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Globalization: Economic Challenges and the Political Response

Recently, resistance to the – presumed and actual – consequences of globalization in both developed and developing countries has gained momentum. While the arguments raised against globalization often lack economic substance, it will probably only prevail if a broad majority of the population can be convinced that closer worldwide integration does serve their interests. This can hardly be achieved without a convincing strategy for compensating the potential losers of globalization, given that globalization tends to reduce the national states' leeway for taxation and redistributive measures through social policies.

Globalization is one of those catchwords which stir highly controversial debates, in economics as well as in politics. Recently, resistance to the presumed and the actual consequences of globalization in developed and in developing countries has gained momentum. The "Battle in Seattle" probably initiated what will turn out to be the usual background noise for international high-level meetings focusing on trade, finance, and development. Subsequent meetings in Davos and Washington also had to realize that there is a backlash against globalization. Many arguments raised against globalization lack economic substance, but the question remains how the nation-state can live up to its traditional role as a provider of public goods and redistribution in a world with unlimited factor mobility.

The emerging resistance to globalization does not focus on the potential long-run consequences for the provision of public goods, but mainly targets international organizations as proponents of economic policies which are said to be harmful for workers and the environment in developed and in developing countries[1]. For instance, the World Trade Organization (WTO) is criticized for employing undemocratic rules of the game, which aim at reducing existing barriers to international trade and prohibit implementing new trade barriers. Some observers think that rules like these only serve the interests of large multinational corporations, which account for a large fraction of international trade and capital flows.

In public debate, this impression may easily be supported by pointing out that rules which appear to be less beneficial to international corporations, such as international labor standards and environmental standards, have been kept out of the WTO up to now. Is globalization, as some critics seem to believe, something like a conspiracy by big business to the detriment of workers and the environment, especially in poor countries? And is not globalization causing unemployment and income insecurity among workers in developed countries as well?

A Fundamental Misunderstanding

At face value, it may appear difficult to understand why a democratically elected government should obey the abstract WTO rule of not imposing trade restrictions on certain goods, if trade restrictions actually express the wishes of its electorate. However, the point to note is that no country is forced to become a member of the WTO. On the contrary, present non-members like China are eagerly struggling to be

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[1] See, e.g., the homepage of "Mobilization for Global Justice" (http://www.a16.org/), which criticizes policies supported by the IMF and the World Bank.

accepted as WTO members. Most countries want to participate in globalization, because they believe that integration into the world economy does serve their interests. Such a belief is not wrong, despite all rhetoric suggesting otherwise.

Recent public debates about the costs and benefits of unrestricted international trade are often based on a fundamental misunderstanding. For free trade to be welfare increasing, trading partners do not have to liberalize all at the same time. Economic theory maintains that every country can realize the gains from trade by unilateral liberalization. Hence deciding not to liberalize trade is comparable to deciding not to pursue a productive investment (e.g., a school building, a hospital, a bridge, a power station). That is, an international treaty like the WTO, which requires member countries to liberalize multilaterally, misses an underlying economic logic. The existence of the WTO can only be justified in political terms as an arrangement which binds policy makers not to retreat to protectionism in times of economic recession.[2]

Previous negotiations about trade liberalization have always been sold to the public as a haggling for "concessions". According to this purely mercantilist logic, each country only liberalizes its trade regime if all other countries also liberalize at the same time. If trade liberalization were actually to be understood as a concession to other countries or even to multinational corporations, some resistance to free trade should not come as a surprise to policy makers.

However, the missing economic rationale for multilateral trade negotiations must not be used as an argument for trade restrictions. Even restrictions against the import of goods which are said to damage the health of consumers under certain circumstances often lack a convincing explanation. Most of the time the heralded protection of consumers against foreign goods is used to disguise the protection of home produce. British beef may provide an actual case in point: British consumers obviously do not have to be protected, and allowing the import of British beef does not mean that consumers are forced to buy it. In any case, trade restrictions cannot prevent criminal activities in the production of goods which may damage the health of consumers, because offenses against existing regulations not only happen in foreign countries.

Other arguments in favor of trade restrictions refer to labor standards and to environmental standards. To realize that free trade and environmental degradation are not necessarily related, a look towards the formerly socialist countries is quite instructive. These countries provide ample evidence that environmental destruction can be achieved without multinational corporations and international trade. By contrast, international trade in services like tourism may even provide strong incentives to preserve intact eco-systems. This also holds for international trade in renewable resources like timber. After all, national governments decide on the actual amount of protection of the environment. But especially in poor countries, environmental goals will always compete with other goals like expanding the education and health systems. Imposing European eco-standards on developing countries in effect means diminishing the chances of these countries for an improvement in their standard of living.

The same reasoning applies to the imposition of labor standards. It is well known that workers in some developing countries suffer from labor conditions which probably prevailed in Europe at the beginning of the industrial revolution. As in Europe at that time, child labor is a fact of life. Enjoying the fine carpet at home bought at a moderate price may indeed become difficult if one starts thinking about all those tiny hands which wove it. But not buying a carpet for this reason does not solve the problem of child labor. In some cases, a boycott of goods produced by children may change things for the worse because child labor is caused by poverty and international trade is one of the possibilities of reducing poverty.

This is not to say that international trade provides a guaranty for escaping poverty. But the simple fact that up to now all countries which have been catching up in economic terms have done so by integration into the world economy deserves second thoughts by critics of globalization. Over the last hundred years, there is no example in economic history for an inward-looking development strategy which led to a sustainable improvement in the standard of living of the average person. On the contrary, many development strategies that were focusing on national autarky ended in terrible catastrophes. In this regard, economic openness can serve as insurance against permanent political repression and against corrupt governments. Not least because of these reasons, it is good news that many developing countries have joined the trend towards liberalization that gained momentum over the last two decades.

[2] See Paul Krugman: What Should Trade Negotiators Negotiate About?, in: Journal of Economic Literature, Vol. 35, 1997, pp. 113-120.

Rising Distributional Imbalances

A close link between worldwide integration and a rise of the standard of living of the vast majority of the population has apparently been lost recently. In many newly industrializing economies, especially in Latin America, and in developed economies the distribution of income has shifted to the detriment of unskilled workers since the early 1980s. This trend most likely reflects the uniquely new aspect of globalization: the strong increase in international capital mobility over the last twenty years.

Both rising international trade and rising international capital mobility will increase the wealth of nations. But at the same time, according to the same economic logic, rising distributional imbalances across factors of production are to be expected. This is because welfare gains can only be realized if the sectoral structure of the economy changes according to changes in comparative advantage caused by trade and capital flows. Growth and sectoral structural change are two sides of the same coin. If trade and capital flows do not initiate changes in the sectoral structure and hence changes in the distribution of income across factors of production, they cannot have contributed to an increase in welfare. That is, arguing that globalization is welfare increasing but does not touch upon the distribution of income comes close to a self-defeating argument.

Low-skilled workers are the losers of globalization in developed countries. Their income and their level of employment will no longer be determined by supply and demand conditions in the national labor market. With further increases in the international mobility of capital and high-skilled workers, the wage for low-skilled workers will ultimately be determined by the fairly elastic worldwide supply of low-skilled workers and thus remain relatively low in developed countries. Hence in the long run, low-skilled workers in developed countries will lose that part of their income which is only due to their physical proximity to other factors of production like capital, technology, and knowledge, which were tied to specific locations before globalization started about 20 years ago.

The owners of these factors of production, namely shareholders, managers, and high-skilled workers, are the winners of globalization, at least in developed economies. In developing countries, the opposite result should emerge, at least in theory. In these countries the established elite has to realize what it means to defend an income position partly based on rents in the presence of fierce competition by foreign capital owners. Foreign competition is usually not welcomed by rent owners. This explains why countries like India still hold reservations against liberalizing the inflow of foreign direct investment, despite years of successful economic reform in other areas.

Wages of low-skilled workers in poor countries should rise with ongoing globalization as rents of low-skilled workers in rich countries are dissipated by international competition. That this has not happened on a broad scale up to now may have a number of reasons. One obvious reason is that many of the poorest countries actually do not participate in globalization. Another reason is that fierce competition also prevails within the group of developing countries, which is not a homogenous bloc. Countries like Brazil and Mexico face a need for adjustment through sectoral structural change similar to that of developed countries when low-wage countries like China demand a larger share of world markets in labor-intensive goods. A third reason is that because of new technological developments, comparative advantage may become "kaleidoscopic" and may change back and forth with previously unknown speed, so it will prove to be difficult to say in advance which factors of production will belong to the losers and which will belong to the winners of globalization.[3]

Protectionism the Wrong Response

All this does not mean that globalization is a zero-sum game, as would be suggested by mercantilist logic. Protectionism is the wrong response to globalization just because an increase in the international division of labor does lead to an increase in welfare for all countries involved. The retreat to protectionism after the Great Depression and the ensuing breakdown of international trade is an example for the disastrous economic and not least political effects of a wrong response to the challenge of globalization.

But if the losers of globalization cannot rely on being compensated by the winners, there is no reason to believe that a broad consensus in favor of globalization will ever emerge. Nobody can predict where the dividing line between winners and losers will lie in the future. More economic insecurity as a consequence of ever faster changes in the pattern of the international division of labor is likely to generate a backlash

[3] See Jagdish Bhagwati: The Global Age: From a Skeptical South to a Fearful North, in: The World Economy, Vol. 20, 1997, pp. 259-283.

against the forces of globalization. The question that has not been answered by proponents of globalization so far is how the losers of globalization can indeed be compensated if nation states lose their tax base due to increased international capital mobility.

The reason that increasing international trade flows, which can be observed for the last 50 years, did not cause distributional problems in the past is probably that all market economies pursued a more or less active social policy. Accordingly, some authors view the modern welfare state as a social insurance against the risks of an international division of labor.[4] As long as capital and high-skilled workers are not mobile internationally, they can not easily escape taxation. Such kind of taxation in turn provides the resources for public subsidies in fields like education, health, unemployment benefits, and old-age pensions. The amount of public subsidies in each field is certainly debatable and differs across countries. What is not debatable is that the basis for these subsidies will disappear if the factors which have been highly taxed in the past can now threaten to leave the system of taxation altogether.

At present, locational competition generated through increased capital mobility seems to have induced a reasonable reconsideration of the role of the state. Many but not all activities pursued under public management in developed economies could also be pursued under private management. In this regard,

[4] See Dani Rodrik: Has Globalization Gone Too Far?, Institute for International Economics, Washington DC 1997.

locational competition has helped to identify sectors where allowing for competition helps to improve productivity. But in the end, unrestricted locational competition for capital must be inefficient, simply because the public goods cannot be sufficiently provided privately through markets. In theory, the international mobility of capital and high-skilled workers initially reduces the possibility of a country-specific social policy and finally leads to an under-provision of public goods, which destroys the defining foundation of a social market economy.

Reduced National Leeway for Redistribution

Such a theoretical development will hardly be observed in practice, however, because increasing distributional conflicts would sooner or later initiate a counter reaction against the forces of globalization. The national welfare state can probably be regarded as the response to the first age of globalization, which began with the gold standard in the nineteenth century and ended with the First World War in 1914. Maybe the time has come to think about an appropriate response to the second age of globalization, in order to avoid a return to protectionism as in the 1930s. Such a response requires a clear understanding of the role of the state in a market economy.

The state has primarily the task to guarantee the rule of law and to protect private property rights. Without the rule of law and no protection against theft and expropriation, private resources have to be used individually to defend private property. Such an outcome is inefficient, because the public good "internal security" can be produced cheaper by the state than by markets. The reason is not that the state can offer cheaper security forces than private firms, but less security forces are required than under a competitive solution if the state holds a monopoly in providing internal security.

Only by inhibiting the anarchistic fighting of each individual against everybody else for the resources of an economy, the state generates positive incentives for an exchange of goods and services through markets. At the same time, precisely because of its monopoly in internal security, the state can appropriate private resources which can be used for redistribution. Public appropriation and redistribution of private resources is required to finance the basic tasks of the state and to compensate the losers of globalization. How these basic principles can be applied in practice and at what level public redistribution begins to unfold negative incentives remains to be debated.

Some evidence on how to proceed has become available after large-scale privatization in many sectors of developed economies. Developed economies do not fall apart if, say, transport, postal service, telecommunication, and utilities like energy are provided by private suppliers. As expected, prices have declined and service has improved in many cases after privatization. It is also self-evident that an economy becomes more productive if low-productivity sectors are no longer subsidized at the cost of dynamic sectors. But it remains questionable from a society's point of view whether an optimal amount of services like education and health can be provided without public subsidies. A suboptimal provision of public goods may be the final outcome if globalization reduces the available national leeway for taxation and redistributive measures through social policies.

A World Tax Organization?

One reaction to these basic conflicts is to celebrate globalization as the triumph of liberalism, and to address the ensuing distributional consequences with benign neglect. However, especially proponents of globalization should realize that the second age of globalization will only last if a broad majority of the population can be convinced that closer worldwide integration does serve their interests, not only for economic but also for political reasons.[5] Without a convincing strategy for compensating potential losers of globalization, this can hardly be achieved.

Nation states will probably not be able to provide the required compensation in the future, because globalization weakens their monetary and fiscal autonomy by limiting their tax base. If so, an international organization should inhibit inefficient locational competition once the existing inefficiencies in public sectors in many countries have been competed away through international factor mobility. It may take same time until this point is reached, but finally something like a WTO (World Tax Organization) would be needed. The problem is that in contrast to trade issues and similar to environmental issues, no country would have an individual incentive to join an international regulation of taxes on internationally mobile factors as long as other countries cannot be forced to join such a regulation as well. The economic challenge of globalization requires a positive political response which will be difficult to achieve.

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[5] Jeffrey G. Williamson: Globalization, Labor Markets and Policy Backlash in the Past, in: Journal of Economic Perspectives, Vol. 12, 1998, pp. 51-72.