FEASIBLE GLOBALIZATIONS

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July 2002

Introduction

We want economic integration to help boost living standards. We want democratic politics so that public policy decisions are made by those that are directly affected by them (or their representatives). And we want self-determination, which comes with the nation-state. This paper argues that we cannot have all three things simultaneously. The political trilemma of the global economy is that the nation-state system, democratic politics, and full economic integration are mutually incompatible. We can have at most two out of the three. It follows that the direction in which we seem to be headed—global markets without global governance—is unsustainable.

The alternative is a renewed "Bretton-Woods compromise:" preserving some limits on integration, as built into the original Bretton Woods arrangements, along with some more global rules to handle the integration that can be achieved. Those who would make a different choice—toward tighter economic integration—must face up to the corollary: either tighter world government or less democracy.

During the first four decades following the close of the Second World War, international policy makers had kept their ambitions in check. They pursued a limited form of internationalization of their economies, leaving lots of room for national economic management. Successive rounds of multilateral trade negotiations made great strides, but focused only on the most egregious of the barriers at the border and excluded large chunks of the economy

[1] I am grateful to Michael Weinstein for very helpful suggestions.

(agriculture, services, "sensitive" manufactures such as garments). In capital markets, restrictions on currency transactions and financial flows remained the norm rather than the exception. This Bretton Woods/GATT regime was successful because its architects subjugated international economic integration to the needs and demands of national economic management and of democratic politics.

This strategy changed drastically during the last two decades. Global policy is now driven by an aggressive agenda of "deep" integration—elimination of all barriers to trade and capital flows wherever those barriers may be found. The results have been problematic--in terms of both economic performance (relative to the earlier post-war decades) and political legitimacy. The simple reason is that "deep" economic integration is unattainable in a context where nation states and democratic politics still exert considerable force.

The title of this essay conveys therefore two ideas. First, there are inherent limitations to how far we can push global economic integration. It is neither feasible nor desirable to maximize what Keynes called "economic entanglements between nations."[2] Second, within the array of feasible globalizations, there are many different models to choose from. Each of these models has different implications for whom we empower and whom we don't, and who gains and who loses. We need to recognize these two facts in order to make progress in the globalization debate. One implication is that we need to scale down our ambitions with respect to global economic integration. Another is that we need to do a better job of writing the rules for a thinner version of globalization.

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[2] Keynes used this phrase in an essay written in the midst of the Great Depression, in which he appeared to have given up on free trade altogether: "I sympathize with those who would minimize, rather than those who would maximize economic entanglements between nations. Ideas, art, knowledge, hospitality and travel should be international. But let goods be homespun whenever it is reasonable and conveniently possible, and above all let finance be primarily national." (John Maynard Keynes, "National Self-Sufficiency", *Yale Review*, 1933.)

My argument about the limits to globalization is not (or should not be) self-evident. It rests on several building blocks, and it may be useful to state these at the outset. The argument proceeds from the starting point that markets need to be embedded in a range of non-market institutions in order to work well. These institutions perform several functions critical to markets' performance: they create, regulate, stabilize, and legitimate markets.

The second and much less appreciated point is that there is no simple or unique mapping between these functions and the form that the institutional infrastructure can take. American-style capitalism differs greatly from Japanese-style capitalism; there is tremendous variety in labor-market and welfare-state institutions even within Europe; and low-income countries often require heterodox institutional arrangements to embark on development.

The third point is that institutional diversity of this kind is a significant impediment to full economic integration. Indeed, now that formal restrictions on trade and investment have mostly disappeared, regulatory and jurisdictional discontinuities created by heterogeneous national institutions constitute the most important barriers to international commerce. "Deep integration" would require removing these transaction costs through institutional harmonization—an agenda on which the World Trade Organization has already embarked. However, once we recognize that institutional diversity performs a valuable economic (as well as social) role, it becomes clear that this is a path full of dangers.

Fortunately, there are "feasible" models of globalization that would generate significantly more benefits than our current version—and a much more equitable distribution thereof. I discuss towards the end of the paper a modification of global rules that would produce particularly powerful results: a multilaterally negotiated visa scheme that allows expanded (but temporary) entry into the advanced nations of a mix of skilled and unskilled workers from developing nations. Such a scheme would create income gains that are larger than all of the items on the WTO negotiating agenda taken together, even if it resulted in a relatively small increase in cross-border labor flows.

Markets and non-market institutions

The paradox of markets is that they thrive not under *laissez-faire* but under the watchful eye of the state. Here is how Jacques Barzun describes the extensive regulatory apparatus in place in Venice at the height of its wealth and power around 1650:

> There were inspectors of weights and measures and of the Mint; arbitrators of commercial disputes and of servants and apprentices' grievances; censors of shop signs and taverns and of poor workmanship; wage setters and tax leviers; consuls to help creditors collect their due; and a congeries of marine officials. The population, being host to sailors from all over the Mediterranean, required a vigilant board of health, as did the houses of resort, for the excellence of which Venice became noted. All the bureaucrats were trained as carefully as the senators and councilors and every act was checked and rechecked as by a firm of accountants.[3]

What made Venice the epicenter of international trade and finance in 17th century Europe was the quality of its public institutions. The same can be said of London in the 19th century and New York in the second half of the 20th.

It is generally well understood that markets require non-market institutions—at the very least, a legal regime that enforces property rights and contracts. Without property rights and contract enforcement, markets cannot exist in any but the most rudimentary fashion. But the dependence of markets on public institutions goes beyond property rights. Markets are not self-regulating, self-stabilizing, or self-legitimating. Businessmen seldom meet together, complained Adam Smith, without the conversation ending up in a "conspiracy against the public." In the

[3] Jacques Barzun, From Dawn to Decadence: 500 Years of Western Cultural Life, Perennial, New York, 2000, p. 172.

absence of regulations pertaining to anti-trust, information disclosure, prudential limits, public health and safety, and environmental and other externalities, markets can hardly do their job correctly. Without a lender-of-last-resort and a public fisc, markets are prone to wild gyrations and periodic bouts of underemployment. And without safety nets and social insurance to temper risks and inequalities, markets cannot retain their legitimacy for long. The genius of capitalism, where it works, is that it has managed to continually re-invent the institutional underpinnings of a self-sustaining market economy: central banking, stabilizing fiscal policy, antitrust and regulation, social insurance, political democracy.

What is generally less well understood is that the institutional basis of market economies is not unique. Creating, regulating, stabilizing, or legitimating markets are *functions* that do not map into specific institutional *forms*. Consider property rights, for example. What is relevant from an economic standpoint is whether current and prospective investors have the assurance that they can retain the fruits of their investments—and not the precise legal form that this assurance takes. China, to take an extreme but illustrative example, has managed to provide investors with this assurance despite the complete absence of *private* property rights. Institutional innovations in the form of the Household Responsibility System or the Township and Village Enterprises, it turns out, have served as functional equivalents of a private-enterprise economy. How else can we explain the tremendous burst in entrepreneurial activity that has taken place in China since the reforms of the late 1970s? By contrast, many countries fail to provide investors with effective control rights over cash flow even though private property rights are nominally protected. Russia during the 1990s provides a good example of the latter.

Perhaps the best way to observe that market economies are compatible with diverse institutions is to note the variety that exists among today's advanced countries. The United

States, Europe, and Japan are all successful societies: they have each produced comparable amounts of wealth over the long term. Yet their institutions in labor markets, corporate governance, regulation, social protection, and banking and finance have differed greatly. Scandinavia was everyone's favorite in the 1970s; Japan became the model to emulate in the 1980s; and the United States was the undisputed king of the 1990s. Such predictable changes in institutional fashions should not blind us to the reality that none of these models can be deemed a clear winner in the contest of "capitalisms." Furthermore, despite much talk about convergence in recent years, there have been few real signs of it. Financial systems (and to a much lesser extent corporate governance regimes) have tended to move towards an Anglo-American model. But labor marker arrangements (as captured by union membership or collective bargaining coverage rates) have in fact diverged.[4]

There are good reasons for institutional diversity, and for why national institutions are resistant to convergence. For one thing, societies differ in the values and norms that shape their institutional choices. To take an obvious example, Americans and Europeans tend to have different views as regards the determinants of economic outcomes: compared to Americans, Europeans put greater weight on luck and smaller weight on individual effort.[5] Europeans correspondingly favor extensive redistribution and social protection schemes. Americans, for

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[4] On the limited convergence in effective patterns of corporate governance, see Colin Mayer, "Corporate Cultures and Governance: Ownership, Control, and Governance of European and US Corporations," Said Business School, University of Oxford, unpublished paper, March 2002, and Tarun Khanna, Joe Kogan, and Krishna Palepu, "Globalization and Corporate Governance Convergence? A Cross-Country Analysis," Harvard Business School, unpublished paper, October 2001. On divergence in labor market institutions, see Richard Freeman, "Single Peaked vs. Diversified Capitalism: The Relation Between Economic Institutions and Outcomes," National Bureau of Economic Research Working Paper 7556, Cambridge, MA, February 2000.

[5] For an analysis of differences in attitudes towards inequality, see Alberto Alesina, Rafael di Tella, and Robert MacCulloch, "Inequality and Happiness: Are Europeans and Americans Different?" National Bureau of Economic Research Working Paper 8198, Cambridge, MA, April 2001.

their part, tend to focus on equality of opportunity and tolerate much larger amounts of inequality.

There is a second, subtler reason for the absence of convergence in institutional arrangements. Different elements of a society's institutional configuration tend to be mutually reinforcing. Consider, for example, the manner in which Japanese society provides its citizens with social protection. Unlike Europe, the Japanese government does not maintain an expensive welfare state financed by transfers from taxpayers. Instead, social insurance has been provided in the postwar period through a combination of elements unique to "Japanese-style" capitalism: lifetime employment in large enterprises, protection of agriculture and small-scale services ("mom-and-pop" stores), government-organized cartels, and regulation of product markets. All of these have in turn repercussions for other parts of the institutional landscape. One implication of these arrangements is that they strengthen "insiders" (managers and employees) relative to "outsiders" (shareholders) and therefore necessitate a different corporate governance model than the Anglo-American one: in Japan, "insiders" have traditionally been monitored and disciplined not by shareholders but by banks.[6] In the United States, by contrast, the prevailing model of shareholder-value maximization privileges profits over the interests of insiders and other "stakeholders." But the flip side of this is that profit-seeking behavior is constrained by the toughest anti-trust regime in the world. It is difficult to imagine governments in Europe or Japan humiliating their premier high-tech company the way that U.S. has done with Microsoft.

With such mutual dependence among the different parts of the institutional landscape, anything short of comprehensive change can be quite disruptive, and is therefore difficult to

[6] See Masahiko Aoki, "Unintended Fit: Organizational Evolution and Government Design of Institutions in Japan," in M. Aoki et al, eds., The Role of Government in East Asian Economic Development: Comparative Institutional Analysis, Clarendon Press, Oxford, 1997.

contemplate in normal times. The result is what economists call "path dependence" or "hysteresis:" once the institutional setup performs reasonably successfully (and often when it is not), it gets locked in.

The last major category of reasons for institutional diversity has to do with the special needs of developing nations. Sparking and maintaining economic growth often requires institutional innovations that can depart significantly from American or Western ideals of "best practice." Consider China again, the most spectacular case of success in the developing world in the last quarter century. A Western trained economist advising China in 1978 would have advocated the complete overhaul of the socialist economic regime: private property rights in land, corporatization of state enterprises, deregulation and price liberalization, currency unification, tax reform, reduction of import tariffs and elimination of quantitative restrictions on imports. China undertook few of these, and those that it did take on (such as currency unification and trade liberalization) were delayed for a decade or two after the onset of high growth. Instead, the Chinese leadership devised highly effective institutional shortcuts. The Household Responsibility System, Township and Village Enterprises, Special Economic Zones, and Two-Tier Pricing, among many other innovations, enabled the Chinese government to stimulate incentives for production and investment without a wholesale restructuring of the existing legal, social, and political regime.[7]

The Chinese experience represents not the exception, but the rule: transitions to high growth are typically sparked by a relatively narrow range of reforms that mix orthodoxy with domestic institutional innovations, and not by comprehensive transformations that mimic best-

[7] See the discussion of "transitional institutions" in Yingyi Qian, "How Reform Worked in China," in Dani Rodrik, ed., In Search of Prosperity: Analytic Narratives on Economic Growth, Princeton University Press, Princeton, NJ, forthcoming.

practice institutions from the West. South Korea and Taiwan since the early 1960s, Mauritius since the early 1970s, India since the early 1980s, and Chile since the mid-1980s are some of the more significant examples of this strategy.[8]

Institutional diversity versus deep integration

When economists talk about obstacles to global economic integration, they typically have in mind things like import tariffs, quantitative restrictions on trade, multiple currency practices, restrictive regulations on foreign borrowing and lending, and limitations on foreign ownership. The past few decades have witnessed unparalleled reduction in such barriers, as all of these have been eliminated or slashed across the globe. With the textbook impediments gone, one would have expected national economies to become seamlessly integrated with each other. But, to their surprise, economists have discovered that economic integration remains seriously incomplete.

To be sure, the volume of cross-border trade and investment flows has increased by leaps and bounds in recent decades. Still, when measured against the benchmark of *national* markets, international markets remain highly fragmented. A well-known study calculated that the volume of trade between two Canadian provinces is 20 times larger than trade between a province and an equidistant U.S. state across the border.[9] While later academic studies have been able to reduce this large differential, they all confirm that national borders exert strong depressing effects on

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[8] This is why studies such as David Dollar and Aaart Kraay's "Trade, Growth, and Poverty" (Development Research Group, The World Bank, unpublished paper, March 2001), which purport to show that "globalizers" grow faster than "non-globalizers," are so misleading. The countries used as exemplars of "globalizers" in these studies (China, India, Vietnam) have all employed heterodox strategies, and the last conclusion that can derived from their experience is that trade liberalization, adherence to WTO strictures, and adoption of the "Washington Consensus" are the best way to generate economic growth. China (until recently) and Vietnam were not even members of the WTO, and together with India, these countries remain among the most protectionist in the world.

[9] John McCallum, "National Borders Matter: Canada-U.S. Regional Trade Patterns," *The American Economic Review*, Vol. 85, No. 3. (Jun., 1995), pp. 615-623.

economic exchange.[10] A different strand of the literature has focused on a related phenomenon trade economists call "missing trade." This refers to the observation that factor flows (e.g., labor and capital) embodied in trade fall far short of what standard theories of comparative advantage predict. Given the very large differences in relative factor endowments across countries and the apparent absence of formal trade barriers, there is much less trade in "factor services" than there should be.[11]

From an economic standpoint, what matters most is not the volume of trade as much as the degree of price convergence across national markets. Here too, the results have been disappointing. Prices of tradable commodities often diverge substantially across national markets, even after indirect taxes and retail costs are purged from the comparison.[12] Moreover, when prices do converge to a common level, the process of convergence tends to be slow, taking several years.[13] All of these pieces of evidence point to the same conclusion: national borders continue to act as serious impediments to economic exchange, even though formal trade barriers have all but disappeared.

It may come as a surprise that the situation is not much different in capital markets. In a world of free capital mobility, households would place their wealth in internationally diversified portfolios, and the location of enterprises would not affect their access to financing. In reality,

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[10] See James E. Anderson and Eric van Wincoop, "Gravity with Gravitas: A Solution to the Border Puzzle," National Bureau of Economic Research Working Paper 8079, Cambridge, MA, January 2001.

[11] The standard reference on this is Daniel Trefler, "The Case of the Missing Trade and Other Mysteries," *The American Economic Review*, Vol. 85, No. 5. (Dec., 1995), pp. 1029-1046.

[12] For example, Scott Bradford estimates that domestic prices of motorcycles and bicycles exceed world prices by 100% in the U.K., 76% in Bergium, and 60% in Germany. For these and other estimates, see Bradford, "Paying the Price: The Welfare and Employment Effects of Protection in OECD Countries," Economics Department, Brigham Young University, December 2000, unpublished paper, Table 2.

[13] See the survey by Kenneth S. Rogoff, "The Purchasing Power Parity Puzzle," *Journal of Economic Literature*, Vol. 34, No. 2. (Jun., 1996), pp. 647-668.

financial markets are subject to a great amount of "home bias." Investments in plant and equipment are still constrained by the availability of domestic savings and portfolios remain remarkably parochial.[14] Even in periods of exuberance, *net* capital flows between rich and poor nations fall considerably short of what theoretical models would predict. And in periods of panic, which occur with alarming frequency, capital flows from North to South can dry up in an instant. Global foreign exchange markets may turn over $1.5 trillion in a single day, but any investor who acts on the assumption that it's all one big capital market out there and national borders don't matter would be in for a big surprise—sooner rather than later.

Where do these border barriers arise from if not from attempts by governments to directly restrict trade and capital flows? We are now in a position to link this discussion with the previous one on institutional diversity. The key point is that national borders, and the institutional boundaries that they define, impose a wide array of transaction costs. Institutional and jurisdictional discontinuities serve to segment markets in much the same way that transport costs or import taxes do.

These transaction costs arise from various sources. Most obviously, contract enforcement is more problematic across national boundaries than it is domestically. Domestic courts may be unwilling--and international courts unable--to enforce a contract signed between residents of two different countries. This problem exists across the board, but is particularly severe in the case of capital flows as financial contracts inevitably involve a promise to repay. A key reason why more capital does not flow to poorer countries is that there is no good way such

[14] Linda Tesar and Ingrid Werner, "The Internationalization of Securities Markets since the 1987 Crash," in R. Litan and A. Santomero, eds., Brookings-Wharton Papers on Financial Services, The Brookings Institution, Washington, DC, 1998.

a promise can be rendered binding across national jurisdictions—short of resorting to the gunboat diplomacy of old.

Often, contracts are implicit rather than explicit, in which case they require repeated interaction between the parties or side constraints to make them sustainable. In the domestic context, implicit contracts are often "embedded" in social networks, which allow incentives to be aligned properly by providing sanctions against opportunistic behavior. One of the things that keep businessmen honest is fear of social ostracism. The role played by ethnic networks in fostering cross-border trade and investment linkages (as in the case of the Chinese in Southeast Asia) is indicative of the importance of group ties in facilitating economic exchange.[15] But such ties are generally harder to set up across national borders, in the absence of fortuitous ethnic and other social linkages. More broadly, the poor quality of national institutions and the lack of adequate protection of property rights in many developing countries is a serious handicap for these countries' effective participation in the international economy.

Transaction costs also result from national differences in regulatory regimes and in the rules of doing business—informal as well as legal. That such differences raise the cost of buying, selling, and investing across national boundaries is one of the most frequent complaints heard from businessmen around the world. Indeed, trade conflicts are increasingly the consequence of these differences. When the United States blames Japan's retail distribution practices for keeping Kodak out of the Japanese market or when it lodges a complaint against the EU in the WTO because of the latter's ban on hormone treated beef, what is at issue is the impact that different styles of regulation have on international trade. These complaints do not go in a unique direction. Developing nations have won WTO judgments against the U.S. that centered

[15] See Alessandra Casella and James Rauch, "Anonymous Market and Group Ties in International Trade," National Bureau of Economic Research Working Paper W6186, September 1997.

on gasoline standards and fishing regulations enacted pursuant to the U.S. Clean Air Act and the U.S. Endangered Species Act—on the grounds that these regulations were harmful to their sales of gasoline and shrimp, respectively. Trade negotiations have correspondingly become more focused on harmonizing such regulatory differences away. In the Uruguay Round, a major victory for this agenda was the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPs), which established a minimum patent length requirement. In the area of international finance, a similar push is under way through the promulgation of a series of codes and standards on corporate governance, capital adequacy, bank regulation, accounting, auditing, and insurance.

In sum, national borders stand in the way of deep economic integration because they demarcate institutional boundaries. One conclusion, and the one that many economists have drawn, is that the way forward is to offset these centrifugal forces through international agreements, harmonization and standard setting. That, after all, is how the economic gains from further integration can be reaped. But, as I have argued earlier, diversity in national institutions serves a real and useful purpose. It is rooted in national preferences, sustains social compacts, and allows developing nations to find their way out of poverty. There is no easy choice here.

<u>The political trilemma of the global economy</u>

The tradeoffs can be illustrated with the help of Figure 1, which displays what I call the political trilemma of the global economy.[16] The key message of the figure is that the nation-state system, deep economic integration, and democracy are mutually incompatible. We can have at

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[16] The discussion of this trilemma draws heavily on my "How Far Will International Economic Integration Go?" <u>Journal of Economic Perspectives</u>, Winter 2000.

most two out of these three. If we want to push global economic integration much further, we have to give up either the nation state or mass politics. If we want to maintain and deepen democracy, we have to choose between the nation state and international economic integration. And if we want to keep the nation state, we have to choose between democracy and international economic integration.

To see the logic in this, consider a hypothetical perfectly integrated world economy in which national borders do not interfere with exchange in goods, services or capital. Transaction costs and tax differentials would be minor; convergence in commodity prices and factor returns would be almost complete. Is such a world compatible with the nation-state system? Can we maintain the nation-state system largely as is, but ensure that national jurisdictions—and the differences among them—do not get in the way of economic transactions? Possibly, if nation states were to singularly focus on becoming attractive to international markets. National jurisdictions, far from acting as an obstacle, would then be geared towards maximizing international commerce and capital mobility. Domestic regulations and tax policies would be either harmonized according to international standards, or structured such that they pose the least amount of hindrance to international economic integration. The only public goods provided would be those that are compatible with integrated markets.

It is possible to envisage a world of this sort, and in fact many commentators believe we already live in it. Governments today try to outdo each other in pursuing policies that they believe will earn them market confidence and attract trade and capital inflows: tight money, small government, low taxes, flexible labor legislation, deregulation, privatization, and openness all around. These are the policies that comprise what Thomas Friedman (1999) has aptly termed the Golden Straitjacket. As Friedman notes, the price of maintaining national sovereignty while markets become international is that politics has to be exercised over a much narrower domain. "As your country puts on the Golden Straitjacket," Friedman writes (1999, 87),

> two things tend to happen: your economy grows and your politics shrinks…. [The] Golden Straitjacket narrows the political and economic policy choices of those in power to relatively tight parameters. That is why it is increasingly difficult these days to find any real differences between ruling and opposition parties in those countries that have put on the Golden Straitjacket. Once your country puts on the Golden Straitjacket, its political choices get reduced to Pepsi or Coke--to slight nuances of tastes, slight nuances of policy, slight alterations in design to account for local traditions, some loosening here or there, but never any major deviation from the core golden rules.

The crowding out of democratic politics gets reflected in the insulation of economic policy making bodies (central banks, fiscal authorities, and so on), the disappearance (or privatization) of social insurance, and the replacement of developmental goals with the need to maintain market confidence. Once the rules of the game are set by the requirements of the global economy, domestic groups' access to, and their control over, national economic policy-making has to be restricted.

No country went farther down this path in the 1990s than Argentina, which looked for a while like the perfect illustration of Friedman's point. Argentina's ultimate collapse carries an important lesson for this discussion. Argentina undertook more trade liberalization, tax reform, privatization, and financial reform than virtually any other country in Latin America. It did everything possible to endear itself to international capital markets. Obtaining investment-grade rating—the ultimate mark of approval by international markets—became the Argentine government's first priority.[17] Why did international investors nonetheless abruptly abandon the country as the decade was coming to a close?

[17] The much-maligned currency board system, originally aimed at stopping inflation, eventually became part of this same strategy. A government that was prevented from printing money, it was felt, would be more attractive to foreign investors.

Whatever financial markets feared, it could not have been a lack of commitment by the political leadership to pay back the foreign debt. Indeed, during the course of 2001 President de la Rúa and economy minister Cavallo abrogated their contracts with virtually all domestic constituencies--public employees, pensioners, provincial governments, bank depositors--so as to not skip one cent of their obligations to *foreign* creditors. What ultimately sealed Argentina's fate in the eyes of financial markets was not what Cavallo and de la Rúa were doing, but what the Argentine people were willing to accept. Markets grew increasingly skeptical that the Argentine congress, provinces, and common people would tolerate the policy of putting foreign obligations before domestic ones. And in the end the markets were proven correct. After a couple of days of mass protests and riots just before Christmas, Cavallo and de la Rúa had to resign in rapid succession.

So Argentina's lesson has proved to be a different one than Friedman's: Mass politics casts a long shadow on international capital flows, even when political leaders single-mindedly pursue the agenda of deep integration. In democracies, when the demands of foreign creditors collide with the needs of domestic constituencies, the former eventually yield to the latter. When push comes to shove, democracy shoves the Golden Straitjacket aside.

Conceptually, an obvious alternative is to drop nation states rather than democratic politics. This is the solution of "global federalism" shown in Figure 1. Global federalism would align jurisdictions with markets, and remove the "border effects." Politics need not, and would not, shrink: it would relocate to the global level. This is the United States model expanded on a global scale. Despite the continuing existence of differences in regulatory and taxation practices among states, the presence of a national constitution, national government, and federal judiciary ensures that markets in the U.S. are truly national. The European Union, while very far from a federal system at present, is headed broadly in the same direction. Under global federalism national governments would not necessarily disappear, but their powers would be severely circumscribed by supranational legislative, executive, and judicial authorities.

If this sounds like pie in the sky, it is. The historical experience of the U.S. shows how tricky it is to establish and maintain a political union in the face of large differences in institutional arrangements in the constituent parts. The halting way in which political institutions within the EU have developed and the persisting complaints about their democratic deficit are also indicative of the difficulties involved--even when the union encompasses a group of nations at similar income levels and with similar historical trajectories. Federalism on a truly global scale is at best a century away.

The only remaining option is to sacrifice the goal of deep economic integration. I have termed this the Bretton Woods compromise in Figure 1. The essence of the Bretton Woods-GATT regime was that countries were free to dance to their own tune as long as they removed a number of border restrictions on trade and generally did not discriminate among their trade partners.[18] They were allowed (indeed encouraged) to maintain restrictions on capital flows, as Keynes and the other architects of the postwar economic order did not believe that a system of free capital flows was compatible with domestic economic stability. Even though an impressive amount of trade liberalization was undertaken during successive rounds of GATT negotiations, there were also gaping exceptions. Services, agriculture and textiles were effectively left out of the negotiations. Various clauses in the GATT (on anti-dumping and safeguards, in particular) permitted countries to erect trade barriers when their industries came under severe competition

[18] John Ruggie has written insightfully on this, describing the system that emerged as "embedded liberalism." See his “International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order,” in Stephen D. Krasner, ed., International Regimes, Cornell University Press, Ithaca, NY, 1983.

from imports. And developing country policies were effectively left outside the scope of international discipline.

Until roughly the 1980s, these loose rules left enough space for countries to follow their own, possibly divergent paths of development. Western Europe chose to integrate within itself and to erect an extensive system of social insurance. Japan caught up with the West using its own distinctive brand of capitalism, combining a dynamic export machine with large doses of inefficiency in services and agriculture. China grew by leaps and bounds once it recognized the importance of private initiative, even though it flouted every other rule in the guidebook. Much of the rest of East Asia generated an economic miracle relying on industrial policies that have since been banned by the WTO. And scores of countries in Latin America, the Middle East, and Africa generated unprecedented economic growth rates until the late 1970s under import-substitution policies that insulated their economies from the world economy.

The Bretton Woods compromise was largely abandoned in the 1980s as the liberalization of capital flows gathered speed and trade agreements began to reach behind national borders. We have since been trapped in the uncomfortable (and unsustainable) zone somewhere in between the three nodes of Figure 1. Neither of the alternatives to the Bretton Woods compromise provides a real way forward. The Golden Straitjacket may be feasible, but it is not desirable. Global federalism may be desirable, but it is not feasible. If the principal locus of democratic politics is to remain the nation state, we have to lower our sights on economic globalization. We have no choice but to settle for a "thin" version of globalization–to reinvent the Bretton Woods compromise for a different era.

<u>Alternative globalizations: example of labor mobility</u>

What kind of globalization should we strive for then? Posing the question is important in its own right, as it makes us aware that there are real choices to be made. Global economic rules are not written by Platonic rulers, or their present-day pretenders, academic economists. If WTO agreements were truly about “free trade,” as their opponents like to point out, a single sentence would suffice (“there shall be free trade”). The reality of course is that there is considerable politics in agenda setting and rule making—and those who have power get more out of the system than those who do not. While this is well understood at some level, advocates of globalization have to a tendency to present their agenda with an air of inevitability, as if it has a natural logic that only economic illiterates would reject. Recognizing that there is a multiplicity of feasible globalizations—as there is a multiplicity of institutional underpinnings for capitalist economies—would have an important liberating effect on our policy discussions.

To make the point as starkly as possible, consider the following thought experiment. Imagine that the negotiators who recently met in Doha to hammer out an agenda for world trade talks were really interested in boosting incomes around the world. Imagine further that they really meant it when they said the new round would be a “development round,” i.e., one designed to bring maximum benefit to poor countries. What would they have focused on? Increasing market access for developing country exports? Reform of the agricultural regime in Europe and other advanced countries? Intellectual property rights and public health in developing nations? Rules on government procurement, competition policy, environment, or trade facilitation?

The answer is none of the above. These are areas where the benefits to developing countries are slim at best. The biggest bang by far lies in something that was not even on the agenda at Doha: relaxing restrictions on the international movement of workers. This would produce the largest possible gains for the world economy, and for poor countries in particular. Nothing else comes close to the magnitude of economic benefits that this would generate.

We know this because of a simple principle of economics. The income gains that derive from international trade rise with the square of the price differentials across national markets. Compare in this respect markets in goods and financial assets, on the one hand, with markets for labor services, on the other. Removal of restrictions in markets for goods and financial assets has narrowed the scope of price differentials in these markets (although not done away with them completely, as we have seen). Remaining price wedges rarely exceed a ratio of 2 to 1. Meanwhile, there has been virtually no liberalization of markets for cross-border labor services. Consequently, wages of similarly qualified individuals in the advanced and low-income countries can differ by a factor of 10 or more. Applying the economics principle enunciated above, liberalizing cross-border labor movements can be expected to yield benefits that are roughly 25 times larger than those that would accrue from the traditional agenda focusing on goods and capital flows!

It follows that even a minor liberalization of international labor flows would create gains for the world economy that are much larger than the combined effect of all the post-Doha initiatives under consideration. Consider for example a *temporary* work visa scheme that amounts to no more than 3 percent of the rich countries' labor force. Under the scheme, skilled and unskilled workers from poor nations would be allowed employment in the rich countries for 3-5 years, to be replaced by a new wave of inflows upon return to their home countries. A back-of-the-envelope calculation indicates that such a system would easily yield $200 billion annually for the citizens of developing nations, vastly more than the existing estimates of the gains from the current trade agenda. The positive spillovers that the returnees would generate for their home countries—the experience, entrepreneurship, investment, and work ethic they would bring back with them and put to work—would add considerably to these gains. What is equally important, the economic benefits would accrue directly to workers from developing nations. We would not need to wait for trickle-down to do its job.

Relaxing restrictions on cross-border flows through temporary work contracts and other schemes has a compelling economic logic, but is it politically feasible? One concern is that such flows would have adverse distributional implications in labor markets of advanced countries. In particular, wages of low-skill workers would be depressed. A second concern is that immigration is already highly unpopular in many industrial countries. Indeed, worries about crime and other social problems (as well as racism) have made immigration a hot political issue in an increasing number or rich countries. Third, might increased labor flows enhance the threat of terrorism in our post-September 11 world? All of these suggest that pushing for larger worker inflows may well amount to political suicide.

But while opposition to immigration is real, the political factors at work are subtler than is commonly supposed. Imports from developing countries—which are nothing other than inflows of embodied labor services—create the same downward pressure on rich country wages as immigration, and that has not stopped policymakers from bringing trade barriers down. The bias towards trade and investment liberalization is certainly not due to the fact that that is politically popular at home (whereas labor flows are not). The median voter in the advanced countries is against both immigration *and* imports: fewer than 1 in 5 Americans and Britons reject import restrictions when they are asked their views on trade policy. In these countries, the proportion of voters who want to expand imports tends to be about the same or lower than the proportion that believe immigration is good for the economy. In any case, a well-designed scheme of labor inflows can mitigate much of the concern regarding adverse distributional implications for the host countries. For example, we can imagine aligning the skill mix of "guest" workers with that of the natives—allowing in no more than one construction worker or fruit picker, say, for every physician or software engineer. Finally, there is no clear answer to the question of whether the world would be a safer place with a small, multilaterally-regulated regime of registered contract workers than it is presently. Arguments can be made in either direction.

If substantial liberalization of trade and investment has taken place, it is not because it has been popular with voters at home, but largely because the beneficiaries have organized successfully and become politically effective. Multinational firms and financial enterprises have been quick to see the link between enhanced market access abroad and increased profits, and they have managed to put these issues on the negotiating agenda. Temporary labor flows, by contrast, have not had a well-defined constituency in the advanced countries. This is not because the benefits are smaller, but because the beneficiaries are not as clearly identifiable. When a Turkish worker enters the European Union or a Mexican worker enters the U.S., the ultimate beneficiaries in Europe and the U.S. are not known ex ante. It is only after the worker lands a job that his employer develops a direct stake in keeping him in the country. This explains why, for example, the U.S. federal government spends a large amount of resources on border controls to prevent *hypothetical* immigrants from coming in, while it has virtually no ability to deport employed illegals or fine their employers once they are actually inside the country. The same principle also explains why significant relaxations on labor restrictions do come about occasionally, but only in response to pressure from well-organized interest groups such as agricultural producers or Silicon Valley firms.

The lesson is that political constraints can be malleable. Economists have remained excessively tolerant of the political realities that underpin the highly restrictive regime of international labor mobility, even as they continually decry the protectionist forces that block further liberalization of an already very open trading system.

To ensure that labor mobility produces benefits for developing nations it is imperative that the regime be designed in a way that generates incentives for return to home countries. While remittances can be an important source of income support for poor families, they are generally unable to spark and sustain long-term economic development. Designing contract labor schemes that are truly temporary is tricky, but it can be done. Unlike previous such schemes, there need to be clear incentives for all parties—workers, employees, and home and host governments—to live up to their commitments. One possibility would be to withhold a portion of workers' earnings until return takes place. This forced saving scheme would also ensure to workers would come back home with a sizeable pool of resources to invest. In addition, there could be penalties for home governments whose nationals failed to comply with return requirements. For example, sending countries' quotas could be reduced in proportion to the numbers that fail to return. That would increase incentives for sending government to do their utmost to create a hospitable economic and political climate at home and to encourage their nationals' return.

In the end, it is inevitable that the return rate will fall short of 100 percent. But even with less than full compliance, the gains from reorienting our priorities towards the labor mobility agenda remain significant.

Concluding remarks

I have highlighted two shortcomings of the current discussion on globalization. First, there is inadequate appreciation of the fact that economic globalization is necessarily limited by the scope of desirable institutional diversity at the national level. Under current political configurations and economic realities, deep integration is a utopia. Second, there are many possible models of "feasible globalization," with different implications for economic benefits and their incidence. As my discussion of labor mobility illustrates, we are not focusing currently on areas of economic integration where the biggest gains are. The hopeful message is that it is possible to squeeze much additional mileage out of globalization, while still remaining within the boundaries of feasibility I have identified.

THE POLITICAL TRILEMMA OF THE WORLD ECONOMY

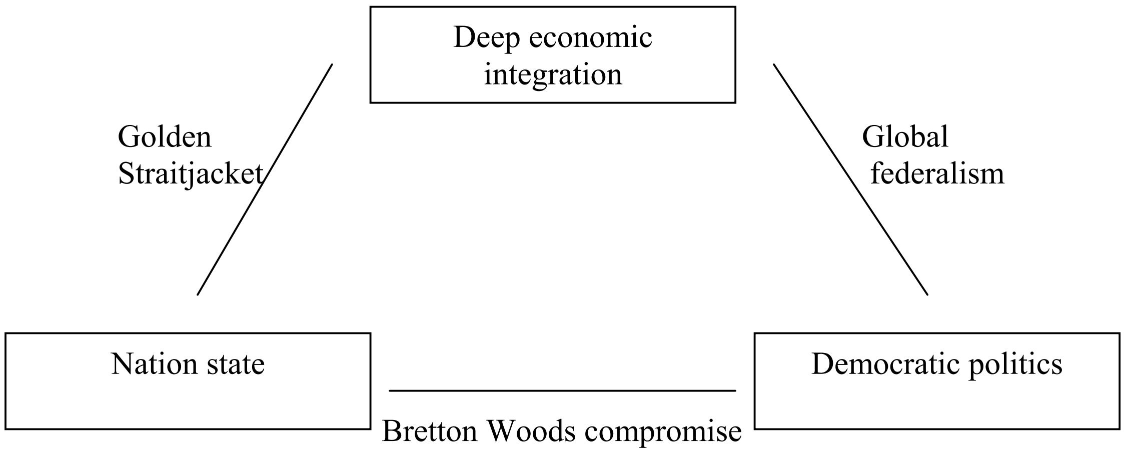

Figure 1: Pick two, any two