requires government, especially in developing countries, to actively secure the needed finances. The needed finances for investment come not only from abroad but also from domestic savings. Domestic savings are an essential instrument for sustainable investment and growth. Unfortunately, most developing countries have low household, corporation, and government savings rates. Converting savings into investment requires security, law and order, physical infrastructure, clearly defined property rights, a skilled labor force, exports to pay for imported capital goods, soundness of fiscal and monetary policies, and sound regulation of the financial sector. Also sound fiscal and monetary policy are important instruments for achieving low inflation rates, reducing unsustainable current account deficit, creating smaller public debts, and reducing the potential of crowding out private investment. In addition, the proper amount of investment in public education and health, and social programs are essential for reducing poverty.

Globalization led government to reduce its tariffs and corporate taxes which reduces government revenue without finding an alternative source of revenue that does not burden the poor unfairly. Foreign aid may help build the

productive capacity of an economy if it is used for investment and not for consumption. Also, growth may lead to increased income inequity and not a reduction in poverty.

In developing countries, the larger the difference between the interest paid by the borrowers and the interest received by the depositor reflects a lack of efficiency, weak competition, and a higher risk associated with their financial sectors. The Asian miracle was based on planning, hard work, sacrifice and deliberate public policy. Public policy was the engine for creating a large middle class in Singapore and Malaysia and was also the power behind industrial transformation of these two countries. The Asian miracle was achieved because the state kept inflation low, encouraged savings, strengthened the legal framework, created an attractive environment in which the private sectors could prosper, managed trade, and followed prudent fiscal policy. Also, the government targeted education which provided a skilled labor force and created regulations to protect investment. All of the above implies sound fundamental economic policies.

The state's new role is designed to stimulate human capital, financial resources for investment, and economic openness. Sustainable economic growth requires coherent economic policy. Physical capital still is important for economic growth but its relative value is declining while the relative importance of social and human capital is increasing according to Agosin and Bloom (2003). The improvement of social and human capital is the ultimate objective of economic development.

Governments of developing countries play a crucial role in economic development by mobilizing sufficient resources for investment. This role leads to budget deficits and substantial debt. Also, lack of voluntary regular tax payment makes their budget woes worse since government can get the resources from taxes, non-tax revenues (return on government investment and foreign grants), and borrowing.

One way to mobilize resources is through taxes. Taxes are the main source of revenue for the government, but it creates direct costs for the taxpayers, indirect costs by causing economic distortion that alters relative prices, and creates administrative costs for compliance (collecting) and enforcement. If the internal sector is a very large percentage of the economy, then taxable income from wages is a tax paid by lower and middle income classes, while rich taxpayers will be able to escape the income tax according to Shende (2003). Mobilizing financial resources can be achieved through progressive tax, equitable tax incidence, improved legislative and administrative measures to prevent tax evasion, and a simplified tax code.

Another way to mobilize resources is through public debt. If debt is not used for economic growth, then the cost of borrowing would create

macroeconomic problems in the future in the form of debt repayment and debt servicing. But if government finances the internal debt by printing money, then inflationary pressure will be the result of borrowing. On the other hand, if the government issues bonds to finance the expenditures, then crowding out private investment may become a serious problem. If a fiscal deficit is the result of government consumption, then that may also trigger crowding out of private investment. But if a fiscal deficit is the result of large public investment, then that may trigger crowding in the private investments due to an increase in productivity and a higher return of private investment. Some countries export their tax burden by luring foreign consumers to shop in their country by providing low sales taxes which also reduces foreign countries= tax revenue.

Final Remarks

Globalization, changing technology, spread of knowledge, and freer financial capital mobility require the state to rethink its role in order for the state to improve the welfare of its citizens. In order for the state to be relevant, especially in small economies, it needs to promote the production of goods and services that has the competitive advantage, provide better quality education, better infrastructure, and encourage more participation in the decision making. Due to the failure of the market on one hand and the failure of the state run economy on the other hand, economists are no longer accepting an economic theoretical approach to increase welfare of society by relying on the market growth or relying on the state approach to economic development. Economies of scale, internal markets, external markets, efficiency, institutional settings, regulations, the private sector and government are needed for effective development strategy.

Globalization made the economic responsibilities of the government very different than before. The government has to reduce volatility, minimize potential financial crisis, deal effectively with the consequences of economic crisis, and create effective and sound regulatory bodies in the financial sector and financial capital flows.

The information communication technology and personal computers created the rise of knowledge-based economy. This knowledge-based economy requires less societal control, and more governmental help in reducing the digital divide. The digital gap can worsen distribution of income and wealth in favor of those who master the new factors of wealth creation. This digital gap may create social tension and unrest which could produce a new ideological backlash similar to that of socialism as a reaction to unregulated capitalism of the 19th century.

The liberalization policies in many countries led to the worsening distribution of income between different groups and regions. Also globalization led to different advantages and disadvantages for small, medium, and large companies. Government and civil societies need to find an effective way to respond to the negative consequences of globalization.

CONCLUSION

Finding an efficient government to achieve the maximum welfare of society is not an easy task. Currently, fiscal liberalism is replaced with fiscal conservatism and government plays the role of facilitator for individual entrepreneurship. State owned companies have been privatized and the welfare state is no longer a viable political option. Privatization and deregulation moved the governmental role from that of a provider of basic utilities to the regulator of these utilities and from monopolist to an advocate of consumer interest through the promotion of a competitive environment. Physical capital is still important for economic growth but its relative value is declining while the relative importance of social and human capital is increasing. Thus, the state's new roles are designed to improve human capital for employment since the main asset of the poor is labor). Under the new era of globalization, government functions became more focused on strategic objectives and planning, privatizing its role in producing goods and services, and creating enough regulations to limit the market failure potential. Economics became a powerful force in governance and the creation of wealth has become more important than social equity.

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