Modes of Social Policy in the Developing World

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Abstract

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Governments can engage in budgetary social policy by supporting *income maintenance* through social insurance and assistance programs or by providing *social infrastructures and services* such as public housing, education, and health services. This study examines conditions under which developing country governments prioritize one mode over the other.

I argue that a developing country government newly embarking on a path to welfare state would seek to fill in the welfare gap by prioritizing the mode that the private sector is less incentivized for or less capable of engaging in. Doing so helps the government to maximize the marginal political returns and tap the efficiency gains from social spending. I then argue that the preferred mode of private welfare enhancement in a developing country depends on the prevailing production and employment perspectives, which is shaped largely by the type of financing the private sector can access. Thus, financial structure ultimately explains mode of governmental social policy. I illustrate my theory with the distinctive trajectories of social policy development in South Korea and Singapore. I test the theory's generalizability through an analysis of 66 low and middle income countries over a time period between 1974-2006.

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to my parents

Chapter 1

INTRODUCTION

1.1 Puzzle: Variation in Modes of Social Policy

What explains the variation in social policy in the developing world? The variation can be examined along two analytical dimensions. The first concerns the level of social spending, which has been discussed extensively in the extant literature. The literature has focused on a range of factors including economic openness, inequality, labor's political representation, patterns of political competition, and cross-class alignment (Rudra 2002; Wong 2004; Wibbels 2006; Haggard and Kaufman 2008; Wibbels and Ahlquist 2011)[1], and has offered compelling explanations on the breadth–segment of the population protected– and depth–generosity in terms of replacement rate and duration– of social policy in the developing world.

This study focuses on another analytical dimension that the extant literature has not fully explored: the choice by a developing country's government among different social policy instruments. According to Marshall:

> *"Social policy refers to policy of governments with regard to action having a direct impact on the welfare of the citizens, by providing them with services or income...The central core consists, therefore, of social insurance, public (or national) assistance, the health and welfare services, and housing policy...Education obviously belongs..." (T.H. Marshall, 1965:7).*

Facing budgetary constraints, the government needs to prioritize rather than to

[1]See Mares and Carnes (2009) for a review of the literature on the welfare states in the developing world.

spend indiscreetly on all the above actions. This would especially be the case when the governments recognize that the same welfare objective can be addressed with more than one policy instruments. Refining this idea, I categorize the alternative policy means of achieving key welfare objectives into two distinct modes: first, *income maintenance support*, and second, *social infrastructures and services provision.*

Although analytical focus on policy instruments is not new in the welfare state literature, this study's distinction between the two modes is different from the existing classifications. The existing literature's focus on policy instruments was largely subordinate to the accounts of variation in levels of social spending. The examples include the distinction based on eligibility criteria (i.e., means-tested versus universal) or the distinction based on redistributiveness criteria (i.e., social insurance programs with varying degrees of between-income-group risk pooling). Adopting instruments with universal eligibility and high redistributiveness tends to involve high budgetary spending, whereas adopting instruments with strict means tested eligibility or with earnings related rate tends to involve lower budgetary spending. The former is a common description of the social democratic welfare states and the latter is of liberal welfare states (Esping-Anderson 1990). The analytical distinction I make between *income maintenance* on the one hand and *social infrastructures/services* on the other hand is different in that both modes can potentially target the *same* segment of the population, using the *same* amount of budgetary resources.

Table 1.1 lists the key subcomponents of each mode. For example, governments can address life cycle-induced uncertainties, especially from aging and retirement, in either mode. Governments can operate public pensions and offer old age allowances to increase income security of the elderly. This is governmental income maintenance support. Alternatively, governments can provide public housing, which would otherwise be a major component of the household budget. This is governmental social infrastructure/services provision.[2] Similarly, risks induced by labor market uncertainties

[2]The large overlap between the role of income maintenance programs and housing in

can be addressed in either mode. Governments can operate unemployment insurance and offer unemployment benefits so that citizens can get through unexpected financial difficulties caused by job losses. This is governmental income maintenance support. Alternatively, governments can create education and training facilities to provide low cost opportunities for acquiring various levels of skills, which would enhance workers' competitiveness in the labor market. This is governmental social infrastructures/services provision.

	Modes of Social Policy	
Major Welfare Concerns	Income Maintenance	Social Infrastructures&Services
Life Cycle Induced Uncertainties	Pension and Old Age Allowance	Housing
Labor Market Uncertainties	Unemployment Insurance/Assistance	Education and Training
Health Uncertainties	Health Insurance/Assistance	Health Services

Table 1.1: Modes of Social Policy

High level of government spending in one mode does not necessarily mean equally high commitment in another. The potential trade-offs between the two modes have already been recognized in the context of the developed world. For instance, Busemeyer and Nokolai (2010) find that some conservative welfare states in Europe such as German and Italy exhibit far lower level of public education spending than one might expect on the basis of their social insurance spending. On the other hand, some liberal welfare states such as United States and New Zealand spend more on public education than expected on the basis of social insurance spending.[3]

smoothing out lifecycle-induced uncertainties has been recognized in the existing literature (Kemeny 1981; Castles 1998; Schwartz and Seabrooke 2008).

[3]The terms "conservative welfare states" and "liberal welfare states" are from Esping-Anderson (1990).

When the variation in social policy is expanded to encompass the modes of social policy, one would also find the existing typologies for emerging welfare states insufficient. For instance, East Asia's newly industrialized economies (NIEs) are often lumped together as "minimalist," "developmental," "conservative," "Confucius" or "productivist" welfare states (Goodman and Peng 1996; Holiday 2000; Aspalter 2001; Holliday and Wilding 2003; Rudra 2007) where social spending has been contained with an emphasis on economic growth.[4] It is often ignored that these newly industrialized economies (NIEs) have made distinctive prioritization between the two modes of social policy. As summarized in Table 1.2, during the past decade, Singapore spent 1.5% of its GDP (less than a fifth of budgetary social spending) on income maintenance whereas Taiwan spent 4% of its GDP (over 60% of the budgetary social spending) on income maintenance. Singapore, instead, spent 6.4% of its GDP on social infrastructure provision whereas Taiwan spent only 2.5% of its GDP on these infrastructures.[5]

	Singapore	Hong Kong	South Korea	Taiwan
	Spending Levels (% annual GDP)			
Total Social Spending	7.9	11.1	7.3	6.4
Income Maintenance	1.5	2.2	2.9	3.9
Social Infrastructure&Services	6.4	8.9	4.4	2.5

Table 1.2: Modes of Social Policy in the East Asian NIEs

[4]Rudra (2007) categorizes welfare states in the less developed countries (LDCs) into three types: productive, protective, and dual welfare states. Studies by Goodman and Peng (1996), Holliday (2000), Holliday and Wilding (2003) are more specific to the East Asian region.

[5]The data are averaged over 2000-2008 (Source: IMF-Government Finance Statistics). See Table 4.1 in Chapter 4 for the details on the construction of each mode.

Such variations are also discernible in a broader set of developing countries (see Figure 1.1).[6] There is a negative association between public housing and public income maintenance spending. Likewise, a negative association is observed between public education and public income maintenance spending. On the contrary, there is a positive association between public housing and public education, both of which are subcategories of social infrastructure.[7]

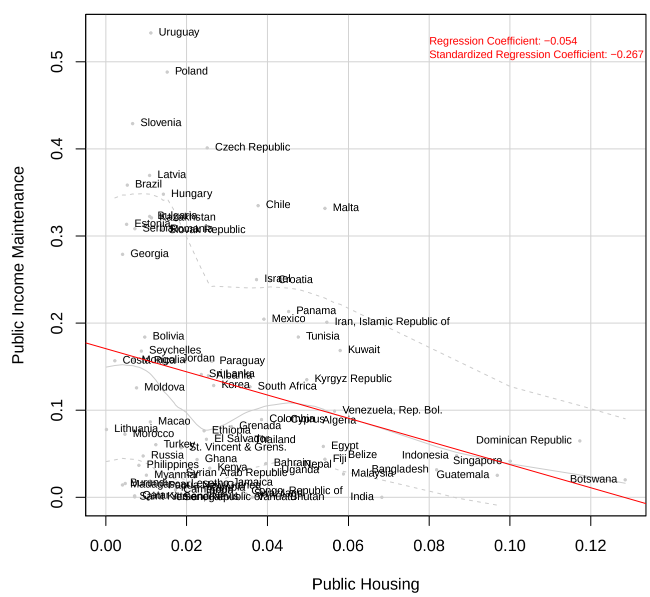

Figure 1.1a: Social Spending in Developing Countries

[6]The scattered points are country level averages over the post cold war (1991-2008) period. Due to data availability, income maintenance spending is not disaggregated. See Table 4.1 in Chapter 4 for the details on the construction of each mode (Source: IMF-Government Finance Statistics).

[7]Solid red lines are bivariate regression lines and solid gray lines are loess curves estimated with a span of 0.5.

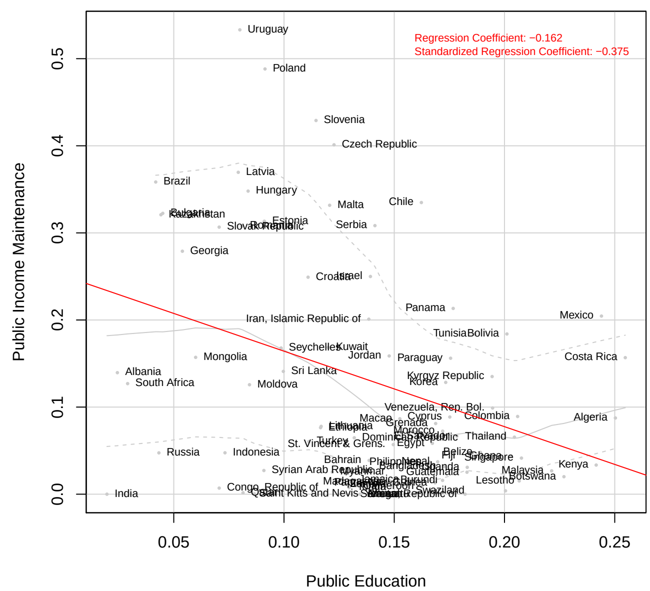

Figure 1.1b: Social Spending in Developing Countries

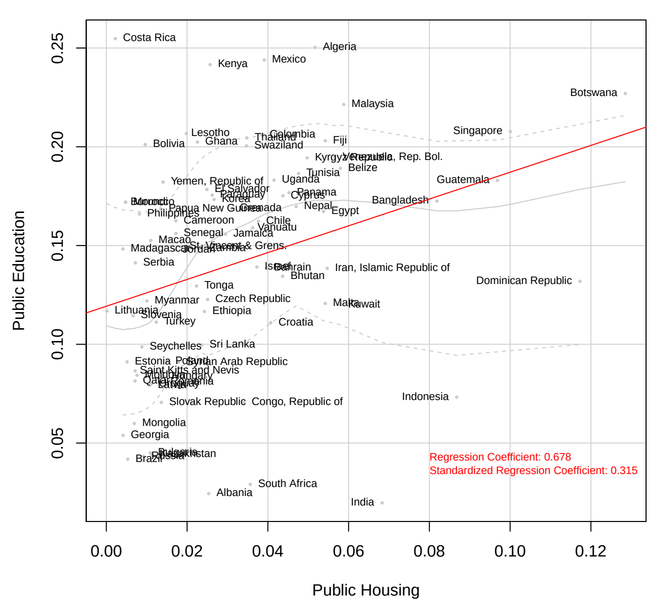

Figure 1.1c: Social Spending in Developing Countries

What explains the prioritization between the two modes of social policy? I begin with the assumption that in addressing any welfare concern, incumbents favor the mode of social policy that promises greater political returns. The political returns for incumbents, in turn, depends on the utility of social policy for their *selectorates* –the segment of the population who participate in the selection of the leader (Bueno de Mesquita et al., 2003). In a country where the welfare state is relatively new and has little or no history, the selectorate would evaluate the marginal utility of each social policy instrument based on what can be provided and acquired in the private sector. This leads the incumbents to fill in the welfare gap based on their assessment of the private sector's capabilities and incentives for welfare enhancement.

A pertinent question is then: what determines the private sector's such capabilities and incentives, or the private mode of welfare enhancement? I argue that it is the production and employment perspectives prevailing in the domestic economy, which, in the developing world context, is shaped largely by the type of external finance the production firms can access. Therefore, the financial structure of a developing economy ultimately determines the private mode of welfare enhancement.

Following Rajan and Zingales (1998; 2001; 2003a; 2003b), I distinguish two broad types of financial transactions: first, relationship-based financial transactions, and second, arm's length financial transactions. The former mitigates the potential risks in financial transactions through political or informal/personal networks. The latter mitigates the risks through impersonal markets that provide avenues to disclose information and align incentives. In which manner the financial transactions are conducted and the firms are financed has important implication on the broader economy of developing countries.

In developing countries where financial transactions are mainly relationship-based, the corresponding long-term horizon production and employment perspectives in the private sector would encourage the private provision of welfare-related infrastructures and services. Governmental social policy would then emphasize income maintenance programs, which complement the private sector's welfare efforts. On the contrary, in developing countries where financial transactions are mainly conducted at arm's length, the corresponding flexible investment and employment perspectives encourage private provision and acquisition of income maintenance programs, while investment in welfare-related infrastructures that typically involve a long-gestation lag is discouraged. Thus, governments would focus on the provision of social infrastructures and services. The causal linkages are summarized in Figure 1.2. Each of the causal linkages is elaborated in Chapter 2.

In Chapter 3, I illustrate my theory with the cases of South Korea and Singapore. South Korea's industrialization is characterized by the dominance of relationship-based financing. The corresponding long-term horizon production and employment perspectives held by firms and workers encouraged the private provision and acquisition of various welfare-related infrastructures and services. Government's budgetary social policy has increasingly been conducted through income maintenance programs. In Singapore, arm's length financing was developed early on to meet the capital needs for industrialization. The corresponding flexible and performance-sensitive production and employment perspectives discouraged the private provision of welfare-related infrastructures and services. Government's budgetary social policy has emphasized the provision of social infrastructures and services.

In Chapter 4, I test the generalizability of the welfare gap-filling approach through an analysis of 66 low and middle-income countries over a time period between 1974-2006. I find that the greater reliance of a country's private sector economy on arm's length finance is associated with the government's prioritization of social infrastructures and services. Conversely, the economy's greater reliance on relationship-based finance is associated with the government's prioritization of income maintenance. I also find that the effect of financial structure on governmental social policy prioritization is not uniform. The effect is mitigated when the existing mode of social policy, over time, develops vested interests and institutional inertia. The effect of financial structure is also weaker in an authoritarian political environment where the size of minimum willing coalition is small than in a democratic political environment.

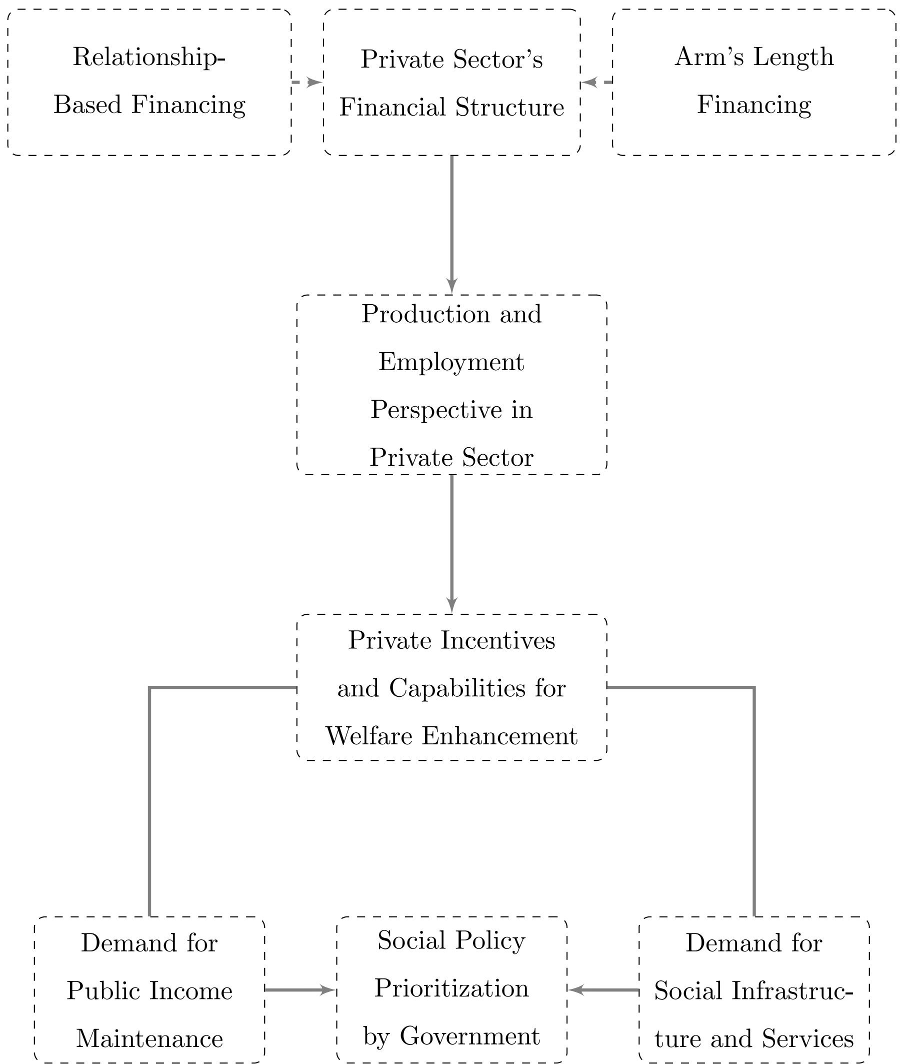

Figure 1.2: Causal Linkages

1.2 Literature

This study engages with a broad literature on welfare states. First, it builds on two distinct approaches on cross-national variations in welfare states: power resource theory (PRT) and varieties of capitalism (VOC). The PRT looks at the influence of contending interest groups, especially the relative strength of the organized left/labor as opposed to capital/employers. Studies taking this approach focus on the correlation between the level of welfare spending and labor's power resource measured, for instance, by the left/labor party share of legislative seats (Korpi 1980; Esping-Andersen 1990; Huber and Stephens 2001). However, accounting for the variation in modes of welfare provision is difficult within the PRT framework since the theory is predicated on "a practical equivalence of interests among like classes in different countries", and on "equivalence of conflict across their respective class divides" (Swenson 2002:8); labor is assumed to prefer higher spending in any mode of social policy, whereas capital is assumed to be against the expansion in any mode of social policy. My theoretical framework complements the PRT literature by allowing for the welfare preferences among like classes to vary by their welfare provision and acquisition potential in the private sector.

The VOC literature focuses on the role of social policy as insurance against various social risks. It emphasizes the function of governmental social policies in creating comparative advantage for the broader economy (Hall and Iversen 2001; Mares 2001). The strength of the VOC approach lies in its comprehensiveness in incorporating institutions on political representation–such as electoral system (Iversen and Soskice 2006, 2010)–, on labor-employer relations, and on social policy. The approach, however, also has its critics. Most of all, it has been argued that the VOC framework suffers from the "functionalist fallacy" of assuming, rather than proving, that employers have vested interests in social policy under certain type of industrial relations–mainly in Coordinated Market Economies, or CMEs (Ebbinghaus 2010:198). Critics of this so-called employer-centered approach argue that, throughout history employers have been reluctant consenters, if not antagonists, of welfare state expansion (Korpi 2006). Employers have little incentive to support social spending if the demand for such spending from labor is weak or private alternatives are available. As Commons noted, "social responsibility is never accepted effectively by employers...until they are faced by an alternative which seems worse to them than the one they willingly accept" (Commons 1934:854). Reconciling the VOC's employer-centered approach and the critique against it, I suggest that employers are key players in the course of welfare state development not because they determine the level of government's social spending, but because their own capabilities and incentives for welfare provision influences the choice of governmental social policy. Employers would want social policies to effectively fill the gap in the private welfare provision rather than to duplicate it.

Second, this study can be placed along with the burgeoning literature on social policy in the developing world. Although existing studies offer compelling explanations on the level-wise variation in social policy, they have not addressed why a certain policy instrument was chosen over the other. For example, Mares and Carnes view Taiwanese president Chiang Kai-skeck's adoption of a series of social insurance programs since the 1950s as an attempt to protect the urban industrial workers who were the regime's core political supporters (Mares and Carnes 2009). They leave unexplored why the partners in this coalition–government, firms, and urban industrial labor– agreed upon social insurance programs rather than other alternatives such as the provision of public housing. Similarly, Wibbels and Ahlquist point out that the Singaporean government's spending on social insurance and assistance programs in the early 1980s, a period of rapid growth, was only 1% of its budget. Its low fiscal priority on social spending is attributed to Singapore's export-oriented economy and small domestic market, among other things (Wibbels and Ahlquist 2011). What the authors left unexplored is the fact that the same country, in the same period, spent over 5% of its total GDP to provide social infrastructures and services such as public housing, education, and health services. I seek to complement the literature to date by adding a new analytical dimension, modes of social policy, and by systematically explaining the variation among the emerging welfare states in this new dimension.

Third, my focus on the financial structure as a key determinant of the social policy choice in the developing world speaks to the continuing debate concerning globalization and the future of emerging welfare states. A majority of studies has focused on how economic and financial globalization affects the level of social spending in the mature welfare states of Europe and the US. Some argue that globalized competition for capital puts downward pressure on welfare states (race to the bottom/efficiency thesis). They predict unavoidable cuts in social spending with an increased emphasis on private arrangements (Mishra 1999; Gilbert 2002). Others argue that the welfare states can withstand the downward pressures and reinforce their efforts to compensate for the increased risks from the globalization (compensation thesis) (Rodrik 1998).

As an attempt to adjudicate the debate, many have shifted focus away from the structural factors–globalization forces– to domestic political and institutional characteristics. The effect of financial globalization on the welfare states would vary, since domestic political context, such as partisan bias in fiscal and electoral institutions, differ among the affected countries (Garrett1998; Mosely 2000, 2003; Mares 2003; Avelino et al. 2005; Tanzi 2006). Some empirical findings also seem to support this strand of approach. Garret (2001), for instance, finds that corporate tax collections by the governments have remained relatively stable in both developed and emerging markets, suggesting that an increased capital mobility does not, in and of itself, cause a significant public spending constraint. As Freeman and Quinn put it, capital is still taxable at a rate that allows for "some distribution" and "production of some public goods" (Freeman and Quinn 2012:63).

While recognizing the central role domestic politics plays in welfare state development, my theoretical framework revisits the role of structure, mainly, the financial structure. My theoretical framework suggests that the trajectory of financial liberalization may not independently determine the *level* of social spending, but can independently shape the *mode* through which a government engages in the provision of welfare. A deeper integration of developing countries with the global arm's length financial market would lead the governments to prioritize social infrastructures and services provision over income maintenance support.

In the following chapter (Chapter 2), I elaborate my theoretical framework. In Chapter 3, I further illustrate each causal linkage with the cases of South Korea and Singapore. In Chapter 4, I test my theoretical framework in a cross-country panel setting and discuss the findings. Chapter 5 concludes with remarks on how my theoretical framework can potentially be applied to issue areas other than social policy.

Chapter 2

THEORETICAL FRAMEWORK

What explains a government's choice between distinct social policy instruments? More specifically, what leads a government under budgetary constraints to prioritize *income maintenance* over *social infrastructures and services*, or vice versa? This chapter develops a theoretical framework to systematically explain the variation in modes of social policy in emerging welfare states. Along with the theoretical narrative, I present anecdotal evidence from the contemporary developed countries in the late 19th and early 20th century as well as from the developing countries in the more recent decades.

2.1 Rationales for Welfare Gap-Filling Approach

I begin with the general assumption that in the context of any welfare goal, incumbents favor the mode of social policy that promises greater marginal political returns: votes, in most countries. Suppose that an incumbent is pressured to address the concerns about aging and retirement. As discussed earlier, such life cycle-induced uncertainties can be addressed in either mode: through income maintenance support (with an emphasis on old age pension and allowance) or through social infrastructures and services (with an emphasis on public housing and elderly care facilities). Within in its budgetary capacity, the incumbent needs to decide an appropriate mix of the two modes that allows him/her to maximize the political returns.

The marginal political returns for the incumbent, in turn, depends on the marginal utility of social spending for his/her selectorate -the segment of the population who participate in the selection of the leader (Bueno de Mesquita et al., 2003). In a developing country where the concept of the welfare state is relatively new and yet to generate vested interests[1], the selectorate would evaluate the utility of governmental social spending based on what is –or is expected to be– provided and acquired in the private sector. If, for instance, there were enough (potential) suppliers of private residential housing, but not enough (potential) suppliers of private pension schemes, then the suppliers and (willing) consumers of the private housing would see the creation of public housing less desirable than the governmental financing of pension schemes. Of course, those with both private housing and private financial arrangement for income maintenance, presumably a small segment of the selectorate in the developing country context, would be indifferent to which mode the government chooses to prioritize, as they will benefit little from neither. Those who can obtain neither housing nor income maintenance arrangement in the private sector would also be indifferent, as they will benefit regardless.[2] Thus, the marginal utility of public pension would be greater than (or at least equal to) that of public housing for most subsets of the self-interested selectorate. The incumbent who wants to appeal to his/her selectorate's concerns about life cycle-induced uncertainties is likely to increase the budgetary allocation to the income maintenance mode of social policy.

This rationale for the welfare gap-filling approach holds across different sizes of the minimum winning coalition. Whatever the size of the meaningful selectorate is, the incumbent's strategy would be to fill in the welfare gap based on his/her assessment of the given selectorate's capabilities and incentives for private welfare enhancement. Of course, the chosen mode of social policy would have more public goods-like features (benefiting broad population) when the size of minimum winning coalition relative to the selectorate is large. The same mode of social policy will have more private goods-

[1]This assumption is relaxed later in this chapter

[2]These people might also prefer income maintenance support because the additional income gives more discretion to them; they can use it to pay rent for housing (given that there is a sizable market for private rental housing) but also to buy other goods.

like features (concentrating benefits to those in the coalition) when the minimum wining coalition is small. This is an important, yet distintive analytical dimension from the modes of policy discussed in this chapter.

What if the incumbent is not a vote maximizer, but a policy maximizer who simply chooses the most efficient mode for achieving a specific welfare objective? The welfare gap-filling approach allows the policy-maximizing incumbent tapping efficiency gains, which is a point often articulated by policy experts. For instance, in discussing the public and private roles in education, Jimenez and Sawada (2001) argue that in developing countries with a relatively large private education sector, expansion of public education may draw away students who may have gone to school anyway, attenuating the efficiency gains from the increased public education spending. Their empirical study of Philippines' public education expansion indeed finds that large public secondary education expansion crowded out private secondary enrollment. The lesson is that "where the private sector is active and provides a viable alternative to the public sector, substitutability between private and public sectors is important in evaluating the net benefits of government expansion" (Jimenez and Sawada 2001:390). The budget could be better spent, at least in terms of policy efficiency, by offering income maintenance support for households who would not otherwise send their children to schools.

Likewise, in discussing the pubic and private roles in health, Musgrove (1996) points out that the decision between governmental provision of health facilities and services on the one hand, and governmental financing of the patients' health care costs on the other hand should be based on which governmental role can be superior in terms of costs and quality compared to the private role. He emphasizes that "tying public finance to public provision [is one thing] governments should not do ...[because] consumers would use more private provision, if they could obtain it at the same price or benefit from the same subsidy as when going to public providers"

(Musgrove 1996:56).[3] Barr (2012) makes a similar point with regard to the debate on the UK National Health Service. He says it is "wholly fallacious" to argue that "we must have a National Health Service because otherwise the poor could not afford adequate health care" or because "everybody has a right to health care" (Barr 2012:77). The fallacy is that such a statement "confuses objectives with methods"; if the true difficulty lies in some segment of the population's inability to pay, this is "not a market-allocation problem, but an income-distribution problem, which could be solved by income transfers" (Barr 2012:77). Engaging indiscreetly in both public provision–"make"– and public finance–"buy"– without proper assessment of the capability of the private sector makes the social policy inefficient, which is indeed what has happened in some developing countries where "public health facilities are used only because they are free or nearly so" (Musgrove 1996: 57).

The aforementioned evidence of the government spending-induced substitution or crowding out effect with regard to the private sector suggests that a competent, policy maximizing incumbent would take the private mode of welfare enhancement into consideration when making social spending decisions.

Last but not least, the welfare gap-filling approach is also applicable under the situation of government capture. Instead of assuming a vote maximizing or policy maximizing government, the capture theory suggests that government regulations are often set up to serve the narrow interest of the powerful firms (Stigler 1971). Applying the theory in the realm of social policy suggests that a group of powerful firms can utilize their political and economic leverage to enact or block the mode of social policy that promotes their profit seeking.

For instance, if a group of powerful firms sees the provision of hospitals or residen-

[3] This does not necessarily mean a government should never use public provision and public finance together, which will sometimes be the best solution. As Musgrove (1996: 57) notes it means rather that "the competition between public and private providers should be based on costs and on quality".

tial housing suits their business interests, they would seek to block the new entrants including public competitors. The firms may also seek to take advantage of direct industrial subsidies, but doing so would be a less optimal strategy. As Stigler (1971) notes, for the industry insiders who have already captured the government with their resources, control of entry and output is a more preferable regulatory strategy than receiving subsidies. This is especially so in developing countries where the market for said infrastructures are far from saturated, and subsidies can potentially attract new entrants. The benefits from subsidies would then be quickly dissipated among a growing number of competitors (Migué 1977). Thus, the powerful firms would generally favor indirect measures that can stimulate the demand for the goods they provide, combined with effective entry and output controls.[4] When possessing the leverage to shape the mode of social policy, these firms would push for public income maintenance programs while blocking public provision of welfare-enhancing infrastructures and services.

In essence, regardless of being a vote maximizer, a policy maximizer, or a captive agent, the incumbent is incentivized to assess what the private sector is able/less able to provide. Rather than duplicating what the private sector does (or has potential for doing), the incumbent chooses a complementary mode of social policy that can fill in the welfare gap in the private sector.

If the private mode of welfare enhancement is what determines the governmental social policy prioritization in developing countries, the root question is: what explains the private mode of welfare enhancement? To answer this question, I focus on one critical dimension of the economy: the financial structure. The type of financing the private sector can access shapes the production and employment perspectives of the

[4]The government might actively subsidize the private providers of welfare-enhancing infrastructures and services in the situation of excess demand, rather than in the presence of powerful industry insiders.

industrializing economy, and in turn, determines incentives and capabilities of the firms and the workers with regard to welfare enhancement. In the following section, I distinguish two types of financing each associated with a distinct set of risks-solving strategies in financial transaction.

2.2 Types of Financing to the Private Sector

Financial transactions everywhere, but especially those in the developing world, involve various risks; they include, but are not limited to, government expropriation, weak contract enforcement, and imprudence by borrowers and lenders (Haber et al. 2008). Following the existing literature (Rajan and Zingales 1998, 2001, 2003a, 2003b; Wolf 2011), I distinguish two distinct strategies for dealing with the risks: relationship-based transaction versus arm's length transaction. The dominance of one type of transaction over the other has important ramifications for production and employment perspectives in the private sector. Table 2.1 summarizes the key problem solving features of the two distinct types of financial transactions and their respective implications to the broader economy.

In relationship-based transactions, the risks of government expropriation are compensated through limits on competition and high barriers for new entrants. There are often a small number of privileged financiers who give capital access to the producers about which they have connection-based private information. Limitations on competition do not just give the financiers power, but also strengthen their incentives to cooperate with the borrowing firms (Rajan and Zingales 2003b). Importantly, as the patterns of relationship-based banking and shareholdings develop, lenders and shareholders become more interested in the long-term and multi-stranded business they do with the firm, and become less interested in the short-term profits to be made from each individual investment (Dore 2000).

In developing countries where most firms lack established reputation, the initial creation of the "relationship" often involves the government and informal networks

	Relationship Based Transactions	Arm's Length Transactions
Risks	**Problem Solving Strategies**	
Government Expropriation	Limits on competition (High barrier for new entrants)	Limits on the role of government (Lower barrier for new entrants)
Financiers Imprudence	Government-created Institutions to reduce risks (public deposit insurance, supervisory institutions)	Institutions created between stakeholders (outside directors, information disclosure)
Monitoring of the Financed	Accumulation of in-depth private knowledge (i.e., information rent)	Disclosure of information reduces the need for direct monitoring
	Implications	
Investment Pattern	Preference for repeated transactions Large, physical asset-intensive projects	Low initial preference for continuing relationship. Intangible assets with high profitability
Production	Longer-term planning and diversification	Flexibility in adjustment of production costs
Employment	Rigid labor market Steady rate of remuneration	Flexible labor market Performance sensitive remuneration

Table 2.1: Types of Financial Transactions

based on personal and familial backgrounds. The government intervenes in the collection and allocation of the foreign as well as domestic capital by employing controls and directions and also by offering implicit and explicit forms of public guarantees (Rajan and Zingales 2003a). A recent cross-country empirical study indeed finds that the existence of government deposit insurance is associated with higher leverage and longer debt maturity of domestic firms in developing countries. (Fan et al. 2012:22).[5]

Such a financing pattern has distinct implications on production and employment perspectives in the private sector. Firms that obtain relationship-based finance tend to have long-term production planning due to relatively stable and often personalized relationship with the providers of capital. Since they only need to maintain the value of the investment in existing relationships and ensure the long-run ability to repay, firms are encouraged to increase the size of tangible assets through expansion and diversification rather than being pressured to increase the short-term profitability (Booth et al. 2001).

[5]The authors find that the same association does not hold in developed countries.

Labor employed in firms relying on relationship-based financing shares the rents from the relationship-based financing, which often comes in a form of high job security (Rajan and Zingales 2003a). Dore (2000)'s observation of Japanese firms facing recession finds that, during the decline, energies are directed to maintain the company as a whole entity, including its size of employment, rather than maintaining profitability. When downsizing is inevitable for a project in the declining sector, the "transfer of the maximum possible number of employees to new activities" is undertaken under the expectation of a long gestation period. The firms do so expecting "hurdle rates of return on investment well below market interest rates". What enables this pattern of behavior is the "relational banking" and "stable shareholdings" prevalent among Japanese firms (Dore 2000: 28-29, 34). Woolcock (1996:183)'s observation of Germany is also in a similar vein: when problems arise, the normal practice for stakeholders is to "voice concern" rather than "exit", which means that "takeovers or change in ownership are not the norm for corporate restructuring." Even when takeovers take place, Rajan and Zingales (2003b: 127) point out that the mergers and takeovers between domestic firms in Germany have been much more "conciliatory" and "protective of the status quo" than those in the US.

Similar remarks are made on firm behaviors in Taiwan, a prototypical relationship-based economy outside of the traditional developed world. Kao (1991:74) points out that the "inertia of tradition" is strong in the Taiwanese firms relaying on personal trust for financing. Even when adapting to new rules and new patterns, there is "no quick and total transformation." This tendency of gradual adaptation allows them to maintain the workforce size even during the downturn of business or during the temporary transition period. In short, relationship-based finance, either foreign or domestic, provides formal sector employees in these economies with relatively high job security.

On the contrary, in cases of arm's length financial transactions, the flow of capital to the private sector is impersonal and contractual. The market provides avenues to align incentives given the disclosed information, which reduces the need for and the cost of direct monitoring. As Tsuru puts it, an arm's length financial relationship is akin to "spot transactions, more short-term and less control-oriented" (Tsuru 2001). As investors focus on short-term return on captal, rather than longer term market share, their links with the company management also tend to be weak (Woolcock, 1996:183). When problems arise, this characteristic allows the investors to "exit" rather than trying to rescue by"voicing" their concerns and address them with the management (Woolcock, 1996:183).

As the nature of financial transactions is transient, and financiers have low (initial) preference for repeating business, short-term projects promising high-profitability and liquidity are preferred to long-term projects involving tangible yet slow-growing assets (Wolf 2011). This would especially be so in the developing world where firms lack established reputation and investors lack information on individual firms; investors would be hesitant to fund long-term projects as their limited knowledge about the business context in developing countries increases the perceptions of risks.

The short term investment horizon that prevails among financiers leads the firms to adopt flexible production patterns. Showing strong and constant profitability is vital to attract short-term loans or equity investments as a major source of production financing. For doing so, firms should maintain flexibility in production costs in response to a potential market fluctuation. This production strategy accompanies frequent adjustment of the labor costs. A rapid liquidation of loss making projects and redundancy dismissals are often inevitable. Thus, countries industrializing with arm's length finance are expected to develop a more flexible labor market than countries industrializing under relationship-based finance. In other words, employment relationship tends also to be based on arm's length contracts. As Fantasia and Voss describe in the context of the United States, employees and employers negotiate "at many thousand workplaces" across the country, producing "thousands of separate labor contracts" that generally apply only within each of the specific workplaces or firms. This allows contracts to be "tailored to a particular situation facing specific workers and firms" (Fantasia and Voss 2004: 24).

An empirical study of OECD economies conducted by by Fehn and Meier (2001) offers supporting evidence that an arm's length financial market is associated with a flexible labor market. The authors find that the level of investor protection, a key feature of an arm's length financial system, is negatively correlated with the level of employment protection. Although the authors view the structures of financial and labor market as "determined simultaneously" by the politics of each country, rather than one causing the other (Fehn and Meier 2001:15), my theoretical framework suggests that the association might be a causal one, especially in the developing world context. The causal linkage starts from the financial structure which determines the prevailing type of corporate financing, leading to the complementary production and employment perspectives, and then to the labor market structure. Firms that compete over capital in an arm's length financial market would also compete over workers in an arm's length labor market. Firms that rely on relationship-based allocation of capital would tend to rely on non-market(regulated-market) rationing of labor.

Table 2.2 compares the labor market structure in six emerging markets in Asia. The rigidity of employment index (World Bank 2010) indicates that those countries that relied on relationship-based financing for industrialization–South Korea and Taiwan– have more rigid labor markets than their regional neighbors who relied more on arm's length financing–Singapore and Hong Kong. Late-late developers such as Malaysia and Thailand that have relied on both types of financing show medium level labor market flexibility. Stallings et al. (2010)'s labor market flexibility indicators also reveal similar variation.[6]

[6]The World Bank's index is the average of three sub-indexes: difficulty in hiring, rigidity in hours, and difficulty in firing. Stallings et al. (2010)'s de jure flexibility index is based on a combination of the World Bank's rigidity of employment index and firing costs. The de facto flexibility index is based on the weighted adjustment of the de jure flexibility index

	Singapore	Hong Kong	Malaysia	Thailand	South Korea	Taiwan
Type of Financing	Arm's Length			↔		Relationship-Based
Rigidity of Employment	0	0	10	11	38	46
Flexibility, De Jure	86.8	-	58.2	58.1	45.9	34.9
Flexibility, De Facto	87.0	-	62.7	63.9	52.9	44.7

Table 2.2: Labor Market Structure in the East Asian NIEs

2.3 *Determinants of Financial Institutions in the Developing World: Endogeneity Bias?*

Since I focus on the type of financing as a key determinant of production and employment perspectives, and in turn, of governmental social policy choice, one might raise the issue of endogeneity; if there were a systematic factor leading a country's financial institutions to privilege one type of financing, that factor should arguably be considered as the fundamental determinant of social policy choice. I briefly respond to such concern below.

Often discussed determinants of financial institutions include colonial-legal tradition, relative timing of industrialization, war, or idiosyncratic political leadership during the early years of industrialization (La Porta et al. 1998; Beck et al. 2003; Gerschenkron 1962 on the case of Germany; Dore 2000 on the case of Japan; Woo-Cummings 2003 on East Asian countries). Some of these factors are found not significant in the developing world; for instance, Fan et al. (2012) finds that legal origins are associated with the external financing structure (measured by leverage and debt maturity) in the developed world, but *not* in the developing world. Other factors might explain why a certain type of financing achieves dominance in a developing country, yet are unlikely to have independent effects on the choice of social policy. For instance,

using the scaled rule of law measure (from the World Bank's governance indicators) to take into account the impact of legal enforcement on labor market flexibility.

neither the Japanese colonial legacy nor the idiosyncratic post-independence leadership can explain the Taiwanese government's prioritization of income maintenance, bypassing the causal linkages to the relationship-based financing and to the corresponding long-term production and employment strategy that prevailed throughout her course of industrialization.

Another strand of more recent literature focuses on the importance of political institutions, especially the ones that limit the power of central government such as electoral suffrage, party competition, and federalism (Haber et al. 2008). This approach argues for the "congruence" between the institutions providing open access to the political system and those providing open access to the economic system (North and Shirley 2008), which suggests a possibility that both the dominant type of financing and the prioritized mode of social policy are fundamentally determined by the type of political institutions. Such an approach, however, has rather limited applicability when one moves away from a group of advanced democracies. For instance, Gourevitch and Shinn (2005) finds that the degree of political cohesion measured in terms of veto points is positively associated with the degree of firm-level blockholding in a small sample of advanced democracies, but *not* in a larger set of newly industrialized and developing countries.

Even if one finds a significant association between the political institutions and the financial system, the causal sequence between the two is ambiguous. North and Shirley (2008) acknowledge that, in some developing countries, institutions for open economic access precede institutions for open political access. Experiences of Chile, Korea, Taiwan, and future China suggest that the former can precipitate the reforms in the latter. A recent empirical study by Freeman and Quinn (2012) also finds that integration with open financial system can encourage democratization of unequal authoritarian countries. In short, there is no sufficient theoretical and empirical ground for treating the financial institutions in the developing world endogenous to the political institutions.[7]

2.4 From Financial Structure to Social Policy Prioritization

In this section, I discuss how the production and employment perspectives determined by the financial structure shape the mode of private welfare enhancement, and in turn, determine the governmental social policy prioritization.

2.4.1 Relationship-based Financing and Public Income Maintenance

As explained earlier, relationship-based financing orients the investments in production sector toward a slow but gradual accumulation of physical assets. Such a pattern encourage firms to take part in the provision of various infrastructures including those that are essential for the promotion of individual welfare: residential housing, schools, and medical care facilities. Labor, expecting relatively steady income through long-term employment, has access to these infrastructures, often with supports from employers who are willing to invest in the long-term productivity of the workforce. For instance, company housing in Japan has long been operated as subsidized housing for workers and their families and further served as an important site for company-organized family education programs (Peng 2002:94).

The private sector, however, is disincentivised to supply income maintenance arrangements. In relationship-based financial system, private insurance and pension funds are typically held within the firm or at related banks, and utilized as one major source of long-term finance. A firm makes pension provisions of its employees by "investing its contribution to employee pensions within the enterprise itself"(Edwards

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[7] That no single political attribute can systematically explain the origins of financial institutions in the developing world does not mean that I regard financial institutions as apolitical. In Chapter 3, I examine how idiosyncratic domestic political circumstances and decisions made by the governments of Singapore and South Korea promoted the development of distinct financing structures.

and Fischer 1994: 55). Since investment tends to be concentrated in slow-growing projects with long gestation lags and limited free cash flows, the internalized health insurance or pension funds often fail to yield enough returns in short and medium term, which makes them inadequate safety nets for the employees against unexpected risks. Moreover, because there are few opportunities for the diversification of risks, returns to these internalized funds are vulnerable to firm-specific shocks. Employers and related banks have to take the risk of not being able to finance the pension promises when "reserve planning and investment is not conducted adequately" (Queisser 1996: 15). This would be especially concerning for the small and medium sized firms. Queisser (1996), in this regard, points out that even in Germany, one of the most developed countries with high salience of relationship-based financing, only large firms have adopted the strategy of internalizing pension assets.

The inefficiency of privately managed income maintenance programs is more pronounced in the developing counties with high salience of relationship-based financing. Illustrative evidence can be found in Turkey's experience up to the 1980s. Although Turkey had no formal legislation restricting asset selections of private pension and insurance funds, portfolios of these funds were composed mainly of deposits and shares of the related banks. Since domestic firms in Turkey received preferential debt finances from commercial banks at low interest rates regulated by the government, private pension and insurance funds invested in these banks also yielded a low rate of return. These funds were also prone to suffer from systemic banking crisis, in which case the government was forced to bail the banks out (Asikoglu et al. 1992:74).

It is also the desire for a stable supply of labor that leads the firms in relationship-based economy to be favorable to publicly managed, compulsory income maintenance programs. In Sweden, for instance, firms were core supporters of the public pension reform in 1946, which led to the adoption of more expensive universalistic proposal. The Swedish firms also supported the public health insurance reform in 1952 that included expensive sick-pay linked to previous earnings (Swenson 2002). According to Swenson, the firms were "glad to jettison company provision of health benefits", lest the explosive competition over company-based welfare benefits could disturb the growth perspective (Swenson 2002: 12,43).[8]

In short, firms relying on relationship-based finance have incentives and capabilities for privately providing welfare-related infrastructures and services, and are often willing to offer them at a subsidized price for their current and potential employees. Providers and beneficiaries of these infrastructures and services would not appreciate, and sometimes even oppose, the increase in the governmental provision of social infrastructures and services. On the contrary, the private sector has little incentive for operating income maintenance programs due to low profitability of insurance and pensions management at relationship-based financial institutions and also due to its potentially destabilizing effect on the labor supply. Even large firms and their employers would be indifferent, if not favorable to, the public intervention. Thus, the government is expected to prioritize public income maintenance programs over social infrastructures.

2.4.2 Arm's Length Financing and Social Infrastructures and Services

Firms operating in the developing countries with high salience of arm's length finance tend to adopt flexible production and employment perspectives. Consistent with such perspectives, the firms would seek to incentivize their workforce by providing performance-related benefits rather than by guaranteeing job security. Contribution to employees' income maintenance schemes such as pension or insurance programs can

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[8]Swedish financial system, prior to its liberalization in the 1980s, featured high salience of relationship-based financial transactions. The government held a strong position in the governance of the financial system, which was predominantly bank-based. The government determined the allocation of credit within the domestic economy (i.e., the use of selective industrial policy similar to that of Germany's), and in doing so, maintained far-reaching capital account or exchange controls (Jonung 2008).

be used as an instrument to incentivize the workers' current performance. American employers' such "whole-hearted promotion of company based social benefits" was in stark contrast to their Swedish counterparts efforts to "suppress and eliminate the same practices" (Swenson 2002:14).

Employers adopting company-based income maintenance schemes can also seek to increase the rate of returns to these contributions through investing the funds by themselves or handing them over to the institutional investors, which have self evidently "a clear interest in promoting private capital investment and savings products"(Minns 2001:82). The funds will then become available as production capital through equity investments, and provide the much needed long-term finance to the firms.[9] Indeed, Fan et al. (2012)'s cross country firm-level analysis finds that domestic firms' reliance on equity financing via capital market (which can be regarded as a proxy for the salience of arm's length financing) is positively associated with the size of investment-based defined contribution pension funds in the country, suggesting a mutually complementary course of development between the two.[10]

Knowing the prevailing employment strategy of firms and the possibility for bargaining, workers with marketable skills would also prefer negotiable firm-level welfare

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[9]Whether the rate of returns is actually higher for private investment based insurances is beyond the scope of this study. While it has been suggested that investment-based insurance funds generally yield higher returns than the pay-as-you-go system adopted by most public social insurances, others (e.g., Zeldes et al. 1998) argue one needs to take into account the riskiness of the former. Arguably, if the investment risks were taken into account, the gap in returns between the two schemes would be much smaller. In this context, Feldstein and Liebman (2002:2296) emphasize that both the "political risk" in a public system and the "market risk" in the investment based system needs to be taken into account when comparing the two schemes. Public social insurances in developing countries with less political stability would involve higher political risks than those in advanced democracies.

[10]The authors' empirical test was conducted on a selected sample of OECD countries.

benefits to public social insurance programs. As Heidenheimer notes, organized labor often regards public social insurance as "potential competitors" to their own, potentially better, bargains with employers (Heidenheimer 1973). His point is epitomized by the political dynamics behind the Post World War II development of the US social security system. As major industrial employers like General Motors made concessions to their employees paying premium pension, health, and unemployment benefits, labor lost incentive to support the expansion of national social security benefits (Quadagno 1988; Swenson 2002).

Contrary to the their willingness to offer private income maintenance arrangements, firms financed with arm's length capital would be reluctant to provide welfare-related infrastructures. Most of these firms, especially the ones in developing countries, have difficulties in attracting funds for long-term projects that promise little immediate return such as investments in education(training) and residential infrastructures. Even those firms who have the financial resources are unwilling to support their employees' access to these infrastructures and services due to the firms' flexible employment strategy. Workers with uncertain employment perspective, in turn, are incapable of acquiring said infrastructures and services at a rate set by the private firms. Labor, as well as firms, would need the government to provide social infrastructures and services.

Anecdotal evidence supporting this narrative can again be found in the US in the early 20th century. The organized labor, an important subset of the selectorate, preferred the government's role in expanding social infrastructures and services to the expansion of public income maintenance programs. Labor, for instance, strongly supported the public education policy increasing the compulsory school-leaving age. Contrary to the lack of support for national social security schemes, "massive support for public education, including higher education, [was a] central component of the American welfare [system]" throughout the 20th century (Janowitz 1976: 34).

In short, arm's length finance encourages the private sector to operate various income maintenance arrangements, but discourages the private provision of welfare-related infrastructures. The government is thus expected to prioritize social infrastructures and services in their budgetary social spending.

2.5 Vested Interests and Institutional Inertia

My theoretical narrative thus far has emphasized the financial structure as an ultimate determinant of governmental social policy prioritization. The salient type of financing accessible to the private sector develops a distinct set of production and employment perspectives, which determines the private mode of welfare enhancement. The government then designs its social policy to make the public mode of welfare provision complementary to, or fill the gap in, the private mode of welfare enhancement.

All along, I have assumed the absence of vested interests or institutional inertia in either mode of social policy, on the ground that the idea of a welfare state is new in the developing world. In this section, the assumption of no vested interest is relaxed, and the role of institutional inertia is introduced. Once a certain mode of social policy is adopted and carried out for some period of time, it may develop vested interests and generate other sources of institutional inertia (Pierson 2004)[11]; developing countries are no exceptions. The influence of the vested interest and the emergence of institutional inertia might condition the effect financial structure has on governmental social policy prioritization.

Suppose that a developing country that has long featured high volume of relationship-based transactions undertakes a series of financial reforms, resulting in a dramatic increase of arm's length financing. On the one hand, this change in financial struc-

[11]In addition to the vested interests and the their political opposition to institutional change, extant literature has also focused on the sunk cost associated with the specificity of institutional capital and technology, risk aversion–uncertainties in outcomes that new institutions bring about–, and bounded rationality as major sources of institutional inertia. My focus in this study is on the role of vestes interests.

ture is expected to promote flexible production and employment strategies among firms. This would, in turn, undermine the private sector's capability and incentives for providing welfare-related infrastructures and service, while encouraging the adoption of flexible and lucrative employment-based pension and insurance benefits. If so, the population would generally benefit from the social policy that places greater emphasis on social infrastructures and services provision. The reforms in social policy, in this regard, are considered as the "second-stage reforms" complementary to the preceding "first-stage reforms" in financial institutions (Naím 1994).

An important point made in the existing empirical literature, however, is that first and second stages of reforms might not coincide, and the politics of the two stages are often very different. Navia and Velasco (2003) argues, based on their observations from Latin America, that the first wave of liberalization reforms was often carried out in "emergency situations", and the "the victims of the reforms were often atomistic or too poor to matter politically". By contrast, "the set of interests potentially affected in the next stage reads like a *Who's Who* [emphasis in the original] of highly organized and vocal groups" including public school teachers, public health sector unions, owners and managers of private monopolies (Navia and Velasco 2003:268). These vested interests, combined with other sources of institutional inertia, might prevent the first wave of changes in financial structure from having further ramifications on the broader economy. If so, the causal linkages I proposed earlier (recall Figure 2.1) would be interrupted at various points.

First, a strong inertia can emerge in corporate management; firms might not change their production and employment strategies despite the change in their external financing situation. Second, the existing (rigid) labor market can develop vested interests; a segment of workers–labor market insiders– might demand for stronger employment protection against the employers' attempts to adopt flexible employment strategy. Last but not least, those with vested interests in the existing mode of social policy would resist the deprioritization of it. For instance, the old and soon to be retired would demand continued public income maintenance financing, as they, unlike the younger generation of the selectorate, expect little benefit from the development of private income maintenance programs. The rank and file administrators of the public income maintenance programs would also see the deprioritization vulnerable to their employment. In essence, if the vested interest and other sources of institutional inertia prevail in the course of policymaking, the expected influence of financial reforms on social policy prioritization would be mitigated. Thus, I seek to bring such possibility into my theoretical framework.

First, I expect that the vested interest and other sources of institutional inertia to be strengthened over time. That is, how long a certain social policy institution has been in place matters. When compared spatially, different parts of the developing world are subject to different degrees of institutional inertia. Indeed, Seekings compares welfare reforms in Latin America and East Asia in the 1990s and suggests that "reforms were easier in East Asia where contributory [social insurance] schemes were very recent... than in Latin America where organized and politically powerful groups of workers had major vested interests in the status quo" (Seekings 2008:38). When compared temporally, I expect the change in financial structure during the most recent decade (2000s) to have less influence on governmental social policy choice than a comparable magnitude of change in the earlier decades.

Second, the pace of change in financial structure (as part of the first wave of reforms) might affect the political leverage of vested interests on social policy reforms (as part of the second wave of reforms). If an emergency situation triggers rapid overhaul of the existing financial institutions, the vested interests would not have time and resources to exert their political leverage collectively. A new political coalition consisting of the winners from the financial change would prevail and drive social policy reforms. On the contrary, if the change in financial structure is gradual, the vested interest can (re)organize and sustain their leverage more easily. Then, changes in social policy might be delayed or even be blocked by the vested interest.

Third, the political leverage of the vested interest would depend on domestic political institutions. More specifically, an authoritarian incumbent who relies upon a small minimim winning coalition is less likely to reprioritize. The incumbent needs to serve only a small segment of population, who are likely to develop vested interests in existing social policies. Even when this incumbent's winning coalition does not overlap much with the vested interest, he/she still may not reprioritize as long as the winning coalition insiders lack alternative political candidate to support. As the costs from supporting an alternative candidate and being excluded from the incumbent's coalition are often substantial, the winning coalition insiders might not strongly demand for reprioritization. A dramatic reprioritization of social policy in an authoritarian country might require leadership change accompanied by structural change.

In democracies, on the contrary, large minimum wining coalition and competitive elections generally mean incumbents' weak attachment to loyal constituencies. High uncertainty about future electoral results "make leaders of all political stripes bolder in pushing [second stage] reforms" (Navia and Velasco 2003:268). Thus, the leverage of the vested interest is expected to be weaker in democracies than in autocracies. The variation among democracies can be explained by the pace of structural change and the resulting distribution of political leverage between the vested interest and the new reformative coalition. Essentially, the role of domestic political institutions in my theoretical narrative is a conditioning one; rather than independently determining the government's social policy choice, domestic politics conditions the role of financial structure.

2.6 Propositions

My theoretical framework leads to the following propositions:

> *Proposition1: High salience of arm's length financing (/relationship-based financing) in the private sector economy leads the government to prioritize social infrastructure and services (/income maintenance programs) in budgetary social policy.*
>
> *Proposition2: The effect of financial structure–Proposition1–would be mitigated by the development of vested interests and institutional inertia.*

In Chapter 3, I illustrate the theoretical narrative developed in this chapter with the distinctive trajectories of social policy development in South Korea and Singapore. In Chapter 4, I operatonalize the above-mentioned prepositions, and test them in a panel of 66 low and middle-income countries covering a time period between 1974-2006.

Chapter 3

CASE STUDIES: SOUTH KOREA AND SINGAPORE

3.1 Cases Overview

In this chapter, I illustrate my theoretical narrative with the cases of South Korea and Singapore. Extant literature has viewed the post-independence political environment in Singapore and South Korea as similar, in some aspects to a "striking" extent (Deyo 1987:240). In both countries, the power of political left had been destroyed effectively with external–British in Singapore and American in Korea–backing for moderate, anticommunist political leadership. The absence of powerful economic bourgeoisie at the time of independence also distinguishes Singapore and South Korea from other ex-colonial nations, especially from those in Latin America. Such a political environment paved a way for "strong state combined with political centralization and effective bureaucracy" in both countries (Deyo 1987:241).

Singapore and South Korea are also known to have gone through parallel trajectories of industrial development. Both started as labor-abundant and land-and-capital-poor countries. Extremely rapid manufactured export growth was the major driving force of industrial development. Industrial structure of both has gradually progressed from labor-intensive manufacturing in 1960s and early 1970s to capital and technology-intensive manufacturing and higher-value added services in the 1980s. Along the way, both countries experienced tight labor market situation as a challenge to sustain high economic growth.

That extant literature makes little distinction between the two countries in the area of social policy is largely attributable to the aforementioned political economic similarities. Aspalter notes in his analysis of the "East Asian Welfare Model" that the "similar developmental strategy and the great similarity of the political context [among the East Asia's NIEs] led to a great degree of unity within the East Asian welfare state systems" (Aspalter 2006: 292). Singapore and South Korea are often grouped together as "minimalist", "developmental", "conservative", "Confucius" or "productivist" welfare states (Goodman and Peng 1996; Holliday 2000; Aspalter 2001; Holliday and Wilding 2003; Rudra 2007), where, in essence, government's role in welfare provision has been limited and often subordinated to export competitiveness and economic growth.

It is interesting, given all the similarities between the two countries, that their governments have made distinct choices when it comes to the mode of social policy. Figure 3.1 summarizes the trends in social spending–in solid lines–and in income maintenance spending–in dotted lines–of the two countries.[1] Throughout the four decades from the 1970s to the 2000s, spending on income maintenance has accounted for a third to half of total social spending in South Korea, while its share has remained less than a fifth of total social spending in Singapore.

A small number of studies have recognized the divergence. Mishra (1995) and Kim (2009) both point out that South Korea's income maintenance programs have progressed towards a nearly universal social insurance system, whereas Singapore has adopted and maintained individualized savings scheme for income maintenance. Choon (2010: 98) points out that Singapore government, instead, has engaged in social policy primarily through providing "merit goods" such as housing, health and education.

[1]As defined in the previous chapter, social spending is the sum of income maintenance spending and social infrastructures and services spending.

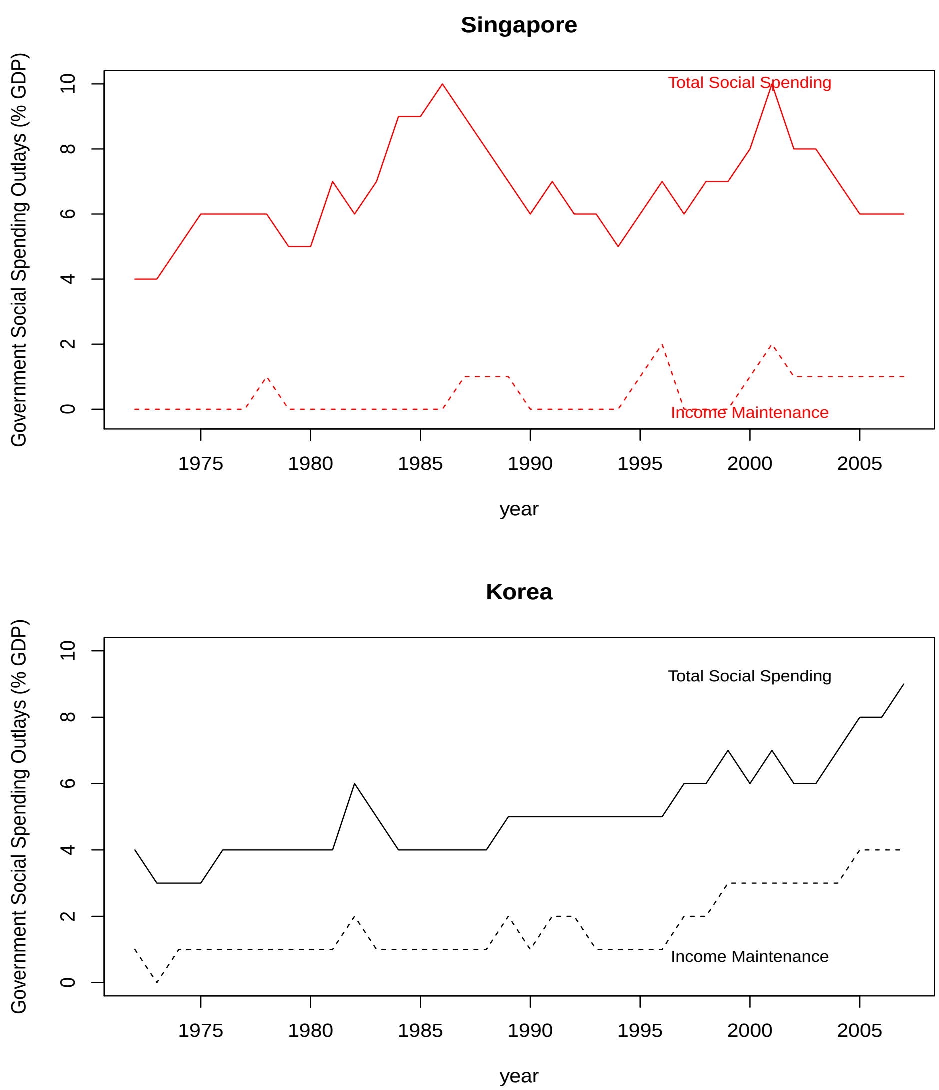

Figure 3.1: Social Spending in South Korea and Singapore

As summarized in Table 3.1, in 2001, the Singapore government provided 80% of the secondary health care and 85% of residential housing.[2] During the same period, in South Korea, public provision accounted for only 8% of total residential housing and 10% of health care. Whereas Singapore funded 87% of the tertiary education out of government budget, the South Korean government expenditure on tertiary education accounted for only 16% of total tertiary education spending, which is substantially lower even compared to that in the US (46.8%) or the UK (62.7%).[3]

	Singapore	Hong Kong	South Korea	Taiwan
	Public Provision as % of Total Provision			
Housing	85	50	8	5
Health (Primary, Secondary)	20, 80	Below 20, 100	10, 10	35, 35
Primary Education	100	89.2	98.6	99.0
Secondary Education	100	77.1	65.7	86.6
Tertiary Education	85.7	90.9	16.1	35.3

Table 3.1: Social Infrastructures and Services Provision in the East Asian NIEs

Extant literature that recognizes the differences in social policy between South Korea and Singapore still tends to treat them as "deviations" from the common ideal-type, where the fundamental logic and functions of the welfare state still "resemble each other a great deal" (Aspalter 2006: 298). This chapter proposes an alternative perspective. South Korea and Singapore represent two different prototypes of the emerging welfare states when it comes to the modes of social policy. The Singaporean welfare state has developed to serve as a primary provider of social infrastructure

[2]The data are from Holliday and Wilding (2003).

[3]The extent of government subsidization of private tertiary education expenditure is also negligible in South Korea. In 1998, the government subsidized only 0.7% of private tertiary education expenditure. In the US and the UK, the governments subsidized 6% and 12% of private tertiary education expenditures respectively (Kim and Lee 2006: 572).

and services, whereas the South Korean welfare state has developed its primary role in financing income maintenance programs. I explain the course of divergence by applying the theoretical framework developed in Chapter 2.

3.2 Financial Developments in South Korea and Singapore

I attribute the divergence in modes of social policy between South Korea and Singapore fundamentally to their distinct financial structures, especially to the manner through which capital for industrialization was garnered and distributed to each country's private sector economy.

Having neither domestic savings nor abundant natural resources, both countries had to come up with a strategy to finance their industrialization. In South Korea, relationship-based, and often government-guided financing dominated the allocation of capital to the private sector. Korean firms, in general, depended on continued access to loans –both foreign and domestic sourced–that are channeled by government controlled banks and financial intermediaries. In Singapore, institutions for arm's length financial transactions have developed early on, and the patterns of external financing for firms have been more diverse including active foreign private borrowing and equity financing.

One of the features that epitomizes their distinct financial development trajectories is the difference in capital market openness. Figure 3.2 summarizes the trends in the Chinn-Ito KAOPEN index, which captures the extent of *de jure* capital controls. The index "takes on higher values the more open the country is to cross-border capital transactions" (Chinn and Ito 2007: 6). For the four decades from 1970 to 2010, capital account openness was higher in Singapore than South Korea.

My emphasis on financial structures is not to ignore other important differences between the two countries. The difference in their financial development must be closely intertwined with their distinct geopolitical (e.g., Singapore being a small, island state versus South Korea confronting the hostile and competitive North) and

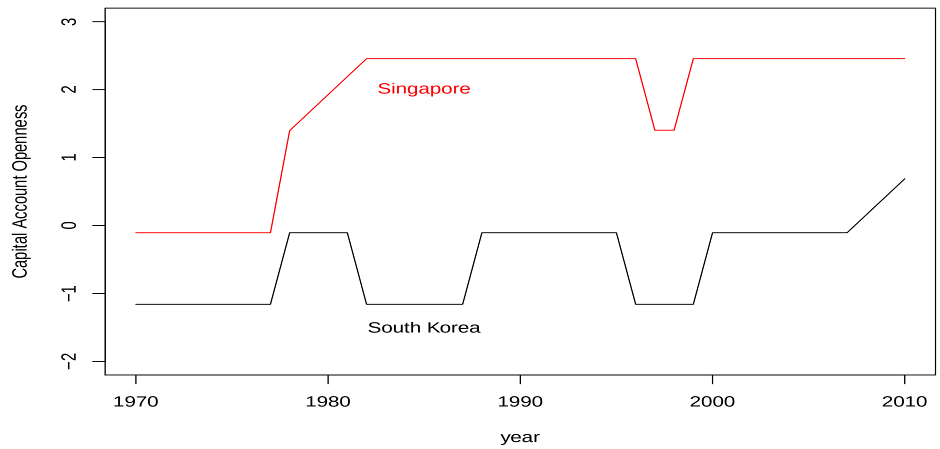

Figure 3.2: Capital Market Openness in South Korea and Singapore

domestic political (e.g., ethnic cleavages in Singapore versus regional cleavages in Korea) factors. Financial institutions have been affected by and had influence on the governments' strategy for addressing their respective geopolitical and domestic political challenges. These other factors, however, are less likely to have had an independent effect on social policy choice. As mentioned in the previous chapter (Section 2.3), my theoretical narrative centers on the importance of financial structure to put forward a systematic, generalizable explanation.[4]

[4]For instance, one could argue that ethnic cleavages in Singapore have affected its financial structure; Singaporean government in the early years of industrialization was discouraged to rely on relationship-based financing partly because it was committed to avoiding ethnic favoritism and economic dominance of one ethnic group. However, the role ethnic cleavages played in Singapore is rather idiosyncratic. Not all governments in ethnically heterogeneous countries would have such strong preference against ethnic favoritism and try to avoid relationship-based financing for that reason. It might even be that the Singaporean government avoided ethnic favoritism because its financial system offered arm's length financing as a viable alternative, not the other way around.

In the remainder of this section, I examine the financial developments in Singapore and Korea since their early years of industrialization. My analysis in this section is confined to the pre-Asian financial crisis period. Later in this chapter, I examine the changes in the financial system following the Aisan financial crisis (mainly in South Korea), and discuss their social policy implications.

3.2.1 Development of Relationship-based Financing in South Korea

Korea's economic development, initiated with the First Five-Year Economic Development Plan (1962-1966), is characterized by strong governmental control over financial flows to promote the growth in the so-called high priority sectors in the economy. In the early 1960s, the Korean government strengthened its control over banking sector by nationalizing the commercial banks and amending the Central Bank Act to subordinate the Bank of Korea to the government (Vittas and Cho 1996:288). Extensive controls were imposed on foreign capital flows as well. All foreign loans required government authorization, and their allocation was also determined largely by industrial policy goals set by the government. Importantly, Foreign Capital Inducement Act of 1965 enabled government-controlled banks to guarantee the repayment of foreign borrowing by domestic firms. These guarantees encouraged inflows of long-term foreign loans, yet simultaneously perpetuated government intervention in the banks (Vittas and Cho 1996).[5]

In the process, Korean banks assumed a critical role of guaranteeing repayment of foreign loans; "through the rescheduling of domestic bank loans, domestic banks had to absorb the external shocks that prevented domestic firms from meeting their foreign debt service" (Vittas and Cho 1996:290). The government's control over credit

[5]Foreign equity investments were gradually permitted since the 1980s, but it was not until in 1998 that the government lifted major restrictions on foreign ownership of shares. The discussion in this section, therefore, focuses on the allocation of foreign loans only.

allocation was further tightened in 1970s to keep up with the change in the industrial development strategy toward the promotion of capital-intensive heavy and chemical industry. Accordingly, directed credit programs became more industry-specific, and guarantees kept increasing.[6]

This encouraged large investments by the privileged firms, or Cheabols, in chemical, constructions, and ship building industries in the late 1970s and 1980s. As Noland puts it, large Korean firms privileged "growth, not profitability, since risk was socialized and increased borrowing made further borrowing advantageous under the too big to fail notion...the bigger the firm, the more credit worthy the firm" (Noland 2005:7). The resulting (over)expansion in such industries that were capital-intensive and slow in profit generating was recognized by the government as a potential problem hindering economic growth in late 1980s. The government's attempt to pursue several market-oriented financial policies, however, was unsuccessful "due to the legacy of extensive government intervention" in the previous decade (Choe and Moosa 1999:1974).

Relationship-based financing has also reached small and medium sized enterprises (SMEs). During the initial period of industrialization, curb markets were the major source of funds for smaller firms that were unable to get access to government's preferential credit allocations (Choe and Moosa 1999:1073). In 1965, however, the government doubled the level of bank interest rates as an attempt to shift funds from the unregulated curb market to the government-controlled banking sector (Cho and

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[6] Unlike the large businesses in Japan, Korean big businesses were for the most part prohibited from owning and controlling the major banks. They, instead, developed a pattern of relationship-banking via personal and governmental connections. The principal transactions bank system was introduced in 1974 by the government, which designated a main bank for each of the top Chaebols. The functions of a principal transactions bank included "reviewing and monitoring its client corporations' plans for improving their capital structure, setting credit ceilings for operating capital, and providing business information and managerial guidance to client corporations" (Nam 1996: 279).

Kim 1995). This move further strengthened the government's role in credit allocation, and curb markets gradually lost its position as an important source of financing to SMEs. In the mid 1970s, curve market lending had accounted for almost one third of total credits, but by the mid 1990s, its share was reduced down to between 2% and 5% of total formal financial sector credits (Baliño and Ubide 1999:11)

In the 1970s and 1980s, SMEs were able to expand in quantities thanks to their close linkages with larger firms. With the expansion and diversification of Chaebols during this period, SMEs that produced parts and materials for Chaebols grew as well. The government also became aware of the critical role played by the SMEs, and introduced a mandatory minimum bank lending ratio to SMEs. In 1976, the mandatory lending ratio was 30% for commercial banks, 40% for local banks. In 1986, the ratio was raise to 35% in commercial banks and as high as 80% for local banks. The same year, foreign banks also became subject to 30% of mandatory lending ratio to SMEs.

The first credit guarantee organization for SMEs, Korea Credit Guarantee Fund (KODIT) was also established in 1976 under the supervision of Ministry of Strategy and Finance. Its funds were sourced from the government budget as well as mandatory donations from banks in proportion to their monthly balance of outstanding commercial loans. These government policies helped many SMEs to develop practices of relationship banking, and enjoy relatively stable source of external financing.[7] Figure 3.3 summarizes the corporate financing structure in Korean manufacturing industry; external financing primarily takes the form of indirect financing through banks and non-bank financial institutions, while direct financing through bonds and

[7]Ferri et al. (2001), for instance, shows that for many viable SMEs in Korea, relationship-banking reduced liquidity constraints and diminished the probability of unwarranted bankruptcy. During the Asian Financial Crisis, those SMEs with strong pre-crisis relationship banking experienced less decrease in outstanding loans and smaller drops in credit lines.

stock market accounts for only a small portion.[8]

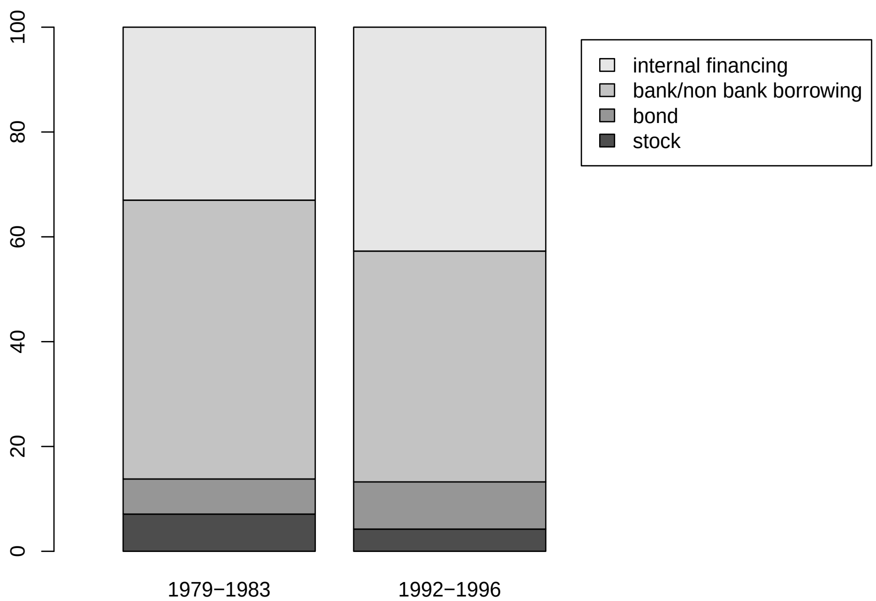

Figure 3.3: Financial Structure of South Korean Manufacturing Firms

This relatively durable nature of relationship-based financing also influenced the labor market structure in Korea. Their long-term orientation in corporate management led to long-term employment on seniority-based wage and promotion system. Although dual career track exists based on the skill levels –for instance, university graduates as middle level managers versus high school graduates in the production lines–, production workers also enjoy employment security and seniority-based promotions. These practices are "present throughout the entire industrial system," although the degree is much higher in larger firms than in SMEs (Park 1999: 25-26).

[8]The data are from the Bank of Korea.

3.2.2 Development of Arm's Length Financing in Singapore

In Singapore, the British colonial authorities pursued a "laissez faire economic policy within the general framework of small open economy" (Tan 1991:201). The laissez faire colonial economic policy came to an end with Singapore's independence in 1963 and subsequent succession from Malaysia in 1965. The new government, however, did not endorse the opposite policy–economic nationalism–which was overwhelmingly adopted by developing economies of that time including South Korea. The government of Singapore was interventionist of a different kind.

Similar to South Korea, the lack of natural resources and huge deficiency in national savings in Singapore generated a desire by the government for foreign capital (Tan 1991). Yet, contrary to the South Korean government that offered extensive guarantees on foreign credit, the Singaporean government identified an open financial sector as a key for attracting foreign capital and thus provided incentives for such development. Also contrary to the South Korean government that utilized directed and subsidized credits, the Singaporean government utilized tax policies and other investment incentives.

As Lee summarizes, the financial system of Singapore have been developed progressively since the 1960s. Its banking sector has developed into an integrated system with the large Western –mostly British– banks at the upper stratum and relatively smaller local–mostly Chinese– banks at the lower stratum. Although they differed in terms of size and global market connection, both have followed "British banking traditions of providing primarily short-term credits to finance trade and other commercial activities" (Lee 1990: 73-104). The former have learned from the latter the techniques of "an objective assessment of loan-application, credit and marketing research" (Lee 1990:48).

Offshore banking system–Asian Dollar Market, ADM, established in 1968– has developed side by side with the domestic banking system. The divide between the domestic banking system and the ADM was gradually reduced. By the end of 1970s, the government abolished all currency exchange controls, and Singaporean residents–both individuals and corporations– were free to move funds, import capital, or repatriate profits without restriction. The free flow of funds from the ADM into Singapore also contributed to the "credit expansion" and the "booming of the stock and property market" (Lee 1990:98).

Singapore also had one of the most vibrant capital markets outside of the Colonial Europe and America. Public trading of stocks started as early as 1960 with the opening of Malayan Stock Exchange. When the Stock Exchange of Singapore Limited (SES) started separate operation in 1973 following the currency split with Malaysia, Singapore was already "at the height of stock market boom" (Lee 1990: 94). In the same year, the new Securities Industry Act (SIA) was passed to control speculative manipulation of the stock market and to prevent insider trading. By the 1980s, the government's focus already moved on to "further diversification, upgrading, and automation of financial services", which have encouraged the development of "investment portfolio management, securities trading, capital market activities, foreign exchange and futures trading, and promotion of other more sophisticated and specialized fee-based activities" (Lepoer 1989).

Such an early development of open financial sector had a profound effect on the investment, production, and employment perspectives throughout the country's course of industrialization. As Vittas and Cho point out, arm's length capital, especially the capital investing in developing countries where firms lack established records on corporate performance, tends to favor either "low-risk activities such as self-liquidating short-term working capital and trade finance" or "high-risk but more speculative projects with short pay back periods such as commercial real estate development" (Vittas and Cho 1996:24). Arm's length financiers are less willing to finance projects with longer pay back period even if they may have higher overall returns (Vittas and Cho 1996:24). Tan's description of the attitudes of early commercial entrepreneurs in Singapore epitomizes such investment perspectives. The entrepreneurs, mainly of Chinese origins, tended to consider their business in Singapore as being "temporary", and have always been beset by a very "short investment horizon and highly opportunistic business mentality". Even though Singapore authorities were anxious to reset the economic priority towards a greater focus on manufacturing industry, they found that the Chinese commercial entrepreneurs were "not ready to settle" as industrial entrepreneurs (Tan 1991:202).

In the absence of the indigenous capitalists, MNCs were encouraged to invest in labor intensive manufacturing industries, but they too, were more enthusiastic in retailing, trading, service, and financial sectors all of which are industries with relatively short investment gestation.[9] By the end of 1980s, four of the eight largest retailers in Singapore were multinational retail establishments, 14 of 16 largest general trading establishments were multinational, and 23 of 36 fully licensed commercial banks were foreign (Tan 1991:206). Even in the manufacturing industry, interdependency between MNCs and local manufacturing firms was weak. Work given out by MNCs in Singapore to the local manufacturing firms, for instance, accounted for only 2.4 percent of the total manufacturing input in 1986 (Tan 1991: 205). Members of the Local Businesses Sub-Committee wrote to Minister of State:

> *"It is clear to all that the foreign companies come here for one purpose: to make as much money as possible and in the shortest possible time...Once the goings are rough, they pull out without giving much, if any, consideration to local employees and businesses..." (Report of the Local Businesses Sub-Committee, 1985:4).*

Singapore's arm's length financial institutions also allowed and encouraged the

[9]It was primarily the state-sponsored enterprises (SSEs) that took charge of the projects requiring long investment gestation lags including the provision of basic infrastructures in transportation, communications, and electricity.

MNCs to finance their investments by borrowings in the domestic market, and invest the short-term excess of funds in the ADM. Despite the rise of domestic savings, the demand for investment funds by MNCs pushed up the interest rates, thus making it very competitive for local firms to borrow (Tan 1991). Also, the high and volatile interest rates in the ADM due to free flow of funds caused difficulties to industries, especially small local entrepreneurs in manufacturing and export industries (Lee 1990; 101). This further encouraged local firms to rely on short-term credits from foreign financial intermediaries and direct financing. Their heavy reliance on arm's length financing posed substantial financial challenges during the economic downturn in 1985:

> *"Of late banks are putting on the credit squeeze and so [local] developers and contractors have cash-flow problems. Some of them were even forced to sell out or close down. While government's intervention in this matter was expected, it is not forthcoming. It other words, local businesses do not get the support they expect from the government..." (Report of the Local Businesses Sub-Committee, 1985:4).*

Overall, a high level of financial openness and heavy reliance on arm's length financing made Singapore's economy "extraordinarily vulnerable to external shocks" (Peebles and Wilson 2002:175). The domestic firms as well as the MNCs were sensitive to short-term market performance and thus maintained flexible production plans.[10] Such production plans in the private sector also fostered flexible employment perspective. Just as firms competing for arm's length capital, workers competed in the arm's length labor market. Singapore's labor market flexibility has indeed been emphasized in extant literature as one of key factors that enabled the country to "ride the ups and

[10]By 1980, foreign portfolio equity investment already accounted for 5% of GDP in Singapore, whereas in South Korea its share was less than 0.1% of GDP. At the onset of Asian financial crisis in 1997, foreign portfolio equity investment accounted for 18% of GDP in Singapore, as opposed to 1.3% of GDP in South Korea.

downs of changes in global demand"(Chia 2005: 24). From 1972 to early 1980s, the tripartite National Wages Council had guided annual wage increases to avoid a wage explosion resulting from the tight labor market at the time. Yet, after the recession in 1985, the quantitative wage guidelines were abandoned. With the establishment of a tripartite Subcommittee on Wage Reform in 1986, many firms, both in the private sector and the public sector, adopted the flexible wage system.

According to the tripartite National Wage Council, adoption of flexible wage system was to allow "more flexibility in wage negotiations" and to make sure that "wage increases are more closely linked to the performance of the economy, company and individual employees". The system also enables companies to "adjust wage costs more responsively to changing business conditions so as to remain competitive in the global market".[11] By early 1990s, 85% of the unionized sector firms and 70% of the non-unionized sector firms adopted some form of flexible wage system (Singapore Ministry of Labor 1993:7). In 1997, the variable component of the payment reached 20% of total payment in the unionized sector (Tan 1999:223).

In the following section, I examine how the distinct production and employment patterns of South Korea and Singapore have led to divergent trajectories of welfare state development.

3.3 Diverging Social Policy Prioritization

3.3.1 Expansion of Public Income Maintenance in South Korea

Although authoritarian political environment had preempted organized labor to gain political leverage in the early years of industrialization, long-term production and employment perspectives in the private sector encouraged the development of stable labor market, especially in the fast-industrializing urban areas. The authoritarian

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[11]Excerpted from Singapore National Wage Council Website:
http://www.tripartism.sg/page/National-Wages-Council/ accessed on February 21, 2013.

government was quick to adopt a series of income maintenance program based on social insurance framework. Injury insurance for industrial workers of large firms were introduced in 1963, and the health insurance for industrial workers of large firms in 1976.

As extant literature points out, the income maintenance programs initially introduced by the authoritarian government were far from universal. It was not until 1988 that the national pension scheme extended its coverage to all workplaces that had 10 or more employees[12], and it was only in 1989 that the health insurance program was extended to all the self-employed including those in rural areas. Important to note, however, is that the government initiated income maintenance programs when social infrastructures and services could have benefited the same segment of the urban industrial workers.[13] Why did the Korean government initiate public income maintenance programs rather than focusing more exclusively on social infrastructures and services provision? My theoretical narrative suggests that the government confines its direct role in areas where the private sector was expected to willingly come in, and focuses on areas where the private sector is less capable of or less enthusiastic for provision.

In South Korea, welfare enhancing infrastructures and services were viewed as private realm.[14] For instance, in the first Five-Year Economic Development Plan

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[12]Pension schemes were first established for military officers, teachers, and state bureaucrats in 1961.

[13]In post economic reform (i.e., post-1979) China, low costs public housing has been the biggest component of subsidies for the urban residents working for large factories, which aggravated the problems of urban bias (Khan et al. 1992).

[14]The exception is compulsory primary and lower-secondary education that raises the stock of basic human capital available in the economy. The expenditure for such compulsory education accounts for the majority of social infrastructures and services spending in South Korea.

(1962-1966), housing was viewed as something that "each household had to solve by itself" (Park 2004: 170). Even when demand for urban housing rapidly grew in the 1970s, the allocation of budgetary resources in the housing sector remained minimal. Government was not pushed to intervene, as there were enough willing construction companies to build large-scale housing estates. In the Ten-Year Housing Construction Plan established with the aim of building 2.5 million housing units from 1972 to 1981, the government's primary role was to organize the willing "private developers" (Park 2004: 171).[15]

A similar trend can be observed in higher education industry where the government relied heavily on the private sector. Affluent families and family-owned business groups have long been the owners of (or the major donors for) major universities in Korea. These universities are often used as a human resource pool for Chaebols. For instance, the most competitive departments in Ulsan Univeristy, founded by Hyundai in 1970, are department of Mechanical and Automotive Engineering and department of Naval Architecture and Ocean Engineering sponsored by Hyundai motors and Hyundai Heavy Industries, respectively. Similarly, after Samsung took over Sungkyunkwan University, department of Mobile Communications Engineering and department of Semiconductor and Display Engineering have been established, and Samsung has hired most of the graduates from the departments (Lee 2008).[16] As the

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[15]More proactive government intervention came in 1980s with the creation of National Housing Fund in 1981. It offered preferential long-term loans for the private production of small dwellings (under 60 square meters) for sale or rent. Still, as of 2000, the housing stock funded by NHS consisted less than 6% of the total housing stock in Korea (Park 2004: 176).

[16]In addition to Hyundai and Samsung, several other Chaebols own universities. Ssangyong owns Kukmin University since in 1958. Inha Univeristy is under Hanjin's ownership since 1968. POSCO founded Pohang University of Science and Technology in 1986. LG Group owns a two-year technical college, Yonam Institute of Digital Technology, since 1984 through is Yonam Educational Foundation. Doosan has recently acquired Chungang Uni-

government could easily find the willing private sector providers of higher education, Korean higher education policy centered on regulatory controls rather than on the creation of public institutions or direct subsidies.[17]

Provision of welfare-related infrastructures and services were also the key components of company welfarism. The benefits workers received ranged from company housing or subsidized housing loans, educational –especially college– scholarships for the children to the use of luxurious company-owned vacation facilities. The number and generosity of company welfare benefits varied across firms, depending on size and profitability as well as the employer's receptivity toward workers' needs (Song 2003). According to Song (2003), the benefits at large firms amounted to a third of monthly wages, whereas the workers in small and medium-sized firms received smaller but still sizable benefits. As Song (2003) points out, such company welfare would not have been possible had the firms not "have the resources to protect job security in hopes of securing employees' loyalty to management and a commitment to increasing productivity."

Since the 1980s, organized labor's demands to the firms also have centered on welfare-enhancing infrastructures and services. According to a survey conducted by the Korean Productivity Center, "welfare facilities and lunch subsidies" were one of the most common demands made by unions to their company managements, along with the demands for wage increases and vacation payment. (Korea Productivity Center 1987, recited from Kim 1993:131). The stronger their company union was, the better access to welfare-related infrastructures and services the workers could acquire.

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versity.

[17]During the 1970s and 1980s, the government had maintained a strong control over the establishment and expansion of private higher education institutions as well as over their enrollment quotas. Such regulations were gradually lifted to keep up with the rising demand, especially with the inauguration of Kim Youngsam government in 1993 that pursued a series of deregulatory higher education policies (Kim and Lee 2006).

The government's role, thus, was focused on what the private sector is less capable of or less enthusiastic for provision: income maintenance programs. Although firms might seek to tap additional source of capital by operating private insurance and pension schemes for their employees – as some large firms in Germany have done– the benefits from doing so are not substantial under a relationship-based financian system; in Korea, large firms already had easy access for credit via relationship with the government and the banking sector insiders. SMEs, needless to day, did not have the technical and managerial expertise for operating private income maintenance schemes.

With the government's introductions of health insurance and injury insurance programs in 1960s and 1970s respectively, the employees of larger firms were able to enjoy better social safety nets. The subsequent expansion of welfare states was made via expanding public income maintenance programs to cover broader population. Illustrative of this process is the development of national health insurance, which started in 1976 as insurance for employees of large firms and civil servants only. Since then, national health programs introduced mechanisms for the pooling of risks across different sectors. More than four hundred health insurance societies were created at the company level (for industrial employees) and at the regional level (for employers of small firms and self-employed) by the end of 1970s.

One problem that emerged shortly after the creation of many independent medical insurance societies was that most of them were too small to take proper advantage of the pooling of funds and the spreading of risks; making matters worse, workers in higher risk industries were often grouped together. Financial difficulties in smaller insurance societies exacerbated the inequality of benefits across the workplaces despite the similar rate of individual contributions made (Wong 2004; 88-111). In the early 1980s, government intervened again and merged these bodies into a large centralized system administered by a regional medical insurance society. The ultimate goal set by the government then was to "amalgamate all independent societies, standardize benefits and contribution rates, and pool financial resources in order to spread risks and program costs" (Park and Yeon, 1981:154-156).

Firms, especially larger ones, were not entirely supportive to the idea of expanding and introducing more redistributive elements in health insurance schemes. But with the democratization and the tighter labor market situation in late 1980s, it was generally believed that workers' welfare needs had to be accommodated in some way or another for socioeconomic stability. In 1989, the health insurance program was extended to all the self-employed, including those in rural areas. In 1994, a crosscutting –moderate to radical and also rural to urban– alliance entitled *National Solidarity Alliance for the Integration of Health Insurance and the Expansion of Health Insurance Benefits* was formed, which demanded a greater degree of risk pooling in health insurance.

From the larger firms' perspectives, expansion of public income maintenance was still preferable to increased governmental intervention in welfare-related infrastructures and services provision. Cheabol's long-term investment horizon and desire for diversification as well as the growing purchasing power of the citizens rendered the provision of welfare-related infrastructures and services a lucrative business opportunity. This seems evident when one looks at the health care industry, which is characterized by the dominance of private providers paid by fee for service. In 1990s, 95% of health services provision is carried out either by small-scale doctor-owned private clinics or by larger-scale medical centers belong to universities and non-for-profit foundations set up by the Chaebols (Yang 2001). It might be partially true that the initiation of national health insurance and the subsequent expansion of it have had the effect of widening the room for private providers (Haggard and Kaufman 2008: 138). Still, why are Chaebols eager to operate medical centers despite the fact that hospitals are prohibited by law from seeking profits?

Their active role as providers for medical services has been closely related with their diversification into the broader healthcare industry. For instance, Samsung

Medical Centers are run by Samsung Life Public Welfare Foundation and receives donations from various affiliates of Samsung Group. Samsung Group entered the healthcare industry in early 1990s by acquiring medical device maker Medison. It also has long been interested in the biopharmaceutical business, for which medical centers can be good research and development venues with massive pool of patients and extensive experience in carrying out clinical trials. Indeed Samsung Medical Center has said over a period of time that it would like to cooperate with the company in future businesses including development of generic biological medicines (Kim 2012). Likewise, Korea's largest hospital by size, Asan Medical Center, is run by Asan Foundation which is chaired by the largest shareholder of Hyundai Heavy Industries. Hyundai Heavy Industries is the country's largest robot producer, and is working together with the Medical Center to develop medical robots such as those for artificial joint surgery (Kim 2012).

Welfare gap-filling approach thus can account for the gradual expansion of public income maintenance programs in Korea. The government has increasingly committed to income maintenance as the private sector's dependence on relationship-based finance has rendered private income maintenance arrangements perceived to be less profitable for firms, while encouraging the private provision of welfare-enhancing infrastructures and services.

3.3.2 Prioritization of Social Infrastructure and Services in Singapore

Contrary to the South Korean government that initiated and subsequently expanded public income maintenance programs, the Singapore government has always prioritized social infrastructures and services provision. As Choon (2010:98) puts it, its government chose to offer "education and housing," rather than "handing out doles." I attribute such behavior of the Singaporean government to the high dependence of its private sector on arm's length financing. As discussed in the previous section, many firms in Singapore were financed through arm's length capital. The financiers, and thus firms, would prefer not to invest in projects that require long-term commitment in the domestic market, and prefer to adjust their resource allocation frequently for improving short term performance. Under such circumstances, the government could not get the private sector to provide welfare enhancing infrastructures and services, however essential their provision might be for the political economic stability of the country. The government took the role.

The role of government in housing provision well illustrates this point. Without the government intervention, the property market in Singapore was expected to easily become speculative (Wong 1991:147). Thus, publicly provided and privately purchased housing has been the main pillar for addressing welfare concerns associated with lift cycle induced uncertainties. The proportion of total population living in the publicly provided housing was only 26 percent in 1967, but rose to 86 percent in 1987 (Tan1991: 204). During the last decade, Singapore showed over 90% of home ownership. Home equity among public housing dwellers is three times their annual household income, providing households a sense of asset-based security (Chia and Tsui 2009).

The flexible production and employment perspectives held by the firms also make them less incentivized for investing in human capital development. From the workers' perspective, privately investing in education is too costly when such investment still does not guarantee their employment. Thus government's role as a provider of education expanded. As Choon points out, meritocracy-driven labor market in Singapore promoted public education as "the best form of social protection; and helping to facilitate social mobility" (Choon 2010:100).

National Trades Union Congress (NTUC)'s commitment to improve the workers' welfare was exercise mainly via its representation on "Housing and Development", "Vocational and Industrial Training", and "Public Utilities" boards, which are key public bodies providing social infrastructures and services (Leggett 1993: 240). In its "Plan of Action for the 80s", NTCU indeed claimed credits to such benefits as publicly provided but privately owned housing, price-regulated public transportation system, and other community based amenities (NTUC, 1979).[18]

Contrary to its extensive involvement in social infrastructures and services provision, the Singapore government has provided income maintenance support only on an ad hoc or transitory basis with strict means-tested eligibility criteria (Choon 2010: 100). For instance, while the government has provided most health services through public hospitals operated by the government budget, it has not financed individual's health care costs out of the government budget. The only financing component in the government health policy is a means-tested assistance scheme introduced in 1993.

Such minimal budgetary intervention in income maintenance has to do with flexible, meritocracy driven labor market in Singapore, which makes private income maintenance schemes attractive incentives for workers. Indeed, a typical private benefit plan, or *group benefit programme*, covers all regular, full-time, permanent employees up to age 70. Death, accident, disability and medical insurance costs are usually borne by the employer. The more competitive sector of workers can better meet their welfare needs with privately provided income maintenance schemes. Recognizing the market for income maintenance services such as long-term life and health insurances, many private insurance products have also been introduced (Huat et al. 2004).

Central Provident Fund (CPF), although is a publically managed scheme, also reflects the individualistic feature of the Singapore's income maintenance scheme.

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[18]Authoritarian political environment in Singapore, just like that in South Korea until the late 1980s, repressed autonomous labor movements. NTUC was promoted by the ruling People's Action Party (PLP) and formally registered in 1964 as Singapore's only association of trade unions. It was regarded as PAP's protege through out the 1960s and 1970s. However, as Leggett (1993) points out, the NTUC changed its strategy in the 1980s in order to make membership in its affiliates more appealing to the new generation of better-educated workforce. I thus expect the NTUC to represent, although not exclusively, the workers' preferences and demands in this later period.

Unlike the social insurance schemes in South Korea that have gradually expanded the risk pooling across income groups, CPF is a private savings account that has little risk-pooling element. In addition to using the savings for old-age income maintenance which was the initial purpose of the fund, individual members can use their CPF funds to purchase publicly provided social infrastructures and services such as education, health care, and housing.[19] Moreover, the individual savers have been given an increasingly greater independence and choice to allocate their funds to private pension and insurance schemes, so that the savers have the "feeling of owning their own fund" (Eatwell, 1999: 4).

Welfare gap-filling approach, in this regard, can account for the Singaporean welfare state development. Singapore government has prioritized the provision of social infrastructures and services, as the economy's dependence on arm's length finance has discouraged the private provision of said infrastructures and services, while encouraging the utilization of private income maintenance arrangements.

3.4 Post-Asian Financial Crisis Welfare State Development: Convergence or Sustained Divergence?

The trajectories of welfare states development in South Korea and Singapore examined so far are broadly consistent with *Proposition1* of this study; high salience of arm's length financing in Singapore has encouraged the government to prioritize social infrastructure and services, whereas high salience of relationship-based financing in South Korea has encouraged the government to expand public income maintenance programs overtime. In this concluding section, I discuss the social policy implications of financial changes since the 1997 Asian Financial Crisis.

[19]The government has used the savings to fund the construction of public housing.

3.4.1 Singapore

With no fundamental change in financial structure following the crisis, the Singaporean welfare state has sustained its key characteristics. When it comes to the social infrastructures and services provision, the old policies of the so-called "developmental state" period such as "price caps and cost controls on government hospitals" and "tight government control of educational opportunities" have been continued (Haggard and Kaufman 2008:244). During the past decade alone, the government's budgetary education expenditure almost doubled from S$6.2 billion in 2005 to S$11.6 billion in 2013.[20]

In the meantime, the individualistic feature in its income maintenance scheme has been reinforced with the introduction of CPF Investment Scheme (CPFIS) in 1997. With CPFIS, individuals are allowed to invest the CPF balances above a certain threshold and be responsible for their own investments risks. CPFIS, according to the CPF board, is created for "an increasingly sophisticated and investment-savvy population who wanted higher returns on their CPF savings".[21] Although means-tested social assistance spending has increased over the recent years, especially with the creation of Community Care Endowment fund in 2005, such spending is largely for a short-term transitory help provided only until an individual becomes self-reliant again. As Choon puts it, the spending on "merit goods" is expected to remain as the major pillar of the welfare states, while public income maintenance will be limited only to ad hoc and means-tested basis (Choon 2010:119).

Some might attribute such continuity in social policy to Singapore's peculiar political environment: a single party dominance. Arguably, the lack of political competition might allow the Singaporean government to neglect the changing welfare preferences

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[20] http://www.singaporebudget.gov.sg/budget$_2$013/

[21] Excerpted from History of CPF at the Central Provident Board Website: http://mycpf.cpf.gov.sg/CPF/About-Us/HistoryofCPF.htm accessed on March 4. 2013.

of the population. Although this is a theoretically plausible argument, it is not an accurate description of Singapore's political environment. Despite being a one-party state, political legitimacy of the Singaporean government depends on as broad segment of population as its multi-party neighbors such as South Korea and Taiwan. As Chua suggests, pressures on Singapore's PAP might "even be greater because its ability to keep all opposition parties out of government is crucially dependent ton its performance in securing the economic well being of the people as citizens and electorate" (Chua 2007:38). Social policy stability in Singapore can be better explained by the uninterrupted salience of arm's length financing and the continued dominance of flexible production and employment perspectives in the private sector economy.

3.4.2 South Korea

The 1990s was arguably the period in which the South Korean financial system experienced significant changes. In the early 1990s, the preparation for joining the OECD served as a major driving force for the financial sector reform (Baliño and Ubide 1999:14). In 1993, the government announced a three-stage financial liberalization plan entailing a comprehensive set of reform measures ranging from interest rate liberalization to allowing foreign financial institutions to establish branches in Korea.[22] Capital account was substantially liberalized as well. Short-term foreign debt liability soared during the years leading up to the financial crisis, from $40 billion in 1993 to $98 billion at the end of September 1997, which accounted for more than half of total foreign liabilities (Noland 2005:16:17).[23]

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[22]See Baliño and Ubide (1999) for the details of the reform planned for each stage.

[23]As Noland points out, both internal and external factors affected this trend. Internally, government's continued restriction on foreign investments in the long-term corporate bond market created the incentives for short-term foreign borrowing. On the other hand, Basil accord, with assigned a 100 percent risk rate on long term (with a duration of more than one year) loans to non-OECD countries, encouraged capital flows to South Korea to take

Although the Korean government initiated the financial sector reforms in the early 1990s, according to Noland, it was the crisis in the late 1990s that actually forced a "restructuring of South Korea's systems of finance, regulation, and corporate governance, and a dismantling of the pervasive controls on international capital flows" (Noland, 2005:21). The crisis enabled the government to overcome the oppositions from domestic financial and corporate institutions who had vested interests in the pre-crisis regime (Noland, 2005:21). As part of the reform mandates supervised by the International Monetary Fund, major restrictions on foreign ownership of shares were lifted in 1998, leading to a sharp increase in ownership of Korean financial as well as non-financial sectors by foreign banks, private equity funds, and foreign institutional investors.[24] Such changes are reflected in the dramatic increase in the equity share of total foreign liability since mid-1990s (See Figure 3.4).[25]

Provided that the crisis has indeed transformed the South Korean financial system, my theoretical narrative predicts that social policy reprioritization would follow. An increased salience of arm's length financing would encourage the adoption of flexible investment and employment patterns by firms, and affect the private mode of welfare enhancement. More specifically, such a change is expected to undermine the private sector's incentives and capabilities for providing welfare-related infrastructures and services. Song (2003) notes that "the firm no longer could serve as the primary provider of welfare to the workers because the post-1997 economic system did not permit the generation of rents for the firm." At the same time, due to the increased flexibility of labor market, or the so-called "casualization" of labor force, social insurance with universal risk pooling is expected to become less attractive, especially to larger firms and high wage segment of the employees (Yang 2011:16). The pertinent

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the form of short-term lending (Noland 2005:16:17).

[24]At the onset of the financial crisis in 1997, foreign ownership of listed companies had been limited to 20%, with individual stakes limited to 5% (Noland 2005:8).

[25]The data are from Lane and Milesi-Ferretti (2007)

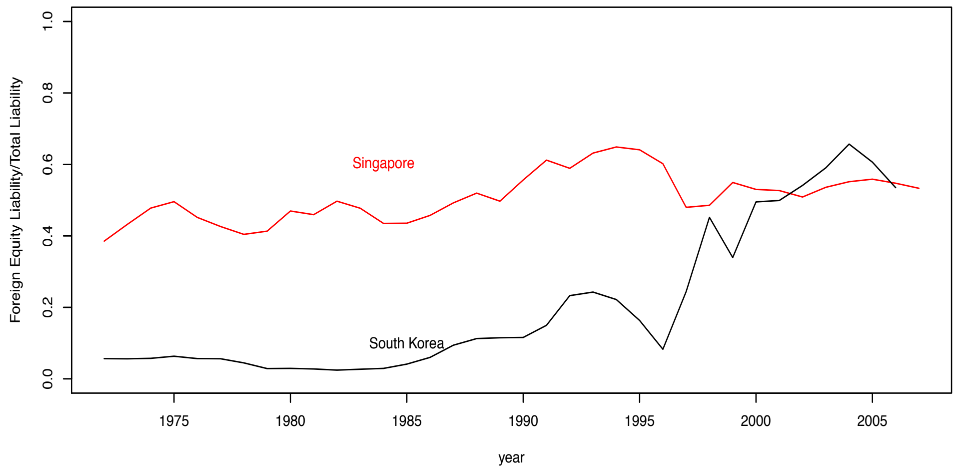

Figure 3.4: Foreign Equity Liability in South Korea and Singapore

questions then are: do we actually observe the reprioritization of governmental social policy? Has the government increased (/reduced) social infrastructures and services (/income maintenance) share of social spending? Interestingly, income maintenance share of social spending *rose* during the crisis (from 30% to around 50% of social spending) and then persisted throughout the early 2000s (recall Figure 2.1).

There are several potential reasons why income maintenance was not deprioritized. First, it might be that the post-crisis financial reforms have not had an immediate, substantive effect on the broader national economy. Despite the *de jure* changes in financial system and the increased inflow of arm's length foreign capital, decades-old practices of relationship-based financing and the corresponding production and employment patterns might not quickly give way. If so, the private sector would see no acute need for changing their mode of welfare enhancement. Noland (2005:3) indeed points out that "changing the lending culture" of the highly bureaucratized financial institutions as one of the major challenges the post-crisis South Korean financial system faces. Nam (2004)'s survey of the officers at major Korean commercial banks is also illuminating in this regard. When asked how a creditor bank would react "when a medium-sized borrowing firm falls into financial distress–from which the firm, although considered solvent, may not get out in the short run–, and asks for an additional loan", the respondents most strongly supported the bank action of continuing the provision of loans as long as necessary restructuring efforts are made. According to Nam (2004), the "liquidating option" –to recover most of the existing loans– received little support.

Also indicative of financial reforms falling short of affecting the broader economy is high "perceived restriction" on financial market. In the latest round of World Economic Forum (WEF)'s Executive Opinion Survey (2012-2013), the most problematic factors for doing business in South Korea still include "access to financing"(13%). Global Competitiveness report by WEF ranked Korea at 89th and 109th place out of 144 countries in terms of availability of financial services and protection of minority shareholders' interest respectively. One could also find some evidence that suggests the South Korean labor market has experienced little fundamental change. Both de facto and de jure indicators of labor market structure (recall Table 2.1) suggest South Korea's labor market is much less flexible than that of her regional neighbors such as Singapore, Hong Kong, and Malaysia.

Overall, this explanation is in line with *Proposition 2* which discusses the effect of institutional inertia; because the South Korean economy had relied on a relationship-based financing for decades, by the time it initiated financial reforms in the 1990s, institutional inertia at various causal linkages became strong enough to overwhelm the mechanisms for change. Yet, this explanation cannot account for the fact that the private sector firms indeed reduced the provision of welfare enhancing infrastructures and services as part of company welfarism. The firms "reduced–and in some cases abolished–subsidized housing loans, school tuition for employees' children, gasoline subsidies, as well as the myriad allowances to pay for meals...welfare facilities, including resort facilities, that they owned and operated for employees. Some even sold the dormitories and housing facilities for employees to secure hard cash" (Song 2003).

Another explanation can be that the growing vested interest in the existing social insurance programs has successfully blocked the government's deprioritization of the income maintenance mode. Particularly relevant in this regard is the position of the labor in the post-crisis political coalition. In South Korea, a series of powerful democratic movements in the late 1980s increased the organizational potential of workers, and set the momentum for social insurance expansion. The democratic transition reached a peak in the midst of financial crisis with the inauguration of the country's first center-left president Kim Daejung in 1997. The leadership change had an effect of strengthening the government's welfare commitment during the crisis, by politically empowering the broader segment of workers including the many potential beneficiaries from the social insurance expansion. To keep the workers' expectations for stronger social safety nets, the government centralized the national health insurance system and expanded the coverage of unemployment insurance in 1998. At the same time, expenditure on social infrastructures and services also increased. As a result, the government's spending in *both* modes of social policy increased dramatically during the late 1990s and early 2000s (recall Figure 3.1).

Also important to consider is the growing political leverage of the elderly. Both the previous president Lee MyungBak and the current president Park Geunhye were elected with a significant support from the elderly voters, who are most likely to have vested interests in public income maintenance programs. Despite being a center-right president, Park recently proposed "doubling the monthly allowance for senior citizens aged sixty-five or older".[26] This explanation is also consistent with *Proposition2*; the effect of financial structure is mitigated when the government is incentivized to serve

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[26]The Employment and Welfare Subcommittee of The Presidential Transition Team Policy Discussion Excerpt,
http://news1.kr/articles/988242 accessed on Jan 31. 2013.

those with vested interests in the existing social policy instruments.

Lastly, it is plausible that the change is simply delayed. The reforms towards arm's length financial system during the past decade would eventually change the mode of social policy, yet it might be "slow moving outcomes" (Pierson 2004: 90). South Korean Chaebols, "given their well established position in international trade and independent access to credit," have gradually become less dependent on the state and the relationship-based financing (Harvey 2005:108). Accordingly, their social policy preferences have gradually changed. Yang notes that Chaebols have raised their voice calling privatization of pensions and introduction of private health insurance, and such voice has began to be accommodated since the conservative Lee Myungbak government took office in 2008 (Yang 2011).[27]

Also indicative of the delayed change is the "new welfare paradigm" promulgated by the president, Park Geunhye. Her plan, reveled at the policy discussion with the Employment and Welfare Subcommittee of The Presidential Transition Team, is to "reform the outdated welfare system based on income maintenance to the one centered on social services, which makes the welfare state be the basis for sustainable economic growth".[28] Her statement is broadly consistent with this study's theoretical prediction that government would seek to adjust the mode of social policy as a response to the structural change in the economy.

Fifteen years have passed since the Asian financial crisis, but it seems still too early to conclude how the crisis and the subsequent changes in the Korean financial system influenced its welfare state. Other compounding factors such as demographical

[27]For instance, the government had proposed to abolish/amend the law mandating all medical providers to accept the national health insurance, although the government faced fierce public opposition and subsequently had to withdraw the proposal.

[28]The Employment and Welfare Subcommittee of The Presidential Transition Team Policy Discussion Excerpt,
http://news1.kr/articles/988242 accessed on Jan 31. 2013.

change and the increased political participation of the elderly also make any parsimonious explanation difficult. One viable social policy strategy for the government might be something in the middle ground: increased social infrastructure and services provision (for alleviating the structural mismatch) combined with more narrowly tailored income maintenance support targeting the low income elderly (for embracing domestic political and demographical reality).

Chapter 4
EMPIRICAL ANALYSIS

In the preceding chapter, I illustrated my theoretical framework with the cases of South Korea and Singapore, two of the East Asia's newly industrialized economies (NIEs). Despite many similarities between the two countries recognized in the existing literature, South Korea and Singapore have developed distinct welfare states when it comes to the modes of social policy. I attributed such divergence to the difference in their financial systems, especially in the patterns of financing to the private sector economy. This chapter tests the generalizability of my theoretical framework through an empirical analysis of a broader set of emerging welfare states in the developing world.

4.1 Scope Condition

My empirical analysis focuses on the *contemporary* developing world–low and middle income countries– for two main reasons. First, in order for the first causal linkage in my theoretical framework to work, there should be a general scarcity of capital in the private sector, so that the type of available external financing has a significant impact on the production and employment perspectives of firms. This part of causal linkage would be less clear-cut when more firms can afford internal financing, which is the case in developed countries. In these countries, the type of external financing would not necessarily determine the private sector's production and employment perspectives at the aggregate country level. Rather, firm-specific investment and production needs would determine an individual firm's choice of financing strategy.

The second important reason for not including the developed countries has to do with the degree of institutional inertia, or the path dependency, in welfare states. Nullmeier and Kaufmann (2010) point out that most of the developed countries in Europe and the US institutionalized welfare states by the end of the World War II, followed by an expansion until the oil crisis in the early 1970. Some date the initial welfare state "innovations" from the 1880s, and the "consolidation of mature systems" as early as in the 1930s, which suggests that the "evolution of welfare states has already spanned more than a century" in the developed world (Meadowcroft 2005:15-16). If so, any change in the financial structure that comes *after* the consolidation of the welfare states might fail to influence the established social policies due to their institutional inertia. Of course, the emerging welfare states in the developing world are subject to similar institutional inertia, but to a much lesser extent, as their social policies are relatively new and at the malleable stage compared to the ones in mature welfare states.

A related concern is about reverse causality. The existing literature has indeed suggested that in mature welfare states, social policy might affect the financial structure, not vise versa. Rajan and Zingales (2003:38) point out that European countries wanted to maintain controls on capital flows even long after they sufficiently recovered from the Great Depression out of their worries that capital mobility hampers the ability to provide social insurance benefits. In this case, it was the vested interest in the existing social insurance schemes that generated support for the restriction of certain financial flows.[1]

After all, my theoretical framework *can* be applied to explain the initial formation of social policies in developed countries. Doing so, however, would require one to analyze their financial and social policy developments in the 19th and early 20th cen-

[1] Janowitz suggests that the welfare institutions can directly affect domestic political institutions as well. He argues that welfare states expansion in Western Europe has allowed the minority and coalition government to become a chronic reality, which resulted in the inability of the political elites to modify basic institutions (Janowitz, 1976; 4-5).

tury.[2] Unfortunately, country-level panel data on financial structure and budgetary social spending suitable for large N analysis are only available from the 1970s for most countries. My empirical analysis focuses on developing countries for the sake of analytical comparability.

For country classification, I use the World Bank's first explicit benchmark between middle income and high income countries, which is $6000 GNI per capita in 1987 price. The resulting subset excludes countries that were already high income as of 1987, but keeps the countries who achieved high income status at some later point of time.[3] The availability of data further limits the number of countries included in the study to the total of 66 countries and the time period between 1974-2006. The list of countries included can be found in the appendix.

4.2 Operationalization

My empirical analysis tests the two propositions introduced in Chapter 2.

> *Proposition1: High salience of arm's length financing (/relationship-based financing) in the private sector economy leads the government to prioritize social infrastructure and services (/income maintenance programs) in budgetary social spending.*

> *Proposition2: The effect of financial structure–Proposition1–would be mitigated by the development of the vested interest and institutional inertia.*

This section explains the operationalization of the propositions as well as the choice of model specifications and methodology.

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[2] In Chapter 2, I present some supporting anecdotal evidence from the US and Sweden in the early 20th century.

[3] Given the time period covered in the analysis (1974-2006), it would be ideal to use a benchmark based on the level of development in the early 1970s, but no explicit benchmark exists for that period.

4.2.1 Dependent Variable

My goal is to explain the governmental budgetary prioritization between the two modes of social policy: income maintenance versus social infrastructures and services.[4] I first construct the indicators for each mode using the central government budgetary (cash based) outlays data from the IMF's Government Finance Statistics (IMF-GFS). Four government outlays are directly relevant to social policy: social protection, housing, education, and health. The subcomponents of each outlay are summarized in Table 4.1.

Social Infrastructures and Services			Income Maintenance
Education (709)	Housing/Community Amenities (706)	Health (707)	Social protection (710)
Pre-primary/primary education	Housing development	Medical products/equipment	Sickness/disability
Secondary education	Community development	Outpatient services	Old age
Postsecondary education	Street lighting	Hospital services	Survivors
Tertiary education	R&D Housing	Public health services	Family and children
Education not definable by level	Water supply	R&D Health	Unemployment
Subsidiary services to education			Housing Support
R&D Education			Social exclusion
			R&D Social protection

Table 4.1: Modes of Social Spending-Subcomponents

[4]I do not discuss the welfare promoting instruments that are not directly reflected in government budgetary outlays, such as the use of the tax system or other regulatory policies and mandates. The bias from not considering these instruments can be minimal as long as they are available for addressing either mode. For instance, tax benefits can be offered to help the private acquisition of welfare-related infrastructures and services (e.g., first time housing purchase and college tuition), but also to help private financing of income maintenance (e.g., private pension or health insurance payments). I assume that in countries with a high salience of arm's length financing, governments' non-budgetary as well as budgetary social policies would tend to prioritize welfare-enhancing infrastructures and services. The opposite would be true in countries with a high salience relationship-based financing.

Income maintenance spending is captured by the social protection outlay that includes spending on various social insurance programs and means-tested cash assistance programs. The other three outlays (education, housing/community amenities, and health) are considered as spending on social infrastructures and services.[5]

Income Maintenance = Social Protection

Social Infrastructures and Services=Housing and Community Amenities+ Education+ Health

Total Social Spending= Income Maintenance +Social Infrastructures and Services

The relative commitment by a government to the two modes of social spending, is captured by the income maintenance share of total social spending. The more a government prioritizes income maintenance, the higher the income maintenance share of total social spending would be.[6]

Prioritization of Income Maintenance $\propto$ *Income Maintenance/Total Social Spending*

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[5] "Housing development" as a subcategory of Housing and Community Amenities is considered as social infrastructure/services. This captures the budget for building and maintaining public housing. "Housing support" as a subcategory of Social Protection is considered as income maintenance. This captures the budget for supporting housing finance for certain individuals, often based on means test.

[6] Since the social infrastructures and services share of total social spending is *1- Income Maintenance/Total Social Spending*, constructing this variable is redundant.

The variable *Prioritization of Income Maintenance* (hereafter referred to as *Prioritization*) is compositional in nature. I employ logit-transformation which is a conventional technique for modeling compositional data with only two categories (Aitchison 1986). The transformation allows addressing the problems associated with the bounded range of the dependent variable, and modeling the non-linear relationship between such dependent variable and independent variables.

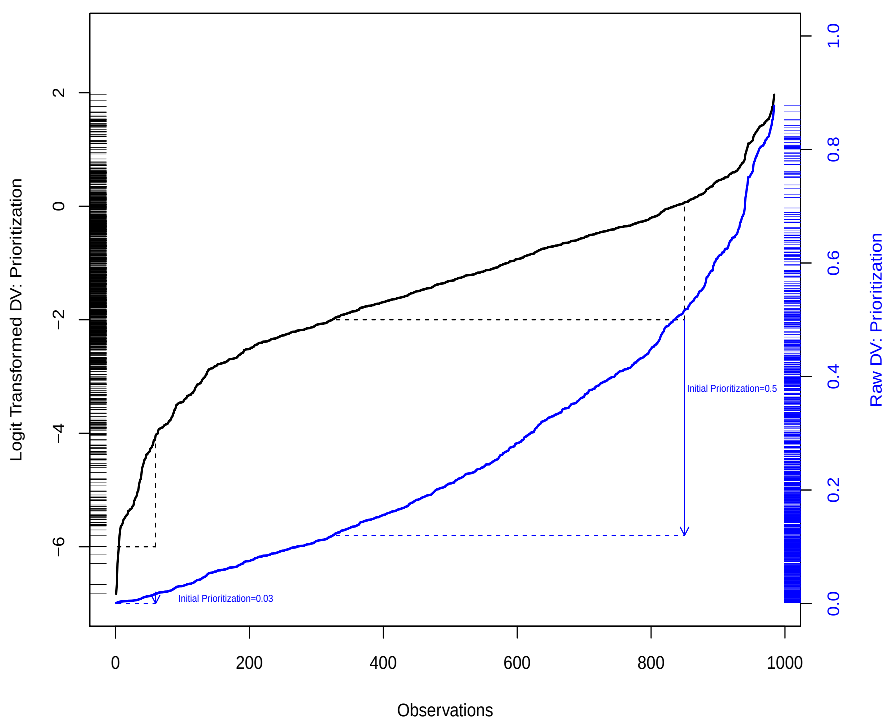

Figure 4.1: Raw and Logit-Transformed Values of the Dependent Variable

Figure 4.1 plots the logit-transformed values and the raw values of *prioritization* for all the observations included in the analysis. Since an independent variable has a linear effect on the logit-transformed dependent variable, the impact of a unit change in the independent variable would vary depending on the initial value of the dependent variable.[7] To investigate whether the dependent variable operationalized as such contains unit root, I conduct a panal unit root test based on Augmented Dickey-Fuller regressions. The result suggests that the series is stationary.[8]

4.2.2 Independent Variable

My independent variable is the salience of arm's length financing as opposed to the relationship-based financing to the private sector economy. The lack of data in most developing countries makes it difficult to assess the proportion of arm's length versus relationship-based financing carried out through domestic banks and stock markets. Even though information on types of domestic financial transactions is available in some countries –for instance, through analyzing ownership structures of major banks and firms– such information are not comparable across a large number of developing countries.[9]

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[7]Consider, for instance, a hypothetical covariate with the coefficient size of 2. The vertical arrows in blue in Figure 3.1 compares the effect of a unit decrease in this covariate in two difference cases: when the income maintenance initially accounted for 50% of social policy budget (initial prioritization= 0.5) and when the income maintenance initially was only 3% of social policy budget (initial prioritization =0.03) respectively.

[8]I employ Fisher type (Chi-square) test with lag length of 2 and individual intercepts. The result also holds when time trends are included. The null hypothesis of unit root is rejected with a p-value<0.001 and a p-value=0.02, respectively.

[9]Some existing studies suggest that a sizable banking sector is associated with relationship-based financial institutions, while a sizable stock market is associated with arm's length financial institutions (see Levine 1997, 2002). Wolf (2011) points out, however, that the alleged overlap between the two classifications (bank versus stock market on the one hand, and arm's length versus relationship-based on the other hand) has become much less pronounced in recent decades. For instance, efforts to cross-sell services have raised the importance of banks in arm's length financial system. In the mean time, some

Alternatively, I focus on the structure of foreign finance received by a developing country. Given the general scarcity of domestic capital in a developing country, foreign finance is an important source of capital for industrialization. During the period covered in this study (1974-2006), country-level average foreign liability in the developing world was 78% of GDP (Lane and Milesi-Ferretti 2007). Thus, the dominant type of financing in a developing country's private sector economy can be inferred by observing the composition of foreign liability of the country.

In a country where relationship-based financing is the dominant strategy for addressing the key risks in financial transactions, foreign capital is expected to enter also in the form of relationship-based transactions, such as public and publicly guaranteed private loans or equity investment in long-term fixed assets promoted and aided by host governments. In a country where arm's length transactions are the dominant strategy for addressing key risks in financial transactions, foreign capital would enter in the form of arm's length finance such as private non-guaranteed loans –often with short term maturity– and portfolio equity investments.

Assessing the salient type of financing based on the structure of foreign liability has another important advantage; it further reduces the potential for reverse causality, the situation where preexisting industrial practices and social policies determine the patterns of financing to the private sector. Such scenario is plausible if the government and firms are committed to a specific industrialization strategy to the extent that such commitment changes the manner of financial transactions. For instance, a government might decide to promote flexible (/stable) production and employment practices and, for doing so, decide to provide social infrastructure and services (/in-

equity markets have developed features of relationship-based financial system. The overlap between the two classifications are expected to be even smaller in emerging economies; for instance, South Korea has developed a sizable domestic stock market (in terms of the total value of stocks as a percentage of GDP), yet the major features of its stock market still include cross-shareholdings among listed companies and family controls.

come maintenance provision). Such decisions, in turn, might encourage the firms to actively utilize arm's length(/relationship-based) financing and provide private income maintenance arrangements. This type of reverse causality is less plausible in determining the structure of foreign liability than in determining the structure of domestic external financing. Given the scarcity of domestic capital for industrialization and the imperatives for growth, it is unlikely that developing country governments and firms would pick and choose only a specific type of foreign finance that can accommodate the predetermined patterns of production and employment. More importantly, foreign lenders and investors are unlikely to enter in a developing country without assessing how their potential investment risks are addressed; if there is no institutions already in place for arm's length transactions, foreign arm's length capital would not enter.

Using the data from External Wealth of Nations Mark II (Lane and Milesi-Ferretti 2007) and World Bank's Economic Policy and External Debt indicators, I construct two alternative indicators for the salience of arm's length foreign finance.[10]

Salience of Arm's Length Foreign Finance (ALFF)

- *ALFF I: (Foreign Private Non-Guaranteed debt + Foreign Portfolio Equity Liability) / Total Foreign Liability*
- *ALFF II: (Foreign Short-term debt + Foreign Portfolio Equity Liability) / Total Foreign Liability*

In the first indicator (ALFF I), foreign private non-guaranteed debt liabilities and foreign portfolio equity liabilities are classified as arm's length foreign finance. The proportion of these two in total foreign liability indicates the salience of arm's length foreign finance. As an alternative indicator, I substitute foreign short-term

[10]Both databases follow residence (as opposed to currency) principle in distinguishing between domestic and foreign finance.

debt for foreign private non-guaranteed debt. This alternative indicator, ALFF II, is constructed based on the reasoning that implicit governmental guides or personal networks can assist the private sector firms' acquisition of long-term finance from foreign financiers, whereas short-term debt might have more characteristics of arm's length finance.[11] Note that I use foreign liability, not GDP, as a denominator to capture the *structure* of the liability rather than the level of liability.

4.2.3 Controls

A set of common control variables is included in all model specifications. I employ total foreign liability of a country (% of GDP) as a proxy for that country's overall dependence on foreign capital. I control for the size of domestic banking sector (% of GDP) as a proxy for the availability of domestic source of external financing.[12] I also control for GDP per capita (logged) to capture the potential workings of the income effect in social policy choice. I control for the manufacturing share of GDP (% of GDP) and the size of urban population (logged) to capture the presence as well as the scale of an urban industrial sector, which is often regarded as a precondition for the emergence of a modern welfare state.[13] I control for export (% of GDP) as the existing literature has argued that industrialization strategy, namely the choice between export

[11]Johnson and Mitton (2003)'s examination on the financing structure of the major Malaysian firms shows that politically connected (through personal history with politicians) firms' debt portfolio tends to have more long-term debt and less short-term debt than firms with no such connection. The ownership structure of the Malaysian banking sector has primarily been private with a substantial share of foreign commercial banks (38% as of 1980s according to Booth et al., 2001). Their finding thus suggests that political and personal relationships might enable firms to obtain foreign private loans with longer maturity.

[12]Data are from Beck and Demirgüç-Kunt, 2009.

[13]For instance, Barr(1993) views welfare state development as a response to the logic of industrialism.

promotion and import substitution, can shape the social policy (Wibbels and Ahlquist 2011). Lastly, I control for two domestic political attributes: level of democracy (Polity II) and left government (a dummy variable indicating a government led by a left-leaning executive).[14]

4.2.4 Methodology

To address the serial correlation present in the panel dataset, I adopt an Autoregressive Distributed Lag (ADL) model. The main model specification for testing Proposition 1, for example, can be written as follows:

$$\begin{aligned} \text{Prioritization}_{it} &= \phi_1 \text{Prioritization}_{i,t-1} + \gamma_1 \text{ALFF}_{it-1} + \gamma_2 \text{ALFF}_{i,t-2} \\ &\quad + \gamma_3 \text{TotalForeignLiability}_{it-1} + \gamma_4 \text{TotalForeignLiability}_{i,t-2} + \\ &\quad \mathbf{x}_{it}\beta_1 + \mathbf{x}_{i,t-1}\beta_2 \\ &\quad + \alpha_i + \tau_t + \varepsilon_{it} \end{aligned} \tag{4.1}$$

where ϕ captures the effect of lagged dependent variable, and γ_1 and γ_2 indicate the coefficient estimates for the key independent variables ALFF.[15] β_1 and β_2 are the

[14]Data on government ideology are from the Database of Political Institutions (DPI 2010). Substituting left governing party for left executive does not change the result. The former has more missing data points, so I employ the latter to keep more observations in the sample.

[15]Note that I employ first and second lag terms of ALFF and Total Foreign Liability variables instead of the contemporaneous and first lag terms. This is to take into account the fact that the data on foreign liabilities are typically complied at the end of each year, and so the data at time t are unlikely to have much explanatory power on budgetary decision made at time t.

vectors of coefficient estimates for the control variables x. α_i and τ_i are country and year fixed effects.[16] ε_{it} is the error term. Breusch-Godfrey test finds the remaining serial correlation statistically insignificant. As an extra caution, Driscoll-Kraay (2008) robust variance-covariance estimator is used, which is a non-parametric technique designed for panel data estimated with country fixed effects. The estimator produces heteroskedasticity consistent standard errors that are robust to general forms of cross-sectional and temporal dependence.

The ADL specification I adopt is algebraically equivalent to Error Correction Model (see Debouf and Keele 2008) that includes differences in the dependent variable and the independent variables as well as their lagged terms. The ECM equation can be written as follows:

$$\begin{aligned}\Delta\text{Prioritization}_{it} = {} & \phi_1^*\text{Prioritization}_{i,t-1} + \gamma_1^*\Delta\text{ALFF}_{it-1} + \gamma_2^*\text{ALFF}_{i,t-2} \\ & +\gamma_3^*\Delta\text{TotalForeignLiability}_{it-1} + \gamma_4^*\text{TotalForeignLiability}_{i,t-2} \\ & +\Delta\mathbf{x}_{it}\beta^*{}_1 + \mathbf{x}_{i,t-1}\beta^*{}_2 + \\ & \alpha_i^* + \tau_t^* + \varepsilon_{it}^* \qquad (4.2)\end{aligned}$$

To identify the total effect an independent variable has on the dependent variable distributed over future time periods, I calculate each independent variable's Long-Run Multiplier (LRM).[17] LRM for the salience of arm's length foreign finance (ALFF), for example, can be calculated from the quantities in Equation 4.1 as follows:

[16] Hausman Test finds the random effect estimator inconsistent; that is, the coefficient estimates from the fixed and random effect models are statistically different, which gives the reason to estimate fixed effects.

[17] I focus on the LRM because the purpose of the analysis is to identify a sustainable equilibrium between the financing structure and the social policy structure (i.e., *prioritiza-*

$$\text{LRM}_{ALFF} = \frac{\gamma_1 + \gamma_2}{1 - \phi} \tag{4.3}$$

The Delta Method is then used to calculate the standard errors for the LRM. The denominator in the equation, 1-ϕ, indicates the speed of adjustment back to the long-run equilibrium level. Larger ϕ would indicate slower adjustment. How long it takes to adjust back to equilibrium following a shock (e.g., change in ALFF) at time t –the mean lag length– can be calculated as follows:

$$\text{MeanLagLength}_{ALFF} = \frac{\gamma_2}{\gamma_1 + \gamma_2} - \frac{-\phi}{1 - \phi} \tag{4.4}$$

Another potentially interesting quantity is the median lag length: the lag length at which half of the adjustment toward long run equilibrium is completed following a shock–a change in ALFF. One intuitive way for calculating the median lag length is by standardizing the effect of a shock at each successive lag as a proportion of the LRM and finding the lag length at which the sum of these standardized effects exceeds 0.5 (Keele and DeBoef 2008:16-20).

4.2.5 Model Specifications

My analysis proceeds as follows. First, I test *Proposition1* by estimating the main model specification presented above, where the *Prioritization* is the dependent variable and ALFF is the independent variable. Since my prediction is that the salience of arm's length financing leads the government to prioritize social infrastructures and

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tion), and thereby systematically explain the variation among the emerging welfare states. Short-term effect coefficients do not provide useful information in this regard.

services, I expect the coefficient estimate of ALFF in this model to be negative. To preview the results, my findings are consistent with the prediction.

To further dissect how the change in *Prioritization* unfolds, I estimate a series of models employing the spending level indicators as dependent variables. To preview the results, I find that the effect of ALFF is negative on income maintenance spending, but positive on social infrastructure and services spending. This finding further supports my theoretical narrative that centers on the trade-off relationship between the two modes.

Next, I fit a series of robustness check specifications keeping the *Prioritization* as a dependent variable. Asides from the basic set of control variables, robustness check specifications control for three other sources of capital in the developing world: natural resource rent, remittances, and official development assistance (ODA). To preview the results, my key findings are robust to the inclusion of these extra controls.

Then I move on to testing *Proposition2*. I explore how the emergence of institutional inertia and the influence of vested interests might condition the effect of ALFF on social policy, even in emerging welfare states. Based on the idea that institutional inertia, whatever sources it originates from, tends to be strengthened overtime, I estimate the main model specification using the moving window approach. The effect of ALFF on *Prioritization* is expected to be reduced in the later windows. To preview the result, I find the effect of ALFF becomes less salient in the windows that include late 1990s and 2000s.

Next, to capture the incumbent's incentive for serving those who have vested interests in the existing mode of social policy as opposed to the preferences of the broader population, I interact ALFF and the level of democracy–Polity II. The logic is that democratic political institutions tend to incentivize the incumbents to serve the interests of the broader population, whereas the lack of such political institutions motivates the incumbents to concentrate welfare benefits to a relatively small segment of population who are then likely to develop strong vested interests in the existing social policy. I expect the effect of an increased salience of arm's length financing to be weaker in autocracies. To preview the results, I find statistically meaningful conditioning effect of domestic political institutions.

4.3 Results

This section reports the results from the empirical analysis and interprets them in light of my two propositions.

4.3.1 Proposition1

Table 4.2 reports the results from the main model specification. The maximum number of years under estimation is 31 (1976-2006), as the years 1974 and 1975 are entered only as lagged terms. Consistent with *Proposition1*, the salience of arm's length financing has a negative association with *Prioritization* across all models. The effect is stronger and statistically significant when arm's length financing is proxied by the sum of foreign short-term debt and portfolio equity investment liability (ALFF II) in Model 3. This suggests that foreign short-term debt might indeed be a better indicator for arm's length financing than foreign private debt for reasons discussed in section *4.2.2*. The finding also holds when ex-communist countries in the sample– Albania, Bulgaria, Kazakhstan, Kyrgyzstan, Lithuania, Romania, and Russia– are excluded from the analysis (Model 4). [18]

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[18] It has been recognized that including both fixed effects and lagged dependent variable (LDV) in a model can (downward) bias the LDV estimate, ϕ. This so-called Nickell bias is known to be more pronounced in small T panels and in models with low (true) ϕ. Since this study is based on a medium length panel (max T=31, mean T=15) with a relatively high estimated value of ϕ (>0.8), the bias is expected to be marginal. In the appendix, I also report the results from ADL-Generalized Method of Moments (GMM) estimation which is often employed as an alternative to standard panel least squares estimation with fixed effects. The negative effect of ALFF holds in GMM models as well.

	Model1		Model2		Model3		Model4	
	ALFF I				ALFF II			
	All Countries		Excluding Ex-Communist		All Countries		Excluding Ex-Communist	
	LRM	Pr(>|t|)	LRM	Pr(>|t|)	LRM	Pr(>|t|)	LRM	Pr(>|t|)
Arm's Length Foreign Financing	-0.027	0.142	-0.031	0.216	-0.065	0.001	-0.067	0.001
Total Foreign Financing	0.002	0.456	0.002	0.375	0.000	0.835	0.000	0.800
Domestic Banking Size	0.003	0.828	0.005	0.695	-0.000	0.983	0.001	0.926
GDP per capita	-0.018	0.978	0.056	0.933	0.503	0.268	0.550	0.253
Manufacturing	0.237	0.000	0.252	0.000	0.253	0.000	0.264	0.000
Export	-0.014	0.580	-0.018	0.550	-0.016	0.501	-0.019	0.492
Democracy	0.039	0.354	0.040	0.347	0.048	0.254	0.049	0.252
Left Government	-0.423	0.488	-0.588	0.364	-0.613	0.272	-0.705	0.244
Urban Population	-0.274	0.679	-0.324	0.651	-0.249	0.677	-0.294	0.669
Total Social Spending	0.100	0.000	0.100	0.000	0.107	0.000	0.106	0.000
	Estimate	Pr(>|t|)	Estimate	Pr(>|t|)	Estimate	Pr(>|t|)	Estimate	Pr(>|t|)
Lagged DV	0.834	0.000	0.835	0.000	0.832	0.000	0.833	0.000
Observation	932		876		932		876	
Countries	66		59		66		59	
(Maximum) Years	31		31		31		31	
Fixed Effects	Country and Year		Country and Year		Country and Year		Country and Year	

Table 4.2: Determinants of Social Policy Prioritization (DV: Prioritization of Income Maintenance)

Figure 4.2 summarizes the long run first difference in *Prioritization* on a percentage scale, with regard to a 1% increase in ALFF. The calculation is made with the LRM estimates from Model 3, and is based on the assumption that an increase in ALFF II at time t is sustained over the subsequent time periods, rather than followed by a decrease in the same magnitude at time $t+1$. 90% confidence intervals are plotted in dotted lines.

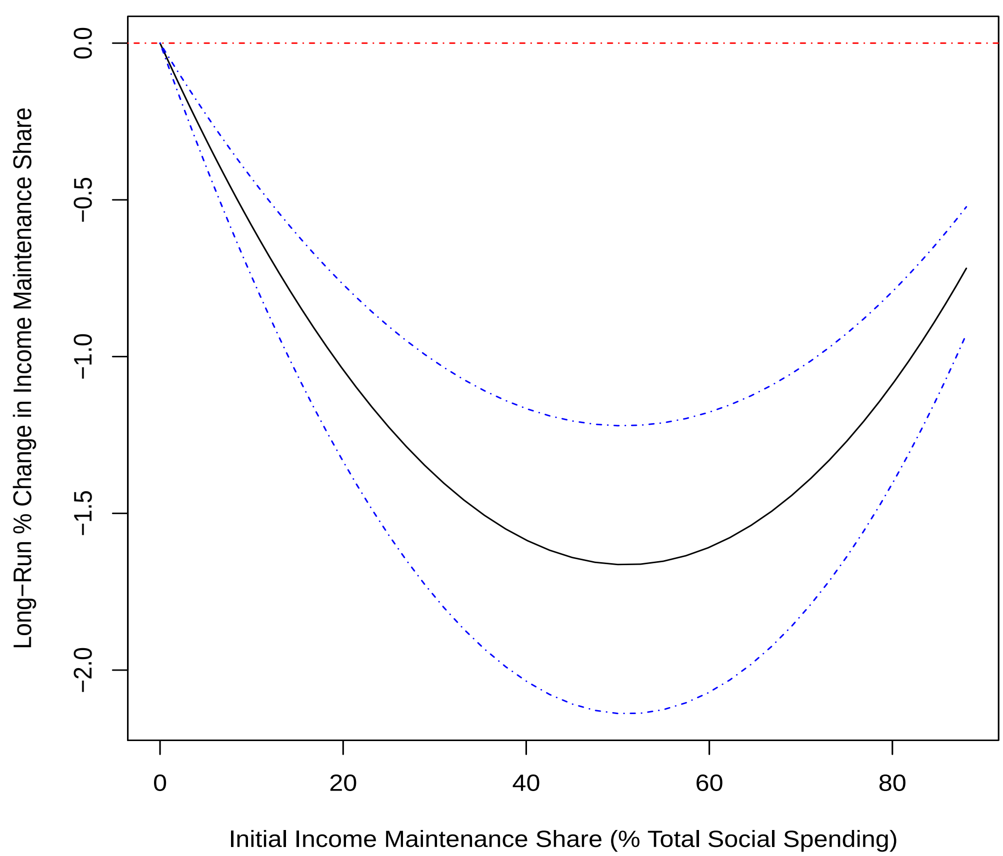

Figure 4.2: First Difference with regard to a 1% Increase in ALFF II

The figure shows that the first differences are negative at all levels of initial *Prioritization*. The magnitude of the ALFF effect varies: for a country that previously spent about 25% (i.e., sample mean) of its social spending on income maintenance, a 1% increase in ALFF II leads, in a long run, to about 1.3% decrease in income maintenance share. The decrease can amount up to 1.7% in cases that initially allocated as much as half of its social spending on income maintenance. When it comes to the speed of such adjustment, the mean lag length calculated from Equation (4.4) is 5.76 years, and median lag length is 3 years.

The negative effect of ALFF also holds without the logit-transformation of the dependent variable: when the dependent variable is operationalized in a simple percentage scale, a 1% increase in ALFF is associated with a 0.21% (when ALFF I is used) to 0.42% (when ALFF II is used) decrease in income maintenance share of social spending. In these models, both ALFF I and ALFF II are statistically significant with a p-value of 0.046 and 0.008, respectively. Table of results from these additional models can be found in the Appendix.

Among the control variables, the only significant variables are *Manufacturing* and *Total Social Spending*. Both variables are positively associated with *Prioritization* of income maintenance. Governments with large manufacturing industries tend to prioritize income maintenance, which might reflect the fact that social insurances are hard to operate when there are few formal sector wage earners to begin with. Why is total social spending positively associated with *Prioritization*? The positive association might suggest that a government needs to have over a certain minimum level of social spending budget in order to consider adopting public income maintenance programs. Indeed, most governments, even those with a very small social spending budget, are expected to provide some very basic social infrastructure and services such as primary education and essential vaccinations. We may not expect similar baseline commitment when it comes to income maintenance programs, which might explain why total social spending is positively associated with *Prioritization*.

The main model specification controls for total social spending, so conveys little information on how the absolute size of spending in each mode responds to the change in ALFF. Without presuming a trade-off between the two modes, one can contemplate multiple ways through which spending in each mode responds. First, an increase in ALFF might reduce one mode of spending but increase the other, and *Prioritization* might change as a result. Second, an increase in ALFF might have positive (/negative) effects on both modes of spending, but the magnitude differs. In such a case, the change in *Prioritization* accompanies an increase (/decrease) in the government's overall social spending. Lastly, ALFF might increase (/decrease) the spending level of one mode while leaving the other mode unaffected, which would then change *Prioritization*. To further dissect how the change in prioritization unfolds, I estimate a series of models employing the spending level indicators as dependent variables. Table 4.3 reports the results of regressing the level of social spending in each mode on ALFF II and other control variables.[19]

When each mode of spending is observed separately, it turns out that ALFF II is positively associated with social infrastructure spending (Model6), yet is negatively associated with income maintenance spending (Model7). Although the change in other government spending (i.e., those outlays that are left outside of each model equation) can compound the causal inference, the findings from Model 6 and Model 7 are largely consistent with my theoretical framework. Increased salience of arm's length financing leads the government to reduce income maintenance spending and

[19]The spending indicators are denominated by total government outlays, instead of GDP, because GDP-denominated social spending can be swayed by other factors such as taxation capacity, size of the government, and even by the GDP growth rate, all of which have their own complex causal determination. By using government outlays-denominated social spending, I can narrow my focus down to explaining the size of a social spending given a country's budgetary capacity. For the same reason, I also control for total government outlays as % of GDP.

focus on social infrastructures and services provision. Meanwhile, Model 5 shows that the association between ALFF II and total social spending is not statistically significant. This finding is consistent with my argument that the change in financial structure mainly affects the mode, not the level, of social spending.

	Model5		Model6		Model7	
DV:	Total Social Spending		Social Infra/Service		Income Maintenance	
	LRM	Pr(>|t|)	LRM	Pr(>|t|)	LRM	Pr(>|t|)
ALFF II	0.007	0.176	0.011	0.002	-0.064	0.046
Total Foreign Financing	0.000	0.552	0.001	0.016	0.000	0.894
Domestic Banking Size	0.007	0.008	0.008	0.001	0.017	0.369
GDP per capita	-0.078	0.721	0.125	0.261	-0.251	0.826
Manufacturing	-0.010	0.430	-0.024	0.004	0.253	0.032
Export	-0.013	0.000	-0.014	0.000	-0.036	0.158
Democracy	0.019	0.014	0.016	0.003	0.067	0.093
Left Government	0.065	0.570	0.050	0.573	-0.998	0.075
Urban Population	0.114	0.384	0.088	0.488	-0.877	0.343
Total Government Outlays	-0.010	0.016	-0.008	0.203	-0.023	0.390
	Estimate	Pr(>|t|)	Estimate	Pr(>|t|)	Estimate	Pr(>|t|)
Lagged DV	0.749	0.000	0.739	0.000	0.855	0.000
Observation	836		836		836	
Countries	64		64		64	
(Maximum) Years	31		31		31	
Fixed Effects	Country and Year		Country and Year		Country and Year	

Table 4.3: Determinants of Social Spending Levels

Note that the coefficient estimates of total foreign liability are negligible in all three models. This finding might help better understanding the effect of financial liberalization on emerging welfares states: if the integration into the global financial market increases the private sector's reliance on arm's length finance, the government would find it necessary to strengthen its commitment to social infrastructures and services provision (Model 6) while reducing spending on public income maintenance support (Model 5). If, however, financial market integration only increases a country's overall reliance on the foreign capital without transforming the structure of it, little change with regard to social policy is expected.

Table 4.4 reports the results from a series of robustness check specifications that regress *Prioritization* on ALFF II, controlling for natural resources (Model 8), remittances (Model 9), and official development aid (Model 10). The negative effect of ALFF II holds across all specifications.

	Model 8		Model 9		Model10	
Additional Control:	Natural Resource		Remittance		Official Development Aid	
	LRM	Pr(>|t|)	LRM	Pr(>|t|)	LRM	Pr(>|t|)
ALFF II	-0.067	0.001	-0.101	0.007	-0.064	0.001
Total Foreign Financing	0.000	0.841	0.000	0.961	0.001	0.492
Natural Resource	0.007	0.750				
Remittance			0.022	0.850		
ODA					-0.024	0.508
Domestic Banking Size	-0.000	0.986	-0.008	0.707	0.001	0.931
GDP per capita	0.562	0.210	-0.393	0.767	0.373	0.452
Manufacturing	0.255	0.000	0.380	0.078	0.254	0.000
Export	-0.018	0.505	-0.018	0.443	-0.016	0.515
Democracy	0.050	0.245	0.066	0.298	0.047	0.273
Left Government	-0.607	0.278	-1.294	0.168	-0.672	0.241
Urban Population	-0.244	0.691	-1.760	0.158	-0.223	0.706
Total Social Spending	0.106	0.000	0.124	0.001	0.107	0.000
	Estimate	Pr(>|t|)	Estimate	Pr(>|t|)	Estimate	Pr(>|t|)
Lagged DV	0.832	0.000	0.870	0.000	0.833	0.000
Observation	931		758		923	
Countries	66		61		66	
(Maximum) Years	31		31		31	
Fixed Effects	Country and Year		Country and Year		Country and Year	

Table 4.4: Determinants of Social Policy Prioritization-Robustness Checks (DV: Prioritization of Income Maintenance)

4.3.2 Proposition2

Many of the developing and newly industrialized countries began to adopt various forms of social policies between 1950s and 1970S, as was the case in South Korea and Singapore. It might be reasonable to expect that, over time, some of the policies have institutionalized and become subject to substantial institutional inertia. If so, the effect of any given change in financial structure on social policy would be weaker in the later period covered in the empirical analysis than in the earlier period. To test this, I estimate the main model specification (Model 3) employing a moving window approach and summarize the results in Figure 4.3.

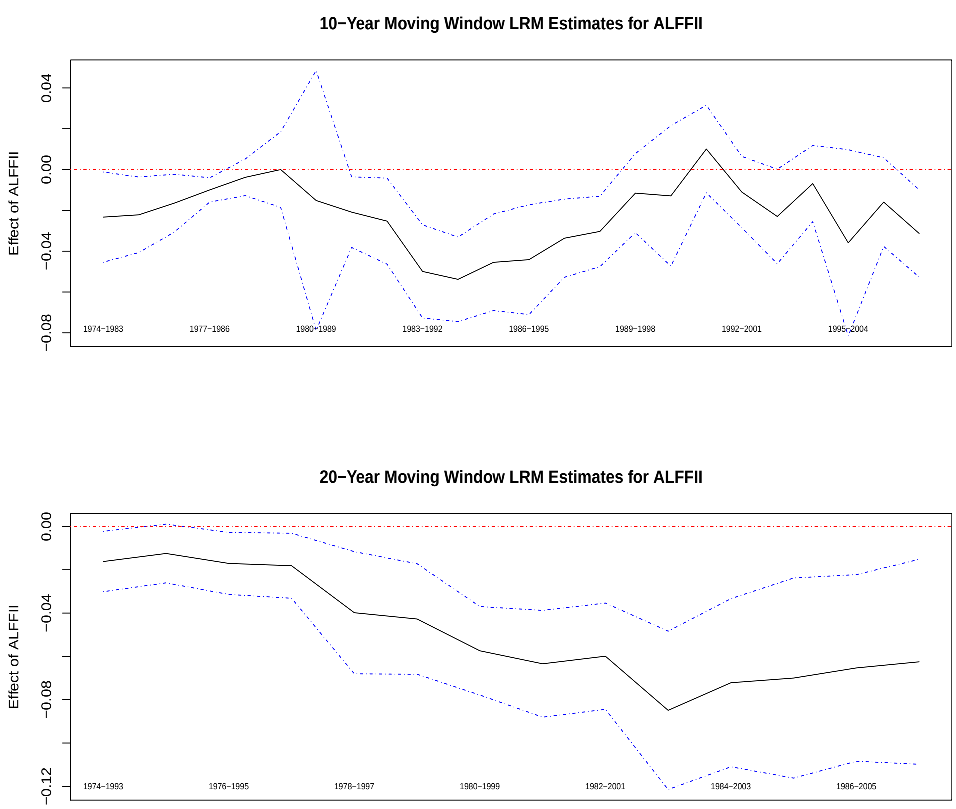

Figure 4.3: Marginal Effect of ALFF II-Moving Window Estimation

The figures graphically present the LRM estimates for ALFF II using a 10-Year (Top Figure) and a 20-Year (Bottom Figure) moving window. The marginal effect of ALFF becomes statistically insignificant (when a 10-year window is used) or involves greater uncertainties (when a 20-year window is used) in the later periods.[20]

Next, Model 11 in Table 4.5 include the interaction term of ALFF II and level of democracy measured by Polity II to capture the influence of vested interests. As explained earlier, incumbents' incentives for serving those who have vested interests in the existing mode of social policy depend on the political costs of doing(/not doing) so. Consistent with my expectation, I find that the effect of ALFF II is negative for all regime types, but the size of the effect is bigger in more democratic observations where the costs associated with serving the vested interest are greater.

As a robustness check, in Model 12, I interact ALFF and the minimum winning coalition size denominated by the selectorate size (w/s), controlling for the level of democracy.[21] This specification allows teasing out the role of the institutional features of autocracies versus democracies while controlling for other–ideological and behavioral–characteristics associated with regime types. Under small w/s ratio, an incumbent is expected to use social policy only to offer concentrated benefits to those in the winning coalition, who are also most likely to develop vested interests in the existing mode social policy. A change in financial structure would not lead the incumbents to adjust the mode of social policy as long as they can offer just enough benefits to those in the winning coalition.[22] Incumbents with large w/s ratio, on the

[20]The effect of ALFF is also marginal in the windows including 1970s. This might be attributable to the fact that the variation among developing countries in the salience of arm's length foreign financing is still small in these early years.

[21]The data are from Bueno de Mesquita et al (2003).

[22]Bueno de Mesquita et al. (2003) refer to the ratio, w/s, as the loyalty norm as it is inversely related to the loyalty of those in the wining coalition to the incumbent. If so, incumbents enjoying high loyalty (small w/s) are less likely to re-prioritize social policy in

contrary, are expected to engage in social policy that benefits the broader population, so would be more responsive to the change in the financial structure of the private sector economy. Model 12 finds a substantive conditioning effect of w/s.

	Model 11		Model 12	
	Democracy X ALFF II		W/S X ALFF II	
	LRM	Pr(>|t|)	LRM	Pr(>|t|)
ALFF II	-0.068	0.000	0.046	0.421
Total Foreign Financing	0.001	0.483	0.003	0.316
Domestic Banking Size	0.002	0.862	-0.006	0.644
GDP per capita	0.664	0.187	0.574	0.646
Manufacturing	0.254	0.000	0.266	0.000
Export	-0.015	0.552	0.069	0.062
Democracy	0.093	0.069	0.000	1.000
Democracy X ALFF II	-0.003	0.208		
W/S			1.417	0.498
W/S X ALFF II			-0.188	0.028
Left Government	-0.681	0.246	-1.616	0.001
Urban Population	-0.376	0.543	0.375	0.607
Total Social Spending	0.105	0.000	0.130	0.000
	Estimate	Pr(>|t|)	Estimate	Pr(>|t|)
Lagged DV	0.832	0.000	0.780	0.000
Observation	932		594	
Countries	66		58	
(Maximum) Years	31		24	
Fixed Effects	Country and Year		Country and Year	

Table 4.5: Determinants of Social Policy Prioritization-Interaction Models (DV: Prioritization of Income Maintenance)

Figure 4.4 summarizes the conditioning effects of Polity II and w/s at the sample mean initial *Prioritization* (i.e., 25% of total social spending). The expected changes from this initial level of prioritization with regard to a 1% increase in ALFF II are graphed at various values of Polity II and w/s. When 90% confidence interval–in dotted lines– is taken into account, the effect of ALFF is nullified when Polity II

response to the change in financing structure, even in the absence of any vested interest.

score is lower than -7, that is, under a very authoritarian political environment. Such findings lend support to my proposition that authoritarian political institutions would mitigate the effect of ALFF by incentivizing the incumbents to serve the narrow vested interests rather than the broader segment of the population. The effect of ALFF is nullified also in those observations with w/s ratio smaller than 0.45, controlling for Polity II. Polity II is no longer statistically significant, which confirms that it is the domestic institutional characteristics related to the size of minimum winning coalition that make democracies more responsive to changes in the financial structure.

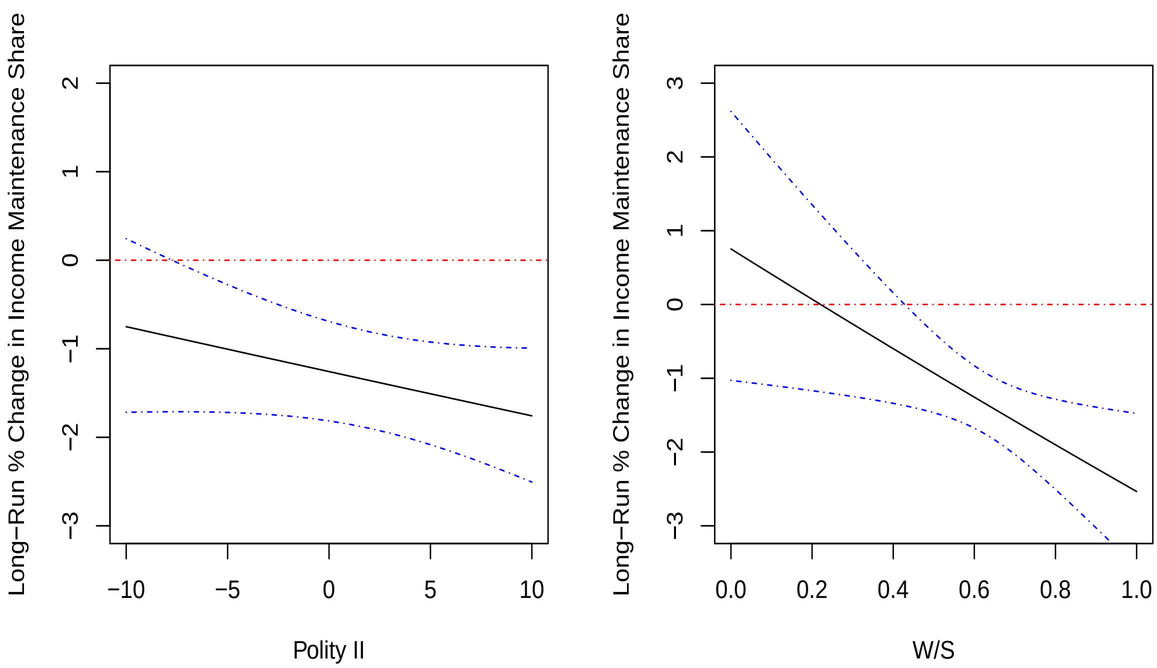

Figure 4.4: Effect of ALFF conditioned by Domestic Political Institutional Context

Overall, my empirical analysis of 66 low and middle-income countries over a period between 1974-2006 lends support to my theoretical framework. Using the structure of foreign financial liability as a proxy for the financial structure of the private sector, I find that the financial structure has a significant influence on governmental prioritization between the two modes of social policy. High salience of arm's length financing is associated with the budgetary priority on social infrastructures and services provision. This finding is consistent with *Proposition1*. Using a moving window approach, I find that the effect of financial structure has become weaker in the most recent decade, indicative of institutional inertia. A series of interaction models show that the effect of financial system is also nullified when incumbent's political survival hinges on the support from a relatively small segment of the population, indicative of the influence of the vested interest. These findings are consistent with *Proposition2*.

Chapter 5

CONCLUSION

This study adds modes of social policy as a new analytical dimension in explaining the variation among welfare states in the developing world. A developing country's government has two distinct modes of policy at its disposal to address the selectorate's welfare concerns: supporting *income maintenance* or providing *social infrastructures and services*. I argue that to maximize the marginal political returns from social spending under tight budgetary constraints, the government prioritizes the mode that is (expected to be) underprovided by the private sector. In other words, the government fills in the welfare gap based on its assessment about the private sector's incentives and capabilities for welfare enhancement.

I then suggest that the private mode of welfare enhancement depends on the production and employment perspectives prevailing in the domestic economy, which in turn, are determined by the type of external financing available in the private sector. I focus on two types of financing: arm's length financing versus relationship-based financing. The former fosters flexible production and employment perspectives in the private sector, which encourages the use of private income maintenance programs. On the contrary, the latter fosters long-term production and employment horizon, which encourages private provision of welfare-related infrastructures and services. In short, by shaping the mode of private welfare enhancement, the financial structure of the private sector ultimately determines governmental social policy prioritization.

I substantiate each causal linkage in my theoretical framework by examining the welfare state developments in South Korea and Singapore since the onset of their industrialization. The predominant casual linkage –from the financial structure to the governmental social policy prioritization– is then put under test for further generalizability with an empirical analysis of 66 low and middle-income countries for the time period 1974-2006. The analysis lends support to my theoretical framework: the greater reliance of a country's economy on arm's length external financing leads the government to prioritize social infrastructure and services over income maintenance support. The effect of financial structure, however, becomes less pronounced at later stages of welfare state development. The effect of financial structure is also found to be weaker in the political environment where the incumben's survival hinges on the support from only a small segment of the population.

One key lesson from this study is to revisit the role of structural factors in shaping public policy choice. A recent strand of the welfare state literature tends to underplay the role of structural factors, and instead, focus on domestic politics such as the partisan bias reflected in the electoral system. In this study, I seek to move the analytical focus to arguably the more interesting issue of how structural and domestic factors systematically interact. My approach can have important implications for envisaging the trajectories of emerging welfare states, as many developing countries are going through simultaneous changes in economic/financial structure and domestic politics. Factors that are largely structural–such as the type of financing the private sector can access–can shape the governmental prioritization between different modes of social policy. Domestic politics conditions the structure-induced social policy adjustments either by reinforcing or mitigating them.

Insights from this study might be applied to other issue areas, especially where it is important to bring about a complementarity between private sector efforts and public policy. Environmental policy is one of the potential areas where my theoretical framework can come into play. Theories for explaining the variation in emerging *welfare states* might help explaining the variation in emerging *ecological states*. Indeed, the trend in the comparative environmental policy literature shares many similarities with that in the comparative social policy literature. Similar to the latter, the former has sought to explain the variation in environmental performances measured by various emission levels or in levels of government commitment measured by regulatory stringency and environmental spending (Neumayer 2003; Holzinger et al. 2008; Knill et al. 2010). The variation in private sector commitment through voluntary environmental regulatory programs or environmental non-government organizations (ENGOs) has also received scholarly attention (Potoski and Prakash 2006). The prioritization by the government between alternative environmental policy instruments has received relatively less scholarly attention, and a few existing studies tend to focus on the advanced economies.

The gap-filling approach advanced in this study might serve as a useful framework to analyze environmental policy prioritization, especially in the developing world context. Developing country governments might prioritize the mode of environmental policy that the private sector is less capable of undertaking, while encouraging the private sector to take part in where it is willing and capable. If so, understanding the private sector's incentives and capabilities for environmental protection is crucial.

Among other things, the financial structure of the private sector and the associated investment and production patterns might shape the private environmental commitment, and in turn, determine the governmental strategy for addressing an environmental concern. Water quality, for instance, is one of the most critical environmental concerns faced by many developing countries. How a developing country's government chooses to deal with this issue might depend on how the broader domestic economy functions. In an economy where firms rely heavily on arm's length finance and are sensitive to short-term profitability, private market-based solutions can be adopted to address point-source pollution, such as tradable permits for water pollutant discharges, as they allow more flexibility in management. The government would then concentrate its budgetary resources to mitigate diffused-source pollution, such as public water and sewage management. Conversely, in an economy where firms mostly depend on relationship-based financing and are interested in long-term projects with large tangible assets, the government could more easily engage the private sector in tackling diffused-source pollution by operating private waste management and sewage treatment. If so, the government's budgetary policy can focus mainly on reducing specific point-source pollutants in the form of environmental subsidies or technology grants.

One can also speculate that different financial structures create advantages for addressing different environmental concerns. For instance, the private sector's reliance on relationship-based financing might allow governments to better engage the private sector in improving slow-moving environmental outcomes, such as biodiversity and forestation. On the contrary, the private sector's heavy reliance on arm's length financing would allow governments to better incentivize the private sector to improve certain environmental outcomes that are readily visible, such as industrial emission of air pollutants.

My future research agenda includes refining and empirically testing these ideas. My key questions would be as follows: How do developing country governments vary in terms of their environmental policy prioritization? How do the private sector's incentives and capabilities for environmental protection vary? Does the private sector's potential for environmental protection affect the government's environmental policy prioritization, and under what conditions? Last but not least, in what aspects are the trajectories of *ecological states* similar to, or distinct from, the trajectories of *welfare states* in the developing world?

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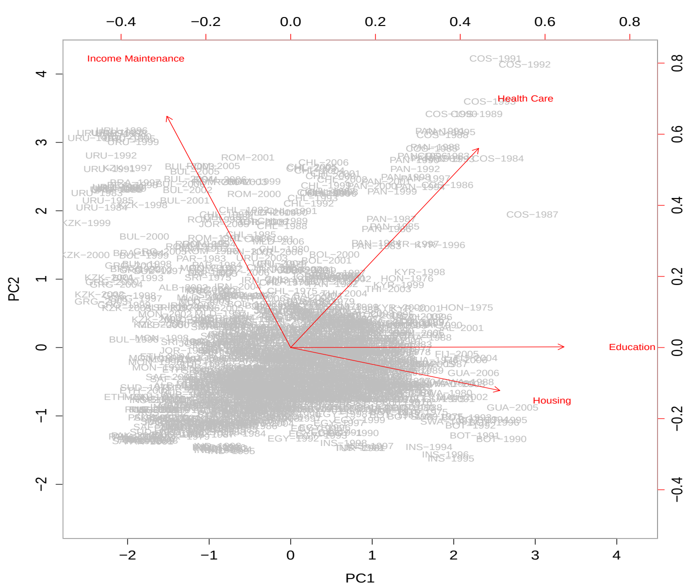
Appendix A

- Principal Component Analysis

	PC1	PC2	PC3	PC4
		Loadings		
Housing	0.509	-0.139	0.848	-0.047
Education	0.665	0.002	-0.432	-0.609
Health Care	0.457	0.646	-0.135	0.596
Income Maintenance	-0.301	0.750	0.275	-0.520
		Importance		
Standard deviation	1.213	1.084	0.910	0.726
Proportion of Variance	0.368	0.294	0.207	0.132
Cumulative Proportion	0.368	0.661	0.868	1.000



- Descriptive Statistics -Country Means

Country Code	No. of Years	Social Spending %Gov't Outlays	Income Maintenance %Social Spending	Foreign Liability %GDP	ALFF I % Foreign Liability	ALFF II
ALB	5	20.2	42.86	48.74	0.78	3.44
ALG	7	43.74	17.4	65.11	1.17	1.25
BFO	14	28.08	15.45	22.95	0	9.39
BHU	21	24.89	1.01	47.64	0	0.88
BNG	6	35.32	9.35	39.01	0.07	3.25
BOL	22	44.7	39.13	113.64	7.1	4.95
BOT	22	36.81	4.76	72.82	0.14	0.63
BRA	5	46.64	76.54	40.62	25.98	22.63
BUI	12	24.5	7.97	92.58	0	1.81
BUL	11	47.01	70.49	103.01	9.65	14.08
CAO	18	25.3	12.79	55.69	8.27	12.27
CHL	32	62.8	53.93	97.93	26.28	12.98
COL	11	43.74	28.44	34.91	14.13	20.86
CON	3	15.43	4.72	209.74	0.03	8.96
COS	24	52.58	29.96	82.42	4.91	9.48
EGY	31	29.47	23.28	71.34	2.68	16.96
ETH	24	24.51	28.31	66.61	0	3.64
FIJ	25	37.83	11.93	62.82	0.05	2.82
GAM	9	24.01	9.65	57.55	0	10.61
GHA	20	36.6	16.95	51.9	2.37	22.62
GRG	10	38.27	75.25	75.82	2.03	1.98
GUA	20	31.66	12.22	32.29	14.23	12.65
HON	5	37.38	13.39	45.56	13.68	11.6
IND	8	9.99	0	32.98	9.67	11.57
INS	23	18.57	13.07	66.77	20.13	18.05
IRN	25	40.01	36.08	14.39	0.16	27.32
JAM	5	29.15	6.39	101.53	1.75	8.45
JOR	29	35.05	36.12	126.48	4.25	14.79
KEN	30	33.67	4.3	56	10.11	12.92
KYR	7	50.36	27.17	127.09	16.77	2.6
KZK	10	42.07	77.82	85.14	45.94	9.22
LES	8	32.75	5.45	105.97	0	0.54
LIT	13	24.24	31.47	55.66	16.76	19.02
MAG	16	22.46	7.09	113.07	0.34	6.89
MAL	20	34.87	9.2	79.16	21.62	19.43
MAS	2	93.11	17.9	31.83	5.28	0
MAW	8	20.38	4.03	99.16	0.03	5.88
MEX	26	40.8	41.68	52.92	18.17	20.09

MLD	11	30.36	43.31	118.4	11.92	15.38
MON	8	25.85	60.26	63.79	0	2.65
MOR	19	27.34	23.09	78.57	2.61	5.91
NEP	21	24.28	7.23	29.16	0.01	5.01
NIR	5	24.12	8.37	33.78	15.9	15.51
PAK	21	7.88	24.06	45.29	3.84	7.12
PAN	22	56.48	30.73	388.5	0.6	6.67
PAR	18	40.42	50.12	39.56	5.83	10.14
PHI	32	24.38	11.47	79.1	19.2	23
PNG	28	27.73	2.88	101.27	22.24	4.74
ROM	15	50.29	60.17	39.46	16.32	13.14
RUS	5	11.53	36.72	73.74	36.13	26.88
SAF	7	11.34	28.61	68.89	34.71	37.54
SAL	17	35	17.21	55.2	4.97	12.16
SEN	10	26.11	8.83	85.77	1.71	8.58
SIE	8	21.67	10.18	69.27	0	2.75
SRI	32	31.41	45.44	62.21	2.02	7.43
SUD	9	10.62	21.1	97.82	1.81	19.22
SWA	17	34.79	0.21	54.35	0.63	5.21
SYR	7	15.73	13.66	120.93	0	26.48
THI	32	34.6	12.99	60.81	30.22	30.12
TOG	10	28.52	24.62	135.56	2.57	10.26
TUN	19	46.05	37.1	122.57	5.56	9.63
TUR	20	20.92	18.38	37.54	11.56	22.96
UGA	11	28.86	7.83	54.95	0.2	4.18
URU	20	65.77	77.96	86.38	1.52	11.3
VEN	19	38.73	19.4	54.89	12.84	26.17
ZAM	20	23.46	5.88	239.78	1.63	9.4

- Results Employing Dependent Variable in Percentage Points

	Model 14		Model 15	
	ALFF I		ALFF II	
	LRM	Pr(>|t|)	LRM	Pr(>|t|)
Arm's Length Foreign Financing	-0.213	0.046	-0.420	0.008
Total Foreign Financing	-0.032	0.087	-0.040	0.010
Domestic Banking Size	-0.009	0.858	-0.034	0.572
GDP per capita	-8.636	0.050	-6.193	0.173
Manufacturing	0.688	0.003	0.831	0.002
Export	0.301	0.002	0.291	0.001
Democracy	-0.056	0.795	0.013	0.954
Left Government	2.996	0.214	1.798	0.409
Urban Population	5.955	0.146	6.068	0.105
Total Social Spending	0.618	0.001	0.664	0.000
	Estimate	Pr(>|t|)	Estimate	Pr(>|t|)
Lagged DV	0.783	0.000	0.785	0.000
Observation	932		932	
Countries	66		66	
(Maximum) Years	31		31	
Fixed Effects	Country and Year		Country and Year	

- ADL-GMM estimators

	Model 16		Model 17	
	One-step Difference GMM			
	LRM	Pr(>|t|)	LRM	Pr(>|t|)
Arm's Length Foreign Financing	-0.043	0.000	-0.030	0.000
Total Foreign Financing	0.002	0.006	-0.002	0.001
Domestic Banking Size	0.006	0.012	0.005	0.012
GDP per capita	1.423	0.000	1.227	0.000
Manufacturing	0.222	0.000	0.150	0.000
Export	0.013	0.001	0.012	0.000
Democracy	-0.068	0.000	-0.043	0.000
Left Government	-0.182	0.036	-0.086	0.152
Urban Population	0.803	0.000	1.325	0.000
Total Social Spending	0.064	0.000	0.068	0.000
	Estimate	Pr(>|t|)	Estimate	Pr(>|t|)
Lagged DV	0.532	0.001	0.440	0.002
Observation	681		681	
Countries	66		66	
(Maximum) Years	31		31	
Fixed Effects	Country and Year		Country and Year	
AR(2)	-1.16 (p.value=0.12)		-1.12 (p.value=0.12)	
Sargan Test	chisq(85)=61 (p.value=0.98)		chisq(82)=61 (p.value=0.96)	
GMM Instruments	DV at t-2, t-3, t-4		DV at t-3 ALFF II at t-3 Total Foreign Financing at t-3	