The Role of the State in an era of Globalisation

MARTIN WOLF

THE SIR RONALD TROTTER LECTURE

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NEW ZEALAND BUSINESS ROUNDTABLE

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The Sir Ronald Trotter Lecture

SIR RONALD TROTTER was the first chairman of the New Zealand Business Roundtable in its present form, a position he held from 1985 to 1990.

Among his many other roles he has been chief executive and chairman of Fletcher Challenge Limited, chairman of the Steering Committee of the 1984 Economic Summit, a director of the Reserve Bank of New Zealand, chairman of the State-owned Enterprises Advisory Committee, chairman of Telecom Corporation, chairman of the National Interim Provider Board, a chairman or director of several major New Zealand and Australian companies, and chairman of the board of the Museum of New Zealand Te Papa Tongarewa.

He was knighted in 1985 for services to business.

This lecture was instituted in 1995 by the New Zealand Business Roundtable to mark Sir Ronald Trotter's many contributions to public affairs in New Zealand. It is given annually by a distinguished international speaker on a major topic of public policy.

The tenth Sir Ronald Trotter lecture was given by Martin Wolf at the Carlton Hotel in Auckland on 2 September 2004.

Martin Wolf

MARTIN WOLF is associate editor and chief economics commentator at the Financial Times. He was awarded the CBE (Commander of the British Empire) in 2000 for services to financial journalism. He is a visiting fellow of Nuffield College, Oxford University, and a special professor at the University of Nottingham in the United Kingdom.

Mr Wolf was joint winner of the Wincott Foundation senior prize for excellence in financial journalism in both 1989 and 1997 and won the RTZ David Watt memorial prize in 1994. He was the winner in the United Kingdom of the 2003 Business Journalist of the Year Decade of Excellence Award and won the Newspaper Feature of the Year Award at the Workworld Media Awards in 2003. He has been a forum fellow at the annual meeting of the World Economic Forum since 1999.

Martin Wolf obtained the Master of Philosophy in economics from Oxford University in 1971. Following that he joined the World Bank, where he became a senior economist in 1974. In 1981 he became director of studies at the Trade Policy Research Centre in London. He joined the *Financial Times* in 1987 as chief economics leader writer and became chief economics commentator in 1996.

Mr Wolf is the author of the book *Why Globalization Works: The Case for the Global Market Economy* published by Yale University Press, New Haven and London, in 2004.

Introduction by Roger Kerr *executive director* New Zealand Business Roundtable

IT IS MY VERY PLEASANT DUTY to introduce our guest speaker, Martin Wolf, to give this year's Sir Ronald Trotter lecture.

The lecture tonight recognises Sir Ron's role as the Business Roundtable's founding chairman and his many contributions to business and public affairs in New Zealand. We are delighted that Sir Ron and Lady Margaret Trotter are with us this evening.

This occasion marks the tenth anniversary of the lecture, the purpose of which is to feature an outstanding international speaker on a major topic of public policy. The series was inaugurated in 1995 and our first speaker was Richard Epstein of the University of Chicago, who was back in New Zealand for a fourth visit as our guest in August of this year.

In subsequent years the Trotter Lecture has been given by Thomas Sowell of the Hoover Institution; Norman Barry of the University of Buckingham; Antonio Martino of the University of Rome (now a minister in the Italian government); Judith Sloan of Flinders University, Adelaide; Yegor Gaidar, former Russian prime minister; Benno Schmidt, chairman of Edison Schools; Francis Fukuyama of Johns Hopkins University and Bjorn Lomborg, of the University of Aarhus and author of *The Skeptical Environmentalist*.

Martin Wolf is a very worthy successor to that distinguished line-up.

Martin is associate editor and chief economics commentator at the *Financial Times* in London. He has a Master of Philosophy from Oxford University and is currently a visiting fellow at Nuffield College, Oxford, and a special professor at the University of Nottingham. He was awarded a CBE (Commander of the British Empire) in 2000 for services to financial journalism, and he has won many journalism prizes.

Prior to joining the *Financial Times* in 1987, Martin was director of studies at the Trade Policy Research Centre in London and before that he worked at the World Bank.

I first encountered Martin's work during his time at the World Bank. Some 25 years ago, when New Zealand was embarked on the first stages of restructuring heavily protected industries such as textiles and clothing, Martin authored a study that looked at whether specific interventions to assist adjustment were desirable. The report argued persuasively that the case for specific assistance on economic grounds was weak, and that governments would be better advised to go about restructuring with predictable, medium-term programmes and to accompany them with broad policies that facilitated industry adaptation, like eliminating inflation and freeing up the labour market. That thinking still seems sound today, and it informed New Zealand's economic changes.

At the *Financial Times*, Martin has written hundreds of weekly articles about aspects of the world economy, and, in my view, now ranks as Britain's leading economic commentator.

Just a few months ago, a new book of Martin's was published, entitled *Why Globalization Works*. In it he mentions his own intellectual journey from social democracy to classical liberalism. He writes:

> I remain such a liberal today, not only because of my belief in the supreme value of personal freedom, but because of an abiding scepticism about the wisdom and capacity of an intrusive government. Today, however, I would consider my differences from social democrats (or, in the United States, liberals, as they call themselves) to be small. This is partly because the death of socialism has killed all sane people's belief in the planned

> economy and state ownership. Liberals, social democrats and moderate conservatives are on the same side in the great battles against religious fanatics … extreme environmentalists … and, of course, contemporary anti-globalizers. This book is addressed to all those who fall within these broad categories, and will, I hope, largely convince them that a global market economy is highly desirable. The big issue is not that, but how best to govern and regulate it.

Why Globalization Works has rightly been described as a "brilliant book" by Lawrence Summers, president of Harvard University. Mervyn King, governor of the Bank of England, called it "… a devastating intellectual critique of the opponents of globalization, but a civilised, wise and optimistic view of our economic and political future". Copies of the book, incidentally, can be ordered from Aristotle Books after the lecture.

The book's argument is that economic liberalisation and international economic integration over the last 20 years or so is transforming the world and lifting hundreds of millions of people in countries like China and India out of abject poverty. As Martin puts it, "The problem today is not that there is too much globalization but that there is far too little". And he adds: "The problem of the poorest countries … is not that they are exploited by multinationals, but rather that they are ignored by them".

In the same period, New Zealand has moved in the direction that Martin says all successful countries today share: "… a move towards the market economy, one in which property rights, free enterprise and competition increasingly [take] the place of state ownership, planning and protection". But, despite the obvious improvements in our economy, we need to be reminded that the world does not stand still; that New Zealand could do a lot more to achieve its full potential; and that the moves in the direction of greater economic freedom that brought the improvements are the only ones that will sustain and extend them.

Tonight, Martin's topic is "the big issue" in the passage that I quoted earlier, namely how best to govern and regulate the global market economy. Contrary to some views, globalisation has not diminished the role of governments. Indeed, economic research has never been more insistent than it is today on the fact that a country's institutions and policies overwhelmingly determine its economic progress and prosperity. So the topic is foursquare in line with the Business Roundtable's goal of seeking to identify and promote policies for a better New Zealand.

It is therefore with very great pleasure that I invite Martin Wolf to give this year's Sir Ronald Trotter Lecture on The Role of the State in an Era of Globalisation.

The Role of the State in an Era of Globalisation
Martin Wolf

FIRST OF ALL, it is an immense pleasure and honour to be here for many reasons.

First, it is a great honour because I think the audience tonight is the equivalent of over 3,000 in London and the thought that 3,000 people might come to hear me in London is beyond my imagination.

The second reason is that I have long admired both the New Zealand reform programme and the role that Roger Kerr, in particular, and the New Zealand Business Roundtable more broadly, have played in putting forward the case for a liberal market economy. Indeed, the Business Roundtable is one of the very few business organisations – perhaps the only one – I can think of around the world that has consistently lobbied in favour of free markets and national rather than sectional interests. One of my great concerns is that in most countries, contrary to the prejudices of the anti-globalisers, businesses and business organisations spend most of their time lobbying in favour of regulations, subsidies and other distortions to the market economy. Far from being liberalisers they are usually self-serving advocates of special privileges.

The third reason I am honoured to be here is the immense distinction of my predecessors. Contrary to what Roger has said, I do not feel in any way worthy to be here, but I am. So I must proceed.

The thesis of my lecture, to put it very crudely, is firstly that governments are essential; indeed, good governments are the single most important institutions the countries of the world can possess.

The second point I make is that the world needs more government, or, more precisely, it needs more good governments. The failure of government in very large parts of the world is the dominant reason for the growing differences between countries that all of us concerned with development have observed and worried about.

The third point I make is that globalisation creates opportunities and choices. However, the view is often expressed that it also means the complete collapse of the welfare state or of any system of social security. The state, it is suggested, will disappear, washed away by the tide of capital and labour moving around the world. This is nonsense. Rather, governments and societies can make choices about all these things. What they must do, however, is choose wisely.

Let me start with two quotations, both of which come from my book. The first is from the great man himself, Adam Smith, who said: “What is prudence in the conduct of every family can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage”.[1] And that, in essence, is the case for globalisation.

The second is a quote from John Gray whose book on the global market economy presents almost every significant fallacy in economic policy. Professor Gray is a very distinguished political philosopher at the London School of Economics who wrote a book in 1998 called *False Dawn: The Delusions of Global Capitalism*, which had a big following. He said: “Sovereign states are waging a war of competitive deregulation, forced on them by the global free market. A mechanism of downward harmonization of market economies is already in operation. Every type of currently existing capitalism is thrown into the melting pot. In this contest the socially dislocated American free market possesses powerful advantages”.[2]

These are two contrasting ideas about the way a liberal international order works. And, *ideas matter*. That is perhaps the most important of the lessons I learned from my father, the late Edmund Wolf. He was an Austrian–Jewish refugee from Hitler who came to Britain before the Second World War. A playwright and passionate intellectual, he taught me how the ideas of the Nazis and communists had destroyed, or were still destroying, civilised life in large parts of the world.

Because I was born just after the Second World War, in 1946, these dangers were not ancient history. By the time I was aware of the outside world, I already knew that ideas mattered a great deal. I understood, for example, that both my parents were refugees from an armed idea. I learned that although the immediate families of both my parents had survived by fleeing Europe, the great majority of their relatives had perished in what is today called the Holocaust. I also soon learned that communist dictatorships had divided Europe and still threatened the freedom and tranquillity of the country in which I was growing up.

Ever since, ideas have been my life. But what idea matters most to me? Freedom is the answer. In the course of my education at home, at school, at Oxford and at the World Bank in the 1970s, I came to the conclusion that the liberal principle of freedom of the individual under the law is the foundation of prosperity and the basis of civilised life.

My book is therefore not a work of academic scholarship, but of persuasion. It starts from the proposition that a world integrated through the market should benefit the great majority of the world's inhabitants. The competitive market is, I argue, the most powerful institution for raising living standards ever invented. But markets need states, just as states need markets. In a proper marriage between the two, one has contemporary liberal democracy. Its blessing needs to be spread more widely.

The problem is not that there is too much globalisation, but far too little. We can do better with the right mix of more liberal markets and more cooperative global governance. I am not arguing for the replacement of states. That would be folly. I am arguing for a better understanding by states of their long-run interest in a cooperative global economic order.

The ruin of the first liberal order – that of the nineteenth century – led to the 30 years of catastrophe, from which my parents' generation suffered so much. Now we all – or almost all – know better. The ideas that undermined faith in liberalism were wrong. Communism and fascism were crimes, as well as blunders. Imperialism was a blind ally. Militarism and nationalism destroyed European civilisation. Now we have, by luck as much as by judgment, recreated a better liberal international order – one that extends opportunities to the world as a whole. It is our duty to our descendants not to throw away this golden opportunity once again.

Globalisation and the state

With this introduction, let me turn to one of the principal themes of my book – the role of the state in an era of globalisation.

A spectre haunts the world's governments. That spectre is globalisation. Critics of globalisation argue that predatory market forces are making it impossible for beneficent governments to shield their peoples from the beasts of prey that lurk beyond their borders. On the free-market side of the debate, proponents counter that beneficent market forces are preventing predatory governments from fleecing their peoples. While the two sides disagree on the benefits of globalisation, both agree that impotent politicians must now bow before omnipotent markets.

This has become one of the clichés of our age. But it is (almost) total nonsense. The notion that unbridled market forces are making governments either impotent or irrelevant is wrong. To be fair to professor Gray, he is merely repeating, in his doom-laden way, what politicians repeat all the time. They insist they have no choice: globalisation makes slashing taxes, cutting spending, reducing regulations, and so on, inescapable. However, this is a dishonest excuse for pursuing the right policies. Worse, it is a dangerous one. It may be convenient for politicians to blame desirable policy changes on the exigencies of global markets, but they are likely to convince many of their citizens that these arguments are true. In that case, voters will turn against globalisation, for mistaken reasons.

Nor are politicians alone. Many pundits have encouraged the world to believe that globalisation is not just inescapable, but that every country must adopt much the same policies, in response. Thomas Friedman, the *New York Times* columnist, author of *The Lexus and The Olive Tree*, is a leading example.[3] At its extremes, the view that governments must embrace globalisation, or perish, mutates into the view that, in our liberalised, high-tech, borderless world, governments are altogether passé. This view is still more absurd than the idea that governments are impotent. They remain indispensable.

In response to such views, I wish to argue, first, that states remain indispensable, second, that the constraints imposed by globalisation do not render them impotent, but, on the contrary, make them perform better; and, finally, that our biggest challenge is responding to state failure in far too many developing countries. Only thus can the benefits of globalisation be available to all.

Throughout I define globalisation, as I do in the book, as the integration of economies across borders and through markets. Declines in the cost of transport and communications facilitate globalisation. Social and cultural changes are its consequence.

Why states remain indispensable under globalisation

The proposition that globalisation makes states unnecessary is wrong. If anything, the 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 provided by governments, such as protection of property rights, sound money, personal security and essential infrastructure. For this, a country must have a strong and effective judiciary, police and civil service and a high-quality policy environment.

Second, albeit less important, the state normally defines the identity of human beings. A sense of belonging is a part of people's sense of security. It is perhaps not surprising that some of the most successfully internationally integrated economies are small, homogeneous countries with a strong sense of collective identity.

Third, all forms of international governance rest on the ability of individual states to provide and guarantee domestic order. The World Trade Organisation (WTO), for example, is not a body of self-executing rules. On the contrary, rules can be exercised only by sovereign states. The bedrock of international order is the territorial state, with a monopoly of coercive power within its jurisdiction. Cyberspace does not change this, because economies are ultimately concerned with – and run for – human beings, who have physical presence and, in consequence, physical location. Because states are territorial jurisdictions, they are also the bedrock of global order and a globalised market economy.

Why globalisation does not render states impotent

If a state cannot raise taxes, it must wither away. Thus, critics of globalisation are right to focus on the ability of states to raise the revenue they need to finance their promises. If social democracy is doomed, then this is where the ruin will begin. The high-tax social democratic states will find their revenue collapsing or their economies imploding (or both), as capital and relatively skilled labour flood out. Moreover, all the other regulations such states impose – on the environmental impact of business, on health and safety, on the treatment of labour, and so forth – can be seen as further aspects of the ability to tax. Thus, if a government can raise taxes, it can, in general, impose regulations, as well. And if it cannot raise taxes, because the tax base will disappear, it will be unable to impose regulations either.

What then is the evidence on the ability of the governments of the high-income countries to impose taxes or regulations? Let us start with Table 1, which shows the growth of government in the course of the twentieth century. Four points shine out from these figures. The first is the enormous – and unrepeatable – growth of the functions of the state over the twentieth century. The second, is the variations among the high-income countries. The ratio of total public spending in the highest spending country (Sweden) to the lowest (the United States), in 1996, was two to one. The third is that there is virtually no sign of a reversal of the trend towards bigger government in the most recent period. Of the countries in the list, only Ireland had a lower ratio of public spending in gross domestic product (GDP) in 1996 than in 1980, while the United Kingdom's, notwithstanding all Mrs Thatcher's efforts, was the same. New Zealand's ratio has also fallen: it is another big exception. The last point is that to describe the period after 1980, as a return to laissez faire, or as marking the collapse of the state and the end of social democracy, borders on the unhinged. The growth of the state has slowed. It could hardly have done otherwise. That may have been a shock to politicians, but it was an inescapable one.

Table 1: General government expenditure (as share of GDP, percent)

Country	1913	1937	1960	1980	1996
Australia	16.5	14.8	21.2	34.1	35.9
Austria	17.0	20.6	35.7	48.1	51.6
Canada	na	25.0	28.6	38.8	44.7
France	17.0	29.0	34.6	46.1	55.0
Germany	14.8	34.1	32.4	47.9	49.1
Italy	17.1	31.1	30.1	42.1	52.7
Ireland	na	25.5	28.0	48.9	42.0
Japan	8.3	25.4	17.5	32.0	35.9
Norway	9.3	11.8	29.9	43.8	49.2
Sweden	10.4	16.5	31.0	60.1	64.2
Switzerland	14.0	24.1	17.2	32.8	39.4
United Kingdom	12.7	30.0	32.2	43.0	43.0
United States	7.5	19.7	27.0	31.4	32.4
Simple average	13.1	23.8	28.0	41.9	45.0

Source: Vito Tanzi and Ludger Schuknecht, *Public Spending in the 20th Century: a Global Perspective* (Cambridge: Cambridge University Press, 2000).

As the Belgian economist, Paul de Grauwe, has noted, between 1980 and 1995, social spending continued to rise in virtually all the significant high-income countries, globalisation notwithstanding.[4] The data from two International Monetary Fund economists, Vito Tanzi and Ludger Schuknecht, strongly support this. Between 1980 and 1995, the share of public spending on subsidies and transfers in GDP rose, on average, from 21.4 percent to 23.2 percent of GDP in a group of 17 high-income countries. The share stayed the same or, much more frequently, rose in every country, except Belgium (a modest fall from 30.0 percent to 28.8 percent of GDP), Ireland (a fall from 26.9 to 24.8 percent), the Netherlands (from an almost unbelievable 38.5 percent to 35.9 percent) and New Zealand (from 20.8 percent to 12.9 percent).

What has happened to taxation has also happened to regulation. As Philippe Legrain puts it in his excellent book: "Environmental laws are generally much tougher than they were twenty years ago: petrol taxes are higher, cars are required to emit less pollution, companies have had to reduce their emissions of noxious chemicals into the air and water: many now have to recycle a lot of their waste too".[5] In all, Clive Crook of *The Economist* has argued, with excellent reasons, that "big government, far from being dead, has flourished mightily".[6]

Now look at taxes. Table 2 shows the ratio of tax revenue to GDP for 1965, 1980, 1990 and 2000. It can be seen that over the period 1960 to 2000, the share of tax revenue in GDP has risen in every one of the countries shown. But the size of the increase has varied from 4.9 percent of GDP in the United States to 19.2 percent in Sweden. Much of the rise occurred between 1965 and 1980. Nevertheless, none of these countries had a lower share of tax revenue in GDP in 2000 than in 1980. New Zealand is a remarkable exception: the share of government revenue in GDP fell from 51 percent in 1987 to 41 percent – still quite high – in 2001.

The conclusion is straightforward. There is no sign of an inability to sustain tax revenue or regulations among the high-income countries. This is true even though average tax rates are twice as high in some countries as they are in others. However, this raises another question.

Table 2: General Government tax revenue (as share of GDP, percent)

Country	1965	1980	1990	2000	Increase 1965–2000
United States	24.7	27.0	26.7	29.6	4.9
Japan	18.3	25.1	30.1	27.1	8.8
Germany*	31.6	37.5	35.7	37.9	6.3
France	34.5	40.6	43.0	45.3	10.8
Italy	25.5	30.4	38.9	42.0	16.5
United Kingdom	30.4	35.2	36.8	37.4	7.0
Canada	25.6	30.7	35.9	35.8	10.2
Denmark	29.9	43.9	47.1	48.8	18.9
Sweden	35.0	47.5	53.6	54.2	19.2
Australia	21.9	27.4	29.3	31.5	9.6
European Union 15 (unweighted average)	27.9	36.0	39.5	41.6	13.7
Unweighted average of OECD countries	25.8	32.1	35.1	37.4	11.6

Source: Revenue Statistics 1965–2001 (Paris: Organisation for Economic Co-operation and Development, 2002). *United Germany from 1991.

Are there any signs that the higher-tax countries are, in some sense, uncompetitive? In his paper, professor De Grauwe takes as his indicator of competitiveness the rankings from the IMD's yearly *World Competitiveness Yearbook* and relates these to ratios of social security spending in GDP. He finds a modest positive correlation: the higher the social security spending, the more competitive the country.

If there is anything to the notion of competitiveness to which many appeal, it must mean something different from overall economic performance, by which we mean growth, productivity, employment and so forth. Poor economic performance can, after all, happen to closed economies just as easily as open ones (far more easily, as a matter of fact). The notion that a dire fate is now, and only now, in this age of globalisation and liberal capitalism coming to the social democratic states of western Europe must be directly connected to international economic integration: low protection against imports and high mobility of capital and people. A sign of the feared lack of competitiveness (caused by excessive taxation and regulation) might be a weak trade performance. It might, still more, be an outflow of capital and skilled people, which would amount to the disappearance of the tax base. So, one question is whether the highly taxed and regulated European economies suffer from these ailments. The answer is: no.

How can some countries have much higher tax and regulatory burdens than others and yet show none of the signs of a lack of international competitiveness. Professor Gray is convinced that the theory of comparative advantage cannot apply when capital is, to any significant extent, mobile. He is wrong. But it is important to spell out precisely why he is wrong and whether he could, under any circumstances be right.

Comparative advantage would only disappear if all countries were identical, in all relevant respects, even then, economies of scale are likely to generate possibilities for trade. Capital mobility does not begin to be enough to bring that about. Indeed, differences among countries today are bigger than they have ever been in history. Differences in natural resources are evident enough. However, the most significant differences are in what is also the most important source of wealth and poverty: the historically created stock of behaviour, values and explicit and implicit knowledge embodied in a population – a country's social and human capital, in other words. To the extent that the reward to labour exceeds that available to unskilled workers in poor countries, it can only be because rich-country workers have more capital at their disposal. A huge proportion of this capital is embodied within them. It is who they are.

If the population of Iran were, over night, to replace Germany's, how long would one expect it to remain among the richest countries in the world? Some poor countries possess within them a stock of values, behaviours and institutions that are better adapted to running a modern economy than others. It is not surprising to find that China, until just a few centuries ago, the world's most advanced economy, is among them, as was Japan, in an earlier generation.[7] In the right policy environment, such countries are likely to grow rapidly and accumulate physical and human capital more quickly than others. Even so, development does not make jumps. Among the processes that take most time is creating a population adapted to – and adept at – running a sophisticated, high-technology economy.

Human populations are, in normal circumstances, geographically fixed. But not only is the human population anchored, so, notwithstanding all the hyperbole about globalisation, is the vast bulk of its capital. By and large, people will invest their savings where they believe they will be safest. People who live in stable, prosperous countries believe their investments are safest at home. (Latin American rich people, in contrast, seem to believe everywhere is safer than home.) Their next favourite destination is other rich countries, with similar behaviour, values and institutions to their own. Then they are prepared to put money in those relatively poor countries that offer the most attractive relationship between risk and reward. Because virtually all developing countries are (rightly) seen as relatively risky places for foreigners to put their money and because only a few have the ability to compensate for that riskiness with credible offers of exceptional reward, the quantity of capital that flows to developing countries is small. Overall, the net flow is from developing countries to developed ones, not the other way round. Even the mobility of corporations can be exaggerated. There are few, if any, true trans-national corporations. They are anchored, instead, in the cultures, histories and human resources of one, or at most a few, specific countries.

What then am I saying? The short answer is that the bulk of the resources that make the difference between wealth and poverty are immobile. Jurisdictions matter hugely. This is not just because there are legal restrictions on the mobility of people, but because the people of high-income countries do not, for the most part, want to move even if taxes are higher where they are, because they are satisfied with the bundle of amenities they are able to consume. Because resources, particularly people, are immobile, patterns of comparative advantage, which are, in the contemporary world, largely dictated by differences in relative supplies of human and social capital, are also deeply rooted.

Moreover, because the most significant income-earning resources are relatively immobile, taxes can vary dramatically, as I have shown they do.

Armed with this analysis, we can begin to understand why professor Gray's warnings about the uncompetitiveness of a highly taxed and regulated economy are nonsense. He assumes, as such analysts do, that real wages (and the costs of other relatively immobile factors of production) are given from outside. That is what people in business assume, quite naturally, because it is true for them. A business person must obtain capital, labour – indeed everything – in competitive markets. If he or she does not provide these resources with the return given by the market as a whole, the business will disappear. But the vast bulk of Swedes are not in the same labour market as Americans. They are in a national labour market. If taxes rise, real disposable incomes, after tax, will fall in the market as a whole. The high social security charges in Germany, France or Italy, will not make these economies uncompetitive. They will, instead, reduce the disposable incomes, after tax, of German, French or Italian workers.

Exactly the same logic applies to environmental regulations. Imagine that all companies in a given country have to pay a tax on polluting activities. If one assumes, only for simplicity, that the return to capital is given internationally and the prices of all outputs are given in world markets, then these companies will need to pay lower wages, with the biggest proportionate reductions in the most polluting industries. However, remember that wages for people of a given skill must be roughly the same across the economy. So, as the economy adjusts to the new taxes, three things will happen, overall real wages will fall, compensated by the pleasure of a better environment, industry will move to less polluting technologies and the output of pollution-intensive industries will shrink, as such output goes partly abroad. None of this has anything to do with the competitiveness of countries.

It follows from the above that it is possible for governments to continue to redistribute income to the extent that those responsible for the more highly taxed activities or factors of production cannot – or do not wish – to evade or avoid that taxation. They may, in fact, be quite willing to pay the taxes, because they regard income redistribution as a location-specific benefit. That may be because they identify with the beneficiaries, or fear that they could themselves become beneficiaries, or treasure the greater personal security that comes from living among people who are not in a desperate plight. Alternatively, they may merely be unable to evade or avoid those taxes without relocating physically outside the jurisdiction, which they are loath to do.

The principles that apply to taxation apply also to regulation. Some regulations are deemed to be in the interests of the regulated. Being monitored by the United States Securities and Exchange Commission, for example, is a signal of quality. Other regulations ensure the provision of location-specific goods: clean air standards are an example of this. In neither case should the opening of an economy undermine the regulation. If people want to live where the air is clean, they will choose jurisdictions that ensure this, even if the price is regulation.

More broadly, regulations should be seen as a tax and, like any tax, mobile factors of production will be better able to avoid paying it. If, for example, an environmental standard were imposed on an activity that could be relocated somewhere else; the cost will be shifted onto an immobile factor of production – workers, for example. Alternatively, the activity will relocate. Either outcome would be politically unpopular. But this does not mean that the consequences are undesirable. If the aim is to reduce a locally polluting activity, this reduction will be still quicker if it is relocated altogether. The implication is then that a country that chooses international economic integration accepts constraints on its action. Nevertheless, the hypothesis that these constraints mean the withering away of the state's capacity to tax, regulate or intervene is wrong. It would be more accurate to say that the impact of international economic integration is to accelerate the market's response to policy, by increasing the range of alternative options available to those affected.

Yet the question must not just be what impact international economic integration has on the options enjoyed by governments, but whether such constraints are desirable. There are three important reasons for believing they are.

The first and most important is that the assumption of a benevolent welfare-maximising government is naive and implausible. International economic integration increases competition among governments – something that exists even when countries fiercely resist the integration, as the fate of the Soviet Union shows. This competition constrains the ability of governments to act in a predatory manner. That constraint is desirable, particularly for its own citizens.

The second is that even if high taxes and onerous regulations do not make a country uncompetitive, they are likely to make the economy perform less well. The impact is likely to include both higher unemployment and lower growth of productivity. Thus, if international integration constrains government intervention, the likely result will be faster growth and better economic performance. This is consistent with the observation from post-Second World War experience that open economies outperform closed ones.

The third is that even a benevolent government needs to find ways to bind itself, in order to increase the credibility of its commitments to the private sector, both domestic and foreign. One of the best ways of doing so is to make commitments to other governments, as in the WTO, or to powerful outside private parties. Even China has come to recognise the benefits it can gain from being able to make international commitments of this kind. Indeed, WTO membership is an effective way of importing the rule of law.

Does globalisation make states impotent? No, it constrains them in valuable ways and so makes them better able to serve the properly defined long-run interests of their citizens. The severity of constraints should also not be exaggerated. Provided a government supplies services that residents wish to enjoy, it can continue to tax, regulate and intervene. However, international integration does tend to make policy more transparent and government more predictable, both of which are desirable. The end result should be a state that is a servant of its people rather than a predatory master.

Why failing states are our biggest challenge

I now turn from worries about the role of states in advanced countries, to their failings in developing ones. States provide the institutions upon which complex market economies depend. They also decide the policies that determine how well private agents are able to identify and exploit economic opportunities. When states do a good job, prosperity soars. When they do a bad job or disappear altogether they create black holes; places from which little else but desperate people, a few natural resources and capital flight emerge.

Today's successful countries have benefited from a virtuous upward spiral of prosperity. Meanwhile, many societies seem stuck in a vicious spiral. Low standards of living mean limited ability to provide the necessary public goods. Education is inadequate and ill-health rife. Ambitious people too often view politics as the way to extract the wealth unavailable from normal economic activity. This is the route to the historically common 'plunder state'.

What are the chances that such vicious spirals can be turned around? Examination of the history of the West suggests there were three driving forces in the birth of good states: competition, consent and morality.

Competition among states works by imposing heavy penalties on any government that tyrannises over its subjects. In the European middle ages, for example, rulers gave charters of rights to cities to encourage the development of commerce, aware that communities of merchants might otherwise move to the realms of rivals.

Consent works through representative institutions and the rule of law. Both bind the actions of the sovereign in the interests of the governed. Today's evolved form is constitutional democracy. Any democracy that survives must be constitutional. Otherwise, one has post-colonial democracy: 'one man, one vote, once'.

Finally, moral reform works by defining the boundaries between the activities of the market and the state, or as Jane Jacobs, the Canadian author, has described it, between the "commercial" and the "guardian" syndromes. At its heart is the distinction between business people, who may sell their wares to the highest bidder but not use force, and judges, soldiers, policemen and politicians, who may not sell to the highest bidder but may use force.

Fortunately, these three forces are at work in today's world. It is because of regulatory competition, broadly defined, that the Soviet Union collapsed and Deng Xiaoping decided to turn China into a vast Hong Kong. Democracy is also on the march: in the last two decades of the twentieth century, 81 countries moved in the direction of representative political institutions. Finally, efforts to improve the quality of administrative and judicial institutions are being undertaken, with varying degrees of success, everywhere. Above all the contemporary advanced democracies exist and correspondingly exert a powerful, if often detested, influence.

Yet while many countries are now making good progress, notably in east Asia, others, notably in sub-Saharan Africa, are not. The world is full of failing and predatory states (with the latter often ending up as the former). Even when that is not the case, well-intentioned states often find it difficult to make credible commitments to good policies that in turn will encourage the entrepreneurship and attract the inward investment upon which a virtuous circle of development can build.

The second of these is the easier challenge to solve. It is hard for Lilliputian subjects to bind their sovereign, who is to them a giant Gulliver. This is why multilateral treaties among states and international jurisdictional integration can be so valuable. Gulliver can bind himself through agreements not with Lilliputians, but with other Gullivers.

Again, if states were credibly and predictably beneficent, there would be little need for such agreements, except to provide international public goods. But states, alas, are not. They are short-sighted and prone to capture by self-seeking domestic interest groups. That is why reciprocal bargaining on trade liberalisation has proved valuable to today's advanced countries. It is also why it is in the self-interest of developing countries to participate in such negotiations. Such integration has also been the most beneficial outcome of the European Union, with its mandated freedom of movement for labour, capital, goods and services.

However, jurisdictional integration only works between functioning and reasonably well-intentioned states. This leaves open the harder question of what to do for states that are barely functioning or are in the grips of murderous, incompetent or murderously incompetent tyrannies.

Aid, the evidence suggests, works well only in countries with tolerable policies and institutions. It can push countries along the upward spiral, but not put them upon it. In some cases outside intervention will be needed, either to remove tyrants or re-establish a minimum of order. This increasingly recognised need has created a nostalgia for the empire. But traditional empires are almost certainly unworkable – and unnecessary – in present conditions. What is needed instead is for the wealthy countries to act through the multilateral institutions, particularly the United Nations, thereby gaining the legitimacy they need both on the ground and with one another.

Conclusion

Technology and quality of government permitting, a market for mutually enriching exchange will span the world, because people will want to buy at the cheapest price (for any given quality) and sell at the highest; meanwhile, jurisdictions, however, are territorial. Because the latter seek to control their economies, they interfere constantly in international transactions. However, markets are also dependent on states, because states alone can provide the legal order, regulatory structure and infrastructure they require.[8]

The state and the market should be seen as two sides of one coin. Neither works without the other. Classical liberals underestimate the importance of a stable and supportive state, although they are right on the need for extensive liberalisation and deregulation. Dirigistes underestimate the importance of dynamic and deregulated markets, although they are sometimes right on the need for taxation and regulation. Good states need good markets, just as good markets need good states. The challenge of our time is to make this insight work for all of humanity.

Questions

What sort of welfare system does a society need in the era of globalisation?

That is a nice simple question! The most important answer I could give is that it is much the same welfare system as you would want in a society that did not have global opportunities available to it, with just a few exceptions.

Let us define the aim of welfare policy. First, the aim should be to ensure that you have a well-educated and healthy population, and this seems to be, at least in part, a government responsibility. This does not mean the government has to pay for everything but I think a government in a modern world has to be sure that people are getting properly educated and that they have the benefits of a reasonable health system.

Secondly, it is extremely important that the income support that societies will want to provide to those who are not doing well, must go with the grain of job creation rather than being inimical to it. There is a very important divergence now visible in the debate on the welfare state in Europe. Britain has followed the United States and other countries – including, I suspect, your own – that are trying to subsidise the incomes of relatively disadvantaged people in ways that encourage work rather than discourage it, whereas the European regulatory welfare state is a machine for generating unemployment. That seems to me immensely damaging.

Thirdly, to return to the theme in the paper I wrote 25 years ago, which Roger Kerr mentioned in his introduction, you want governments to encourage flexibility and adaptability of the business sector and the population at large. This involves, among other things, facilitating the acquisition of new skills when industries have to restructure. You would want this even if globalisation did not exist because economies are always undergoing structural change in response to shifts in supply and demand.

Lastly, I think it is pretty obvious that you would want a pension system for those who can no longer work that a country can afford. Again, this question of cost is not a response to globalisation. Italy and Germany and other countries will face a fiscal crisis merely because their governments have over-promised. Over-promising by governments, and then leaving heavy burdens on subsequent generations, is harmful and a far bigger threat to social stability than globalisation.

If I have understood you correctly, you have said that in spite of globalisation, governments are not condemned to give up regulation and high-tax regimes. I accept that point insofar as one aspect of globalisation is the free movement of capital but my observation is that governments that regulate and tax excessively are facing population collapse. It seems to me that the globalisation of the movement of labour does restrain governments in a way that I find highly admirable. Have you considered that aspect?

I had not thought of it that way and let me discuss why I find it implausible, although there is a possible relationship. The source of what you call population collapse in a number of developed and rapidly developing countries is, of course, low fertility rates. In fact, fertility rates are below replacement levels now in almost every industrial country as well as in quite a number of East Asian countries, including, I think, China. Certainly, the trend is in that direction. The United States is the only exception and, interestingly, that is because of its Hispanic immigrant population. The trends in the rest of the population are the same as in Europe.

There is no evidence that I have seen that the low fertility rate is directly correlated with what you call excessive regulation and taxation. I would be very surprised if it were, because the highest fertility rates in Europe are actually in the most highly taxed and regulated countries, namely those in Scandinavia. The reason is that the welfare state is a family substitute and, in a world in which families are collapsing, the family substitute does better in terms of fertility than not having families at all.

The other element is immigration. The developed countries of Europe are working desperately hard to keep out immigrants, they have to because if they did not there would be a huge net inflow, not just a large one. I find it astonishing that, within my lifetime, nearly every European country has moved from being a net exporter of people to being a big net importer. Some countries have changed their demographic composition quite startlingly in ways that no one would have predicted. In Sweden, for example, 10 percent of the population is foreign-born. The same, of course, is true in Britain.

So, I do not see why demographic collapse is caused by taxation and regulation, except in the sense that if the European countries were prepared to get rid of their controls on immigration more or less altogether, or encourage immigration much more than they are now doing, their populations would not decline. The major point I am making is that it remains the case – I know it is very shocking to some – that countries with a relatively well-chosen combination of taxes and regulations, and governments that do a reasonable job of providing public goods, are immensely attractive to people around the world. They are places people want to go to; not places people are fleeing from. I believe in international economic integration. It would be very satisfying for me to go around saying that countries should liberalise and globalise because if they do not their economies will collapse tomorrow and, anyway, it is impossible to raise any taxes, so forget about it. But it would not be true.

This is a very country-specific question. New Zealand has done three of the things that you think are terribly important, namely reduce the share of government spending in the economy, reform the tax system and embrace globalisation. It has also done these things better than many other countries. So how do you explain the conundrum that, although New Zealand has made some considerable progress over the last 20 years, it has not made as much as other small countries like Ireland, Singapore and Taiwan.

I do not think it is easy to compare New Zealand with Singapore or Taiwan, which are vastly different societies. New Zealand's performance as a small, open, essentially European economy compares very well with Australia and other similar economies with the exception of Ireland, which I will come to in a moment. It also seems clear to me that the growth performance of New Zealand has improved quite sharply relative to where it was before the reform process began. When I first met Roger Kerr some 20 years ago, we discussed New Zealand and I remember saying to him, "My God, this is a banana republic!". I apologise if that seems a bit of an insult, but this was at the time of Robert Muldoon's madness. I had the strong impression that New Zealand, in its own inimitable, respectable, well-managed way, was going the way of Argentina. Its economic problems were desperately serious.

Could a country like New Zealand match the 10 percent a year or so growth rate of Ireland? I think there is a very simple explanation as to why that is not really possible and it is related to international economic integration. A great deal of economic research shows that distance imposes a big cost. It is another form of trade barrier. New Zealand is very distant. Essentially, Ireland is a very small region of a gigantic economy and it has become the favoured location for investment by multinationals – essentially it has become their platform. This unique market opportunity in Europe, combined with the advantage of being an English-speaking country, has given Ireland an astonishing boost. If you took out the foreign direct investment that went into Ireland merely to exploit the favourable terms that Ireland enjoys in the European Union, its growth rate would virtually disappear. The domestic economy outside the international sector has hardly grown at all.

One way of thinking about Ireland is that it is to Europe what Rhode Island is to the United States. If Rhode Island had a third of the GDP per head and a third of the costs of the rest of America you would expect a lot of growth on Rhode Island. That is why Ireland grew so fast. These opportunities are not available to New Zealand, although if New Zealand were part of the kind of global free trade area that I have been advocating for many years, some of those benefits would flow. It seems to me that if you take account of New Zealand's economic circumstances it has done pretty well.

Something that has not come up so far is the United Nations. Can I ask you to be so bold as to make a prediction as to what the United Nations, and the plethora of ancillary bodies that it seems to spawn, might look like in 10–20 years' time.

I regard the United Nations as one of those institutions that everybody likes to hate but if it did not exist we would have to reinvent it. And the reason is perfectly obvious: the United Nations is a reflection of the countries of the world. Many of the countries of the world, as I discuss in my book, are in the most appalling state and therefore you would expect the United Nations, which is made up of those countries, to be in an appalling state also. And it is. However, the world is a small place, and getting smaller. We live side-by-side and share many global amenities. We need to cooperate. We have many problems to tackle and I cannot see any instrument other than the United Nations, in some form, for doing this.

For example, I do not believe that the US 'empire', as it were, is going to deliver a solution to all of these problems. I think it is obvious to any intelligent person that the US empire is failing on its very first small venture. Iraq is a very small venture compared with some of the other possible targets.

So it seems to me clear that the United Nations has to be used if the developed nations wish to achieve common purposes. There are other multilateral bodies, of course, some of which are not global, like NATO for security purposes, but some form of global framework is surely required. The alternative of having a nation essentially run the world on the basis of its own power and will is not going to work. Just as with globalisation, our job is to make the United Nations work as well as it possibly can in the full understanding that it is a reflection of the world. It will never work quite as well as we would like it to.

Given your earlier comments about the governments of Germany and Italy, and perhaps the same is true of France, over-promising their citizens, how do you see the politics of those countries unfolding over the next 10–15 years? From this distance it appears that the German electorate in particular is in a state of flux, and very unhappy with Gerhard Schroeder's administration. The French, although they have a right-wing government, seem to have a left-wing people and the Italians seem happier on the streets than just about anywhere else. So what are the chances that those key countries in the European Union will be able to manage a transition away from their over-stretched welfare states without a return to the instability of the past?

My first answer to that could be a famous line: "I never make predictions, especially about the future". It seems to me, however, that there are processes at work in these countries that, although slower, are similar to those in Britain in the 1960s and 1970s, which led to the crisis that gave rise to Thatcherism. Mrs Thatcher's reforms were a pale imitation of the reforms introduced by Roger Douglas and others here, but big countries are more difficult to change than small ones and that was the best that could be done.

I think the problems in Europe are similar. The important thing to remember – and it is easily forgotten – is that for most of the post-war period these economies and societies were sensational successes, and I mean sensational. I can easily remember the long stretch of years when all the main European economies grew by 4 or 5 percent every year while Britain grew by 2.5 percent, if it was lucky. From the time I was born to the time I was 30, the United Kingdom moved from being the richest country in Europe – after Switzerland – to being sixteenth in per capita income terms. The European economies continued to perform pretty well through the 1980s, and, on a per head basis, they did not do much worse than the United States, even in the 1990s. But the problems have become more visible, and people have begun to notice them. They do not have the kind of disorder that Britain experienced – perhaps that is part of the problem. The crisis is a slow-burning one, but many Europeans have realised that growth has slowed substantially in a number of European Union countries in the last 10 years, especially in Germany and Italy.

I stress that the awareness of this failure is only recent. First, you have to be aware of failure. There has to be a popular sense of the need to change. Then you need politicians who can articulate the problem and put together a reform programme. I think we are beginning to see emerge the sort of radical populist politicians who might, in the right circumstances, seize the opportunity to make changes, whatever they are saying now. Nicolas Sarkozy, in France, is an interesting example. But I would guess that the sequence of decay, awareness of emerging crisis, then real crisis, and, finally, the emergence of new political leaders has got quite a way to run. We may be talking 10 or 15 years. Let me say again that these are some of the richest and most successful countries the world has ever seen. Even now, nearly all of them are as rich as or richer than Britain. It is not easy for them to change. But they have to, and they know it.

In the earlier part of your lecture I think you said the state defines the identity of human beings. Have I quoted you correctly and, if so, why do you believe this?

What I said is that in many cases the state defines the identity of human beings. I think that is true. Perhaps I should have made it clear that it is not the only identity human beings have.

Let me give a flippant answer and then a serious one. The flippant answer is: did you watch the Olympics? They were surely an orgy of state identity. I watched them in Australia and, as far as I could see, Australians were unaware that there was any other nation competing in the Olympics. I am told – I may be wrong – that you regard your rugby team rather highly.

Now the point is that, for reasons Ernest Gellner described, national identity became, in the course of the nineteenth and twentieth centuries, a central element in the identity of human beings. This has not been true in all states but it has been true in most successful ones. Even the United States, where identity is not underpinned by any ethnic element, has done a phenomenal job of creating a national identity – indeed one that sometimes borders on the hysterical. The same of course is true of China, and Japan. Astonishingly, to my mind, it is beginning to come true in a country where this was not in any way natural – India. So, although I would not wish to argue that the only identity human beings have is the one that derives from their membership of a specific state, I would insist that it is often their primary identity. As such, and this was Gellner's insight, it is both a powerful asset and a great danger. And this goes to a central point about human beings: we are capable of understanding our relationship to the world as a whole but we are also intensely tribal. That tribalism takes the form of identification with states and of course identification with Olympic athletes and football teams, which I regard as a relatively harmless form of nationalism.

I think that the sense that you are part of a working community that shares not just institutions but also values, strengthens the capacity of a society to cope with the changes and challenges that the world throws at it. That seems to have been part of the explanation of the success of the Scandinavian countries and probably part of the success, over a long period of time, of countries like New Zealand. I think the notion of a stateless human being, that is to say a human being not attached to a civic identity that is associated with a structure of laws, rules, political processes and so forth, is a rather frightening one. In its benign form, a definition of identity linked to a particular state is, I think, something to be accepted and welcomed.

Vote of Thanks
Ralph Waters
chief executive officer
Fletcher Building

SIR RONALD AND LADY MARGARET TROTTER, Martin Wolf and your family, ladies and gentlemen: first, on behalf of all of us here, let me say that it is pleasing to see the Sir Ronald Trotter Lecture back in Auckland. Thank you Roger and Rob McLeod and we trust our time will come again soon.

I think it is important for us to understand and reflect on the big issues such as those dealt with by Martin Wolf tonight. We are deluged with local or short-term economic data that are often not much more than navel-gazing in the broader scheme of things. International forces lead to changes or impacts that survive and dwarf our domestic whims. The more we understand the benefits of liberalisation of markets, the easier it will be for our leaders to have the courage to stay on that path. As Richard Epstein, a former Sir Ronald Trotter lecturer, said recently: "[T]he policies that return you to prosperity are the only ones that will sustain that prosperity".

Martin Wolf has given us all tonight a much deeper insight into those issues of what is required to govern and regulate the global market economy successfully. As an agricultural exporter to over-regulated markets, New Zealand should be among the most interested of nations in the progress of globalisation and more liberal trading opportunities.

So, on behalf of everyone here, sincere thanks, Martin, for agreeing to give the Sir Ronald Trotter Lecture and for the scholarship and wisdom of your presentation. Would you all please join me in expressing our appreciation.

Notes

1 Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of National* (Oxford: Clarendon Press, 1976) p 457.

2 John Gray, *False Dawn: The Delusions of Global Capitalism* (London: Granta, 1998) pp 78,79,89.

3 Thomas Friedman, *The Lexus and The Olive Tree* (London: HarperCollins Publishers, 2000).

4 Paul de Grauwe, 'Globalisation and Social Security', mimeograph, undated.

5 Philippe Legrain, *Open World: The Truth about Globalization* (London: Abacus, 2002) p 167.

6 Clive Crook, 'The World Economy: the Future of the State', *The Economist*, London, 20 September 1997.

7 The historical status of China's economy, in many ways a rival to western Europe until 1800, is the theme of Kenneth Pomeranz's book, *The Great Divergence: China, Europe and the Making of the Modern Economy* (Princeton University Press: Princeton and Oxford, 2000).

8 An interesting analysis of alternative views of the foundations for the governance of the world economy is contained in Robert Gilpin, *Global Political Economy: Understanding the International Economic Order* (Princeton: Princeton University Press, 2001) chapter 15. Professor Gilpin discusses "the new medievalism" and "transgovernmentalism", but concludes that states remain the foundation of any global economic order, particularly the major states.