

# **The Globalization Paradox**

## **Democracy and the Future of the World Economy**

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## **The Political Trilemma of the World Economy**

In 1990, Argentina couldn't have been in a worse economic mess. In almost perpetual crisis since the seventies, the country reeled under hyperinflation and a crushing debt burden. Incomes had shrunk 25 percent from their levels a decade earlier and private investment had come to a virtual standstill. Prices were rising at unprecedented rates, even by Argentina's demanding standards. In March 1990, inflation climbed to more than 20,000 percent (on an annualized basis), sowing chaos and confusion. Struggling to cope, Buenos Aires' world-weary residents took refuge in gallows humor. With prices soaring by the minute, they told themselves, at least it had become cheaper to take a cab than a bus. With the cab you paid at the end of the ride instead of the beginning!

### **Can You Save an Economy by Tying It to the Mast of Globalization?**

Domingo Cavallo thought he knew the real problem. For too long, Argentina's governments had changed the rules of the game whenever it suited them. Too much governmental discretion had resulted in a complete loss of confidence in Argentine policy makers. The private sector had responded by withholding its investment and fleeing the domestic currency. To restore credibility with domestic and foreign investors, the government needed to commit itself to a clear set of rules. In particular, strict monetary discipline was required to prevent governments from printing money at will.<sup>1</sup>

Cavallo, an economist with a PhD from Harvard, was foreign minister in the administration of President Carlos Menem. He would get the chance to execute his plan when Menem put him in charge of the economy in February 1991. The linchpin of Cavallo's strategy was the Convertibility Law, which legally anchored the Argentine currency to the U.S. dollar at 1 peso per dollar and prohibited restrictions on foreign payments. The Convertibility Law effectively forced Argentina's central bank to operate by gold standard rules. Henceforth the domestic money supply could be increased and interest rates lowered only if dollars were flowing into the economy. If dollars were moving the other way, the money supply would have to be cut and interest rates raised. No more mucking around with monetary policy.

In addition, Cavallo accelerated the privatization, deregulation, and opening up of the Argentine economy. He believed open economy rules and deep integration would reinforce business confidence by precluding discretionary interventions and the hijacking of policy by special interests. With policy on automatic pilot, investors would have little fear that the rules would be changed on them. By the early 1990s, Argentina's record in trade liberalization, tax reform, privatization, and financial reform was second to none in Latin America.

Cavallo envisioned globalization as both a harness and an engine for Argentina's economy. Globalization provided not just discipline and an effective shortcut to credibility in economic policies. It would also unleash powerful forces to propel the economy forward. With lack of confidence and other transaction costs out of the way, foreign capital would flow into the country, allowing domestic investment to rise and the economy to take off. Imports from abroad in turn would force domestic producers to become more competitive and productive. Deep integration with the world economy would solve Argentina's short-and long-term problems.

This was the Washington Consensus taken to an extreme, and it turned out to be right about the short term, but not the long term. Cavallo's strategy worked wonders on the binding constraint of the moment. The Convertibility Law eliminated hyperinflation and restored price stability practically overnight. It generated credibility and confidence—at least for a while—and led to large capital inflows. Investment, exports, and incomes all rose rapidly. As we saw in chapter Six, Argentina became a poster child for multilateral organizations and globalization enthusiasts in the mid-1990s, even though policies like the Convertibility Law had clearly not been part of the Washington Consensus. Cavallo became the toast of the international financial community.

By the end of the decade, the Argentine nightmare had returned with a vengeance. Adverse developments in the world economy set the stage for an abrupt reversal in investors' views on Argentina. The Asian financial crisis hit the country hard by reducing international money managers' appetite for emerging markets, but the real killer was the Brazilian devaluation in early 1999. The devaluation reduced the value of the Brazilian currency by 40 percent against the dollar, allowing Brazilian exporters to charge much lower dollar prices on foreign markets. Since Brazil is Argentina's chief global competitor, Brazil's cost advantage left the Argentinean peso looking decidedly overvalued. Doubts about Argentina's ability to service its external debt multiplied, confidence collapsed, and before too long Argentina's creditworthiness had slid below some African countries'.

Cavallo's relations with Menem had soured in the meantime and he had left office in 1996. President Fernando de la Rúa, who succeeded Menem, invited Cavallo back to the government in March 2001 in an effort to shore up confidence. Cavallo's new efforts proved ineffective. When his initial tinkering with the trade and currency regime produced meager results, he was forced to resort to austerity policies and sharp fiscal cutbacks in an economy where one worker out of five was already out of a job. He launched a "zero-deficit" plan in July and enforced it with cuts in government salaries and pensions of up to 13 percent. The financial panic went from bad to worse. Fearing that the peso would be devalued, domestic depositors rushed to pull their money out of banks, which in turn forced the government to limit cash withdrawals.

The fiscal cuts and the restriction on bank withdrawals sparked mass protests. Unions called for nationwide strikes, rioting enveloped major cities, and looting spread. Just before Christmas, Cavallo and de la Rúa resigned in rapid succession.<sup>2</sup> Starved of funds, the Argentinean government was eventually forced to freeze domestic bank accounts, default on its foreign debt, reimpose capital controls, and devalue the peso. Incomes shrunk by 12 percent in 2002, the worst drop in decades. The experiment with hyperglobalization had ended in colossal failure.

What went wrong? The short answer is that domestic politics got in the way of hyperglobalization. The painful domestic economic adjustments required by deep integration did not sit well with domestic constituencies, and politics ultimately emerged victorious.

### **The Inevitable Clash Between Politics and Hyperglobalization**

The economic story behind Argentina's economic collapse is fairly straightforward in hindsight. Argentina's policy makers had succeeded in removing one binding constraint—monetary mismanagement—but eventually ran into another—an uncompetitive currency. Had the government abandoned the Convertibility Law or reformed it in favor of a more flexible exchange rate, say in

1996, the confidence crisis that engulfed the country later might have been averted. But Argentina's policy makers were too wedded to the Convertibility Law. They had sold it to their public as the central plank of their growth strategy, making it virtually impossible to step back. Pragmatism would have served the country better than ideological rigidity.

But there is a deeper political lesson in Argentina's experience, one that is fundamental to the nature of globalization. The country had bumped against one of the central truths of the global economy: National democracy and deep globalization are incompatible. Democratic politics casts a long shadow on financial markets and makes it impossible for a nation to integrate deeply with the world economy. Britain had learned this lesson in 1931, when it was forced to get off gold. Keynes had enshrined it in the Bretton Woods regime. Argentina overlooked it.

The failure of Argentina's political leaders was ultimately a matter not of will but of ability. Their commitment to the Convertibility Law and to financial market confidence could not have been doubted. Cavallo knew there was little alternative to playing the game by financial markets' rules. Under his policies, the Argentine government was willing to abrogate contracts with virtually all domestic constituencies—public employees, pensioners, provincial governments, bank depositors—so as not to skip one cent of its obligations to foreign creditors.

What 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. Investors and creditors grew increasingly skeptical that the Argentine Congress, provinces, and ordinary people would tolerate austerity policies long discredited in advanced industrial countries. In the end, the markets were right. When globalization collides with domestic politics, the smart money bets on politics.

Remarkably, deep integration cannot sustain itself even when its requirements and goals are fully internalized by a country's political leadership. For Cavallo, Menem, and de la Rúa, globalization was not a constraint to be respected willy-nilly; it was their ultimate objective. Yet they could not keep domestic political pressure from unraveling their strategy. The lesson for other countries is sobering. If hyperglobalization could not be made to work in Argentina, might it ever work in other settings?<sup>3</sup>

In his ode to globalization, *The Lexus and the Olive Tree*, Tom Friedman famously described how the "electronic herd"—financiers and speculators who can move billions of dollars around the globe in an instant—forced all nations to don a "Golden Straitjacket." This defining garment of globalization, he explained, stitched together the fixed rules to which all countries must submit: free trade, free capital markets, free enterprise, and small government. "If your country has not been fitted for one," he wrote, "it will soon." When you put it on, he continued, two things happen: "your economy grows, and your politics shrink." Since globalization (which to Friedman meant deep integration) does not permit nations to deviate from the rules, domestic politics is reduced to a choice between Coke and Pepsi. All other flavors, especially local ones, are banished.<sup>4</sup>

Friedman was wrong to presume that deep integration rules produce rapid economic growth, as we have already seen. He was also wrong to treat his Golden Straitjacket as an established reality. Few countries' leaders put on the Golden Straitjacket more willingly than Argentina's (who then also threw the keys away for good measure). As the unraveling of the Argentine experiment shows, in a democracy, domestic politics win out eventually. The only exceptions are small nations that are already part of a larger political grouping such as the European Union; we will look at the case of Latvia in the next chapter. When push comes to shove, democracy shrugs off the Golden Straitjacket.

Nevertheless, Friedman's central insight remains valid. There *is* a fundamental tension between hyperglobalization and democratic politics. Hyperglobalization *does* require shrinking domestic politics and insulating technocrats from the demands of popular groups. Friedman erred when he overstated the economic benefits of hyperglobalization and underestimated the power of politics. He therefore overestimated the long-run feasibility, as well as desirability, of deep integration.

### **When Hyperglobalization Impinges on Democratic Choices**

We cherish our democracy and national sovereignty, and yet we sign one trade agreement after another and treat free capital flows as the natural order of things. This unstable and incoherent state of affairs is a recipe for disaster. Argentina in the 1990s gave us a vivid and extreme example. However, one does not have to live in a badly governed developing country ravaged by speculative capital flows to experience the tension on an almost daily basis. The clash between globalization and domestic social arrangements is a core feature of the global economy. Consider a few illustrations of how globalization gets in the way of national democracy.

**Labor standards.** Every advanced economy has detailed regulations that cover employment practices. These regulations dictate who can work, the minimum wage, the maximum hours of work, the nature of working conditions, what the employer can ask the worker to do, and how easily the worker can be fired. They guarantee the worker's freedom to form unions to represent his or her interests and set the rules under which collective bargaining can take place over pay and benefits.

From a classical liberal standpoint, most of these regulations make little sense. They interfere with an individual's right to enter into contracts of his or her choosing. If you are willing to work for 70 hours a week below the minimum wage under unsafe conditions and allow the employer to dismiss you at will, why should the state prevent you from accepting such terms? Similarly, if you think it is a good thing for your fourteen-year-old daughter to get a full-time job in a factory, why should the government tell you otherwise? According to classical liberal doctrine, people are the best judge of their own interests (and the interests of their family members), and voluntary contracts, entered freely, must leave both parties better off.

Labor markets were once governed by this doctrine.<sup>5</sup> Since the 1930s, however, U.S. legislation and the courts have recognized that what may be good for an individual worker may not be good for workers *as a whole*. Without regulations that enforce societal norms of decent work, a prospective employee with little bargaining power may be forced to accept conditions that violate those norms. By accepting such a contract, the employee also makes it harder for other workers to achieve higher labor standards. Thus employers must be prohibited from offering odious contracts even if some workers are willing to accept them. Certain forms of competition have to be ruled out. You may be willing to work for 70 hours a week below the minimum wage. But my employer cannot take advantage of your willingness to work under these conditions and offer my job to you.

Consider how international trade affects this understanding. Thanks to outsourcing, my employer can now do what he previously could not. Domestic labor laws still prohibit him from hiring you in my place and putting me to work under conditions that violate those laws. But this no longer matters. He can now replace me with a worker in Indonesia or Guatemala who will work willingly under

those same substandard conditions or worse. To economists, this is not just legal; it is a manifestation of the gains from trade. Yet the consequences for me and my job do not depend on the citizenship of the worker bidding down my labor standards. Why do national regulations protect me from downward competition in employment practices from a domestic worker but not a foreign one? Why should we allow international markets to erode domestic labor regulations through the back door when we do not allow domestic markets to do the same?

The inconsistency is further highlighted by considering whether a society would condone allowing those Indonesian and Guatemalans to be employed *at home* as guest workers under the same labor standards they face in their native countries. Even most free traders would object to such a practice. There should be a single set of labor standards in a country, they will say, applied to all workers regardless of the passport they carry. But why? Outsourcing jobs through trade has exactly the same consequences, for all concerned, as allowing migrant workers to toil under a lower set of standards.

How significant are these issues in the real world? Less than many labor advocates claim, but more than free traders are willing to admit. Wage levels are determined first and foremost by labor productivity. Differences in productivity account for between 80 to 90 percent of the variation in wages around the world. This puts a significant damper on the potential of outsourcing to undermine employment practices in the advanced countries. An employer's threat to outsource my job to someone who earns half my wage does not pose much danger to me when that foreign worker also has half my productivity.

But 80 to 90 percent is not 100 percent. The political and social institutions that frame labor markets exert some independent influence on labor earnings, quite separate from the powerful effects of productivity. Labor regulations, unionization levels, and more broadly the political rights exercised by workers shape the bargains between workers and their employers and determine how the economic value created by firms is shared between them. These arrangements can move wage levels up or down in any country by 40 percent or more.<sup>6</sup> It is here that outsourcing, or the threat thereof, can play a role. Moving jobs to where workers enjoy fewer rights—or threatening to do so—*can be* beneficial to employers. Within limits, it can be used as a lever for extracting concessions on wages and employment practices from domestic workers.

There aren't easy solutions to these conundrums. An employer's freedom to choose where he wants to operate is a competing value that surely deserves attention. The interests of the Guatemalan or Indonesian workers may collide with the interests of domestic workers. We cannot however pretend that outsourcing does not create serious difficulties for domestic labor standards.

***Corporate tax competition.*** The international mobility of firms and of capital also restricts a nation's ability to choose the tax structure that best reflects its needs and preferences. In particular, this mobility puts downward pressure on corporate tax rates and shifts the tax burden from capital, which is internationally mobile, to labor, which is much less so.

The logic is obvious and figures regularly in the arguments of those who push for lower taxes on business. Senator John McCain invoked it prominently in his pre-election debate with Barack Obama when he compared America's corporate tax rate of 35 percent to Ireland's 11 percent. "Now, if you're a business person, and you can locate any place in the world," McCain noted, then obviously



“you go to the country where it’s 11 percent tax versus 35 percent.”<sup>7</sup> McCain got his number for Ireland wrong: the Irish corporate tax rate is 12.5 percent, not 11 percent; but note that he accepted (and cherished) the constraint imposed by globalization. It enabled him to fortify his argument for lower taxes by appealing to their inevitability, courtesy of globalization.

There has been a remarkable reduction in corporate taxes around the world since the early 1980s. The average for the member countries of the OECD countries, excluding the United States, has fallen from around 50 percent in 1981 to 30 percent in 2009. In the United States, the statutory tax on capital has come down from 50 percent to 39 percent over the same period.<sup>8</sup> Competition among governments for increasingly mobile global firms—what economists call “international tax competition”—has played a role in this global shift. The arguments of McCain and countless other conservative politicians who have used globalization to advance their agendas provide still more evidence of this role.

A detailed economic study on OECD tax policies finds that when other countries reduce their average statutory corporate tax rate by 1 percentage point the home country follows by reducing its tax rate by 0.7 percentage points. You either stand your ground and risk seeing your corporations depart for lower tax jurisdictions, or you respond in kind. Interestingly, the same study finds that international tax competition takes place only among countries that have removed their capital controls. When such controls are in place, capital and profits cannot move as easily across national borders and there is no downward pressure on capital taxes. The removal of capital controls appears to be the main factor driving the reduction in corporate tax rates since the 1980s.<sup>9</sup>

The problem has become a big enough headache for tax agencies that efforts are under way within the OECD and European Union to identify and roll back instances of so-called “harmful tax competition.” To date, these activities have only focused on tax havens in a number of microstates ranging from Andorra to Vanuatu. The real challenge is to safeguard the integrity of each nation’s corporate tax regime in a world where enterprises and their capital are footloose. This challenge remains unaddressed.

***Health and safety standards.*** Most people would subscribe to the principle that nations ought to be free to determine their own standards with respect to public health and safety. What happens when these standards diverge across countries, either by design or because of differences in their application? How should goods and services be treated when they cross the boundaries of jurisdictions with varying standards?

WTO jurisprudence on this question continues to evolve. The WTO allows countries to enact regulations on public health and safety grounds that may run against their general obligations under the trade rules. But these regulations need to be applied in a way that does not overtly discriminate against imports and must not smack of disguised protectionism. The WTO’s Agreement on Sanitary and Phytosanitary (SPS) Measures recognizes the right of nations to apply measures that protect human, animal, or plant life or health, but these measures must conform to international standards or be based on “scientific principles.” In practice, disputes in these areas hang on the interpretation of a group of judges in Geneva about what is reasonable or practical. In the absence of bright lines that demarcate national sovereignty from international obligations, the judges often claim too much on behalf of the trade regime.

In 1990, for example, a GATT panel ruled against Thailand's ban on imported cigarettes. Thailand had imposed the ban as part of a campaign to reduce smoking, but continued to allow the sale of domestic cigarettes. The Thai government argued that imported cigarettes were more addictive and were more likely to be consumed by young people and by women on account of their effective advertising. The GATT panel was unmoved. It reasoned that the Thai government could have attained its public health objectives at less cost to trade by pursuing alternative policies. The government might have resorted to restrictions on advertising, labeling requirements, or content requirements, all of which could be applied in a non-discriminatory manner.

The GATT panel was surely correct about the impact of the Thai ban on trade. But in reaching their decisions, the panelists second-guessed the government about what is feasible and practical. As the legal scholars Michael Trebilcock and Robert Howse put it, "the Panel simply ignored the possibility that the alternative measures might involve high regulatory and compliance costs, or might be impracticable to implement effectively in a developing country."<sup>10</sup>

The hormone beef case from chapter Four also raises difficult issues. In this instance, the European Union ban on beef reared on certain growth hormones was not discriminatory; it applied to imported and domestic beef alike. It was also obvious that there was no protectionist motive behind the ban, which was pushed by consumer lobbies and interests in Europe alarmed by the potential health threats. Nonetheless, the WTO Panel and appellate body both ruled against the European Union, arguing that the ban violated the requirement in the SPS Agreement that policies be based on "scientific evidence." There was indeed scant positive evidence to date that growth hormones posed any health threats. Instead, the European Union had applied a broader principle not explicitly covered by the WTO, the "precautionary principle," which permits greater caution in the presence of scientific uncertainty.<sup>11</sup>

The precautionary principle reverses the burden of proof. Instead of asking, "Is there reasonable evidence that growth hormones or GMOs have adverse effects?" it requires policy makers to ask, "Are we reasonably sure that they do *not*?" In many unsettled areas of scientific knowledge, the answer to both questions can be no. The precautionary principle makes sense in cases where adverse effects can be large and irreversible. As the European Commission argued (unsuccessfully), policy here cannot be made purely on the basis of science. Politics, which aggregates a society's risk preferences, must play the determinative role. The WTO judges did acknowledge a nation's right to apply its own risk standards, but ruled that the European Union's invocation of the precautionary principle did not satisfy the criterion of "scientific evidence." Instead of simply ascertaining whether the science was taken into account, the rules of the SPS Agreement forced them to use an international standard on *how* scientific evidence should be processed.

If the European Union, with its sophisticated policy machinery, could not convince the WTO that it should have leeway in determining its own standards, we can only imagine the difficulties that developing nations face. For poor nations, even more than rich ones, the rules imply a single standard.

Ultimately, the question is whether a democracy is allowed to determine its own rules—and make its own mistakes. The European Union regulations on beef (and, in a similar case in 2006, on biotech) did not discriminate against imports, which makes international discipline designed to promote trade even more problematic. As I will argue later, international rules can and should require certain procedural safeguards for domestic regulatory proceedings (such as transparency, broad representation, and scientific input) in accord with democratic practices. The trouble occurs

when international tribunals contradict domestic proceedings on *substantive* matters (in the beef case, how to trade off economic benefits against uncertain health risks). In this instance, trade rules clearly trumped democratic decision making within the European Union.

**“Regulatory takings.”** There are thousands of bilateral investment treaties (BITs) and hundreds of bilateral or regional trade agreements (RTAs) currently in force. Governments use them to promote trade and investment links in ways that go beyond what the WTO and other multilateral arrangements permit. A key objective is to provide a higher level of security to foreign investors by undertaking stronger external commitments.

BITs and RTAs usually allow foreign investors to sue host governments in an international tribunal for damages when new domestic regulations have adverse effects on the investors’ profits. The idea is that the change in government regulations amounts to expropriation (it reduces the benefits that were initially granted to the investors under the BIT or RTA), and therefore requires compensation. This is similar to the U.S. doctrine of “regulatory takings,” which however has never been accepted legal practice within the United States. The treaties include a general exception to allow governments to pursue policies in the interests of the public good, but since these cases are judged in international courts, different standards can apply. Foreign investors may end up receiving rights that domestic investors do not have.<sup>12</sup>

Such cases have been prominent under the North American Free Trade Agreement or NAFTA of 1992, particularly in the area of environmental regulation. Foreign investors have won damages against the Canadian and Mexican governments in several instances. In 1997, a U.S. firm challenged a Mexican municipality’s refusal to grant a construction permit for a toxic waste facility and was awarded \$15.6 million in damages. The same year, a U.S. chemical company challenged a Canadian ban on a gasoline additive and received \$13 million in a settlement.<sup>13</sup>

Perhaps the most worrying case to date involves a suit brought against the South African government in 2007 by three Italian mining companies. The companies charge that South Africa’s affirmative action program, called Black Economic Empowerment, violates the rights provided to them under existing bilateral investment treaties. The program aims to reverse South Africa’s long history of racial discrimination and is an integral element in the country’s democratic transition. It requires that mining companies alter their employment practices and sell a minority share to black partners. The Italian companies have asked for \$350 million in return for what they assert is an expropriation of their South African operations.<sup>14</sup> If they win, they will have achieved an outcome beyond the reach of any domestic investor.

***Industrial policies in developing nations.*** Probably the most significant external constraint that developing nations face as a consequence of hyperglobalization are the restrictions on industrial policies that make it harder for countries in Latin America, Africa, and elsewhere to emulate the development strategies that East Asian countries have employed to such good effect.

Unlike GATT, which left poor nations essentially free to use any and all industrial policies, the WTO imposes several restrictions. Export subsidies are now illegal for all but the poorest nations, denying developing nations the benefit of export-processing zones of the type that Mauritius, China,

and many Southeast Asian nations have used.<sup>15</sup> Policies that require firms to use more local inputs (so-called “domestic content requirements”) are also illegal, even though such policies helped China and India develop into world-class auto parts suppliers. Patent and copyright laws must now comply with minimum international standards, ruling out the kind of industrial imitation that was crucial to both South Korea and Taiwan’s industrial strategies during the 1960s and 1970s (and indeed to many of today’s rich countries in earlier periods).<sup>16</sup> Countries that are not members of the WTO are often hit with more restrictive demands as part of their negotiations to join the organization.

The WTO’s Agreement on Intellectual Property Rights (TRIPS) deserves special mention. This agreement significantly impairs the ability of developing nations to reverse-engineer and copy the advanced technologies used in rich countries. As the Columbia economist and expert on technology policy Richard Nelson notes, copying foreign technology has long been one of the most important drivers of economic catch-up.<sup>17</sup> TRIPS has raised considerable concern because it restricts access to essential medicines and has adverse effects on public health. Its detrimental effects on technological capabilities in developing nations have yet to receive similar attention, though they may be of equal significance.

Regional or bilateral trade agreements typically extend the external constraints beyond those found in the WTO. These agreements are in effect a means for the United States and the European Union to “export their own regulatory approaches” to developing nations.<sup>18</sup> Often they encompass measures which the United States and the European Union have tried to get adopted in the WTO or other multilateral forums, but have failed. In particular in its free trade agreements with developing countries, the United States aggressively pushes for restrictions on their governments’ ability to manage capital flows and shape patent regulations. And even though the IMF now exercises greater restraint, its programs with individual developing countries still contain many detailed requirements on trade and industrial policies.<sup>19</sup>

Developing nations have not completely run out of room to pursue industrial strategies that promote new industries. Determined governments can get around many of these restrictions, but few governments in the developing world are not constantly asking themselves if this or that proposed policy is WTO-legal.

### **The Trilemma**

How do we manage the tension between national democracy and global markets? We have three options. We can *restrict democracy* in the interest of minimizing international transaction costs, disregarding the economic and social whiplash that the global economy occasionally produces. We can *limit globalization*, in the hope of building democratic legitimacy at home. Or we can *globalize democracy*, at the cost of national sovereignty. This gives us a menu of options for reconstructing the world economy.

The menu captures the fundamental political trilemma of the world economy: we cannot have hyperglobalization, democracy, and national self-determination all at once. We can have at most two out of three. If we want hyperglobalization and democracy, we need to give up on the nation state. If we must keep the nation state and want hyperglobalization too, then we must forget about democracy. And if we want to combine democracy with the nation state, then it is bye-bye deep globalization. The figure below depicts these choices.

Why these stark trade-offs? Consider a hypothetical fully globalized world economy in which all transaction costs have been eliminated and national borders do not interfere with the exchange of goods, services, or capital. Can nation states exist in such a world? Only if they focus exclusively on economic globalization and on becoming attractive to international investors and traders. Domestic regulations and tax policies would then be either brought into alignment with international standards, or structured so that they pose the least amount of hindrance to international economic integration. The only services provided by governments would be those that reinforce the smooth functioning of international markets.

The Political Trilemma of the World Economy

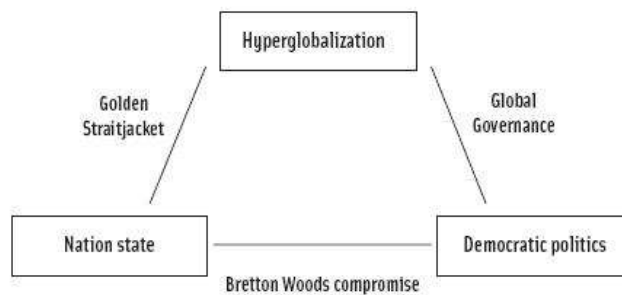


Figure 9-1: Pick

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a world of this sort, Tom Friedman had coined the term Straitjacket.” In this pursue policies that earn them market attract trade and money, small

government, low taxes, flexible labor markets, deregulation, privatization, and openness all around. “Golden Straitjacket” evokes the era of the gold standard before World War I. Unencumbered by domestic economic and social obligations, national governments were then free to pursue an agenda that focused exclusively on strict monetary rules.

External restraints were even more blatant under mercantilism and imperialism. We cannot properly speak of nation states before the nineteenth century, but the global economic system operated along strict Golden Straitjacket lines. The rules of the game—open borders, protection of the rights of foreign merchants and investors—were enforced by chartered trading companies or imperial powers. There was no possibility of deviating from them.

We may be far from the classical gold standard or chartered trading companies today, but the demands of hyperglobalization require a similar crowding out of domestic politics. The signs are familiar: the insulation of economic policy-making bodies (central banks, fiscal authorities, regulators, and so on), the disappearance (or privatization) of social insurance, the push for low corporate taxes, the erosion of the social compact between business and labor, and the replacement of domestic developmental goals with the need to maintain market confidence. Once the rules of the game are dictated by the requirements of the global economy, domestic groups’ access to, and their control over, national economic policy making must inevitably become restricted. You can have your globalization and your nation state too, but only if you keep democracy at bay.

Must we give up on democracy if we want to strive for a fully globalized world economy? There is actually a way out. We can drop nation states rather than democratic politics. This is the “global governance” option. Robust global institutions with regulatory and standard-setting powers would align legal and political jurisdictions with the reach of markets and remove the transaction costs

associated with national borders. If they could be endowed with adequate accountability and legitimacy in addition, politics need not, and would not, shrink: it would relocate to the global level.

Taking this idea to its logical conclusion, we can envisage a form of global federalism—the U.S. model expanded on a global scale. Within the United States a national constitution, federal government, federal judiciary, and large number of nationwide regulatory agencies ensure that markets are truly national despite many differences in regulatory and taxation practices among individual states. Or we can imagine alternative forms of global governance, not as ambitious as global federalism and built around new mechanisms of accountability and representation. A major move in the direction of global governance, in whatever form, necessarily would entail a significant diminution of *national* sovereignty. National governments would not disappear, but their powers would be severely circumscribed by supranational rulemaking and enforcing bodies empowered (and constrained) by democratic legitimacy. The European Union is a regional example of this.

This may sound like pie in the sky, and perhaps it is. The historical experience of the United States shows how tricky it can be to establish and maintain a political union in the face of large differences in the constituent parts. The halting way in which political institutions within the European Union have developed, and the persistent complaints about their democratic deficit, also indicate the difficulties involved—even when the union comprises a group of nations at similar income levels and with similar historical trajectories. Real federalism on a global scale is at best a century away.

The appeal of the global governance model, however wishful, cannot be denied. When I present my students with the trilemma and ask them to pick one of the options, this one wins hands-down. If we can simultaneously reap the benefits of globalization and democracy, who cares that national politicians will be out of a job? Yes, there are practical difficulties with democratic global governance, but perhaps these are exaggerated, too. Many political theorists and legal scholars suggest that democratic global governance can grow out of today's international networks of policy makers, as long as these are held in check by new mechanisms of accountability of the type we shall consider in the next chapter.

I am skeptical about the global governance option, but mostly on substantive rather than practical grounds. There is simply too much diversity in the world for nations to be shoehorned into common rules, even if these rules are somehow the product of democratic processes. Global standards and regulations are not just impractical; they are undesirable. The democratic legitimacy constraint virtually ensures that global governance will result in the lowest common denominator, a regime of weak and ineffective rules. We then face the big risk of too little governance all around, with national governments giving up on their responsibilities and no one else picking up the slack. But more on this in the next chapter.

The only remaining option sacrifices hyperglobalization. The Bretton Woods regime did this, which is why I have called it the Bretton Woods compromise. The Bretton Woods–GATT regime allowed countries to dance to their own tune as long as they removed a number of border restrictions on trade and generally treated all their trade partners equally. They were allowed (indeed encouraged) to maintain restrictions on capital flows, as the architects of the postwar economic order did not believe that free capital flows were compatible with domestic economic stability. Developing country policies were effectively left outside the scope of international discipline.

Until the 1980s, these loose rules left space for countries to follow their own, possibly divergent paths of development. Western Europe chose to integrate as a region and to erect an extensive

welfare state. As we have seen, 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 by relying on industrial policies that have since been banned by the WTO. 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. As we saw, 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.

The world economy has since been trapped in an uncomfortable zone between the three nodes of the trilemma. We have not squarely faced up to the tough choices that the trilemma identifies. In particular, we have yet to accept openly that we need to lower our sights on economic globalization if we want the nation state to remain the principal locus of democratic politics. We have no choice but to settle for a “thin” version of globalization—to reinvent the Bretton Woods compromise for a different era.

We cannot simply bring back wholesale the approaches of the 1950s and 1960s. We will have to be imaginative, innovative, and willing to experiment. In the last part of the book, I will provide some ideas on how to move forward. But the first order of business is getting the big picture right. The necessary sort of policy experimentation will not be unleashed until we change our narrative.

### **Smart Globalization *Can* Enhance National Democracy**

Each of the cases I discussed previously embodies a trade-off between removing transaction costs in the international economy and maintaining domestic differences. The greater the emphasis on deep economic integration, the less the room for national differences in social and economic arrangements, and the smaller the space for democratic decision making at the national level.

More restrained forms of globalization need not embrace the assumptions inherent in deep integration. By placing limits on globalization, the Bretton Woods regime allowed the world economy and national democracies to flourish side by side. Once we accept restraints on globalization, we can in fact go one step further. We can envisage global rules that actually *enhance* the operation of national democracies.

There is indeed nothing inherently contradictory between having a global rule-based regime and national democracy. Democracy is never perfect in practice. As the Princeton political scientists Robert Keohane, Stephen Macedo, and Andrew Moravcsik have argued, well-crafted external rules may enhance both the quality and legitimacy of democratic practices. Democracies, these authors note, do not aim simply to maximize popular participation. Even when external rules constrain participation at the national level, they may provide compensating democratic benefits such as improving deliberation, suppressing factions, and ensuring minority representation. Democratic practices can be enhanced by procedural safeguards that prevent capture by interest groups and ensure the use of relevant economic and scientific evidence as part of the deliberations. Besides, entering into binding international commitments is a *sovereign* act. Restricting it would be like

preventing Congress from delegating some of its rulemaking powers to independent regulatory agencies.<sup>20</sup>

While international commitments can enhance national democracy, they will not necessarily do so. The hyperglobalization agenda, with its focus on minimizing transaction costs in the international economy, clashes with democracy for the simple reason that it seeks not to improve the functioning of democracy but to accommodate commercial and financial interests seeking market access at low cost. It requires us to buy into a narrative that gives predominance to the needs of multinational enterprises, big banks, and investment houses over other social and economic objectives.<sup>21</sup> Hence this agenda serves primarily those needs.

We have a choice in how we overcome this defect. We can globalize democratic governance along with markets; or we can rethink trade and investment agreements to expand space for democratic decision making at the national level. I discuss each of these strategies in turn in the following two chapters.



- [32](#) Atul Kohli, “Politics of Economic Liberalization in India,” *World Development*, vol. 17, no. 3 (1989), pp. 305–28.
- [33](#) Dani Rodrik and Arvind Subramanian, “From ‘Hindu Growth’ to Productivity Surge: The Mystery of the Indian Growth Transition,” *IMF Staff Papers*, vol. 52, no. 2 (2005).
- [34](#) The project was led by my Harvard colleague Ricardo Hausmann. For background and discussion on South Africa’s problems, see Dani Rodrik, “Understanding South Africa’s Economic Puzzles,” *Economics of Transition*, vol. 16, no. 4 (2008), pp. 769–97. The full set of papers prepared for this project can be found in <http://www.cid.harvard.edu/southafrica/>.
- [35](#) For further elaboration, see Ricardo Hausmann, Dani Rodrik, and Charles F. Sabel, “Reconfiguring Industrial Policy: A Framework with an Application to South Africa,” Center for International Development, Working Paper No. 168, Harvard University, May 2008. We may have exaggerated the novelty of our ideas. Meade himself was quite clear about the importance of the government–private-sector dialogue. The Industrial Development Corporation that he recommended was designed in part to stimulate the kind of strategic collaboration we had in mind for South Africa—See Meade, *The Economic and Social Structure of Mauritius*, p. 30.
- [36](#) See the speech by Rob Davies, minister of trade and industry, Budget Vote Address in Parliament delivered in Cape Town on June 30, 2009; available online at <http://www.politicsweb.co.za/politicsweb/view/politicsweb/en/page71656?oid=134655&sn=Detail>.
- [37](#) Alexander Hamilton, *Report on Manufactures*, Communication to the House of Representatives, December 5, 1791.

## 9. The Political Trilemma of the World Economy

- [1](#) See the interview with Domingo Cavallo at [http://www.pbs.org/wgbh/commandingheights/shared/pdf/int\\_domingocavallo.pdf](http://www.pbs.org/wgbh/commandingheights/shared/pdf/int_domingocavallo.pdf).
- [2](#) This account draws on Dani Rodrik, “Reform in Argentina, Take Two: Trade Rout,” *The New Republic*, January 14, 2002, pp. 13–15.
- [3](#) Cavallo would later argue that the true culprit was loose fiscal policy in the years preceding the crisis. See the interview cited in note 1. From a narrow economic perspective, he may well be right. With enough fiscal austerity, price deflation, and belt-tightening, the Argentine economy would have been able to service external debts and maintain financial market confidence. The question is whether this is a sensible way to run an economy. Is it reasonable, or even desirable, to expect that the political system will deliver these drastic measures when needed (that is, when times are already tough) just to satisfy foreign creditors?
- [4](#) Thomas L. Friedman, *The Lexus and the Olive Tree* (New York: Anchor Books, 2000), pp. 104–06.
- [5](#) In a famous decision issued in 1905 (*Lochner v. New York*), the U.S. Supreme Court struck down a New York State law restricting the maximum hours of work for bakery employees. The New York statute was “an illegal interference,” the justices wrote, “with the right of individuals, both employers and employees, to make contracts regarding labor upon such terms as they may think best.” See Michael J. Sandel, *Democracy’s Discontent: America in Search of a Public Philosophy* (Cambridge, MA: Harvard University Press, 1996), p. 41. It wasn’t until the 1930s, following Franklin D. Roosevelt’s threat to pack the Court with sympathetic jurists, that the Supreme Court reversed course

and upheld a minimum wage law for women in 1937 (*West Coast Hotel Co. v. Parrish*). This decision opened the way for subsequent legislation regulating employment practices including maximum work hours—Rodrik, *Has Globalization Gone Too Far?* Institute for International Economics, Washington, DC, 1997, p. 36.

- [6](#) Dani Rodrik, “Democracies Pay Higher Wages,” *Quarterly Journal of Economics*, vol. 114, no. 3 (August 1999), pp. 707–38.
- [7](#) “Transcript of First Presidential Debate,” September 9, 2008, at <http://www.cnn.com/2008/POLITICS/09/26/debate.mississippi.transcript/#cnnSTCText>.
- [8](#) Scott A. Hodge and Andre Dammert, “U.S. Lags While Competitors Accelerate Corporate Income Tax Reform,” *Fiscal Fact No. 184*, Tax Foundation, August 2009, <http://www.taxfoundation.org/files/ff184.pdf>.
- [9](#) Michael P. Devereux, Ben Lockwood, and Michela Redoano, “Do Countries Compete Over Corporate Tax Rates?” *Journal of Public Economics*, vol. 92, nos. 5–6 (June 2008), pp. 1210–1235.
- [10](#) Michael J. Trebilcock and Robert Howse, *The Regulation of International Trade*, 3rd ed. (New York: Routledge, 2005), p. 517.
- [11](#) In a similar case in 2006, the WTO also ruled against EU restrictions on genetically modified food and seeds, finding fault once again with the adequacy of EU scientific risk assessment.
- [12](#) Emma Aisbett, Larry Karp, and Carol McAusland, “Regulatory Takings and Environmental Regulation in NAFTA’s Chapter 11,” Unpublished paper, University of California at Berkeley, February 10, 2006.
- [13](#) For an inventory of cases brought under Chapter 11 of NAFTA, see the Public Citizen Web site: <http://www.citizen.org/documents/Ch11CasesChart-2009.pdf>.
- [14](#) Luke Peterson and Alan Beattie, “Italian Groups Challenge Pretoria Over BEE,” *Financial Times*, March 9, 2007.
- [15](#) Since these zones commonly provide differential benefits to exporting firms, it is easy to find them in violation of WTO’s subsidy rules. Some developing nations have benefited from a delay of the entry into force of these restrictions on subsidies.
- [16](#) For a prescient article on the costs of WTO’s patent rules, see Arvind Subramanian, “Putting Some Numbers on the TRIPs Pharmaceutical Debate,” *International Journal of Technology Management*, vol. 10, nos. 2–3 (1995).
- [17](#) Richard R. Nelson, “The Changing Institutional Requirements for Technological and Economic Catch Up,” Unpublished paper, Columbia University, June 2004.
- [18](#) Henrik Horn, Petros C. Mavroidis, and André Sapir, “Beyond the WTO? An Anatomy of EU and US Preferential Trade Agreements,” Bruegel Blueprint 7, Bruegel Institute, Brussels, 2009.
- [19](#) For more elaboration and examples, see Dani Rodrik, *One Economics, Many Recipes: Globalization, Institutions and Economic Growth* (Princeton: Princeton University Press, 2007), chap. 4.
- [20](#) Robert O. Keohane, Stephen Macedo, and Andrew Moravcsik, “Democracy-Enhancing Multilateralism,” *International Organization*, 63 (Winter 2009), pp. 1–31. See also Robert Howse, “Democracy, Science and Free Trade: Risk Regulation on Trial at the World Trade Organization,” *Michigan Law Review*, 98 (June 2000).

21 In a few cases (such as the U.S.-Peru trade agreement of 2006), labor groups have managed to “balance” those interests by introducing labor standards clauses into bilateral or regional trade agreements. For reasons I will discuss in subsequent chapters, this can compound the problems. Pressure from U.S. trade unions is as unlikely to serve the interests of other countries as pressure from U.S. multinationals.

## 10. Is Global Governance Feasible?

- 1 African Development Bank and World Tourism (not Trade) Organization, respectively.
- 2 See <http://voxeu.org/index.php?q=node/2544>.
- 3 See Jeffrey Garten, “The Case for a Global Central Bank,” Yale School of Management, posted online, September 21, 2009, at [http://ba.yale.edu/news\\_events/CMS/Articles/6958.shtml](http://ba.yale.edu/news_events/CMS/Articles/6958.shtml).
- 4 Carmen Reinhart and Kenneth Rogoff, “Regulation Should Be International,” *Financial Times*, November 18, 2008 ([http://www.ft.com/cms/s/0/983724fc-b589-11dd-ab71-0000779fd18c.html?nclick\\_check=1](http://www.ft.com/cms/s/0/983724fc-b589-11dd-ab71-0000779fd18c.html?nclick_check=1)).
- 5 David Epstein and Sharyn O’Halloran, *Delegating Powers: A Transaction Cost Politics Approach to Policy Making Under Separate Powers* (Cambridge and New York: Cambridge University Press, 1999).
- 6 Anne-Marie Slaughter, *A New World Order* (Princeton and Oxford: Princeton University Press, 2004).
- 7 John G. Ruggie, “Reconstituting the Global Public Domain—Issues, Actors, and Practices,” *European Journal of International Relations*, 10 (2004), pp. 499–531.
- 8 There is a parallel debate in international law on whether it is possible to institute effective legal norms and practices at the global level in the absence of global government. See, e.g., Jeffrey L. Dunoff and Joel P. Trachtman, eds., *Ruling the World?: Constitutionalism, International Law, and Global Governance* (Cambridge and New York: Cambridge University Press, 2009), and Eric Posner, *The Perils of Global Legalism* (Chicago: University of Chicago Press, 2009), in addition to the work of Anne-Marie Slaughter already cited. The case against “global legalism” is stated succinctly by Posner, who argues that without legal institutions—legislators, enforcers, and courts—law cannot control behavior.
- 9 Joshua Cohen and Charles F. Sabel, “Global Democracy?” *International Law and Politics*, 37 (2005), p. 779.
- 10 *Ibid.*, p. 796.
- 11 Peter Singer, *One World: The Ethics of Globalization* (New Haven: Yale University Press, 2002), p. 12.
- 12 Amartya Sen, *Identity and Violence: The Illusion of Destiny* (New York: W. W. Norton, 2006).
- 13 Amartya Sen, *The Idea of Justice* (Cambridge, MA: Harvard University Press, 2009), p. 143.
- 14 See Cohen and Sabel, “Global Democracy,” and Charles F. Sabel and Jonathan Zeitlin, “Learning from Difference: The New Architecture of Experimentalist Governance in the EU,” *European Law Journal*, vol. 14, no. 3 (May 2008), pp. 271–327.