The Handbook of Globalisation

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Globalisation: introduction and overview

Jonathan Michie

The continued globalisation of economic activities is of major significance for the prosperity – or otherwise – of the world's population. It has been accompanied by major policy debates and developments. And this 'globalisation' has been the subject of wide-ranging cross-disciplinary academic research for the past several years – some would say for the past several decades, a point discussed below.

The resulting academic debates are far from being resolved. In this, they reflect the continued policy debate and action, and the continuously changing contours of the globalisation process itself.

The purpose of the current volume is to bring together the key strands of this wide-ranging research agenda, and to report the latest state of play in the resulting academic debates. This literature is one that I have been involved in myself with various co-authors from a series of research projects. However, rather than include anything from these projects, or with my co-authors, within the body of this volume, I have instead referred liberally to various of these contributions within this introductory essay, in which I also give an overview of the subsequent 25 chapters.

1. Globalisation in question?

First is the question of how radical a break the current state of globalisation is from previous developments? The title of this first part of the book is taken from Hirst and Thompson (1996), who are sceptical of such claims. In Chapter 1 of the current volume, Hirst and Thompson bring their arguments up to date, continuing though to question how unprecedented recent globalisation developments really are.

Such scepticism is challenged by Jonathan Perraton in Chapter 2, who argues that globalisation is a process and so cannot be dismissed simply because it has not arrived at some pre-imagined 'state'. The question remains, however, of just how different the current globalisation process is from previous globalisation processes. Scepticism about this had been expressed by other authors before Hirst and Thompson, including Andrew Glyn, who reports the latest state of play in Chapter 3 with his co-author Bob Sutcliffe, arguing that globalisation is widely misinterpreted, and that in particular its quantitative extent and novelty are exaggerated. Their chapter criticises the use of inappropriate statistical measures, conclusions drawn from little data, and the failure to make historical comparisons, or to see counter-globalisation tendencies and limits to globalisation. The best measures suggest that globalisation is neither so new nor so great as is often supposed. The political implications of this argument are then briefly explored.

Similarly, Costello, Michie and Milne (1989) had argued that these globalisation trends 'have been with us for some time, and they need to be seen in historical context' (p. 38), and in particular need to be seen for what they are, namely an attempt to reconstruct the conditions for profitable growth internationally. As to whether the resulting globalisation would prevent national governments from pursuing any alternative paths, they argue that:

> National economic management is only an anachronism if it is seen as operating in an international vacuum. Instead, the nation state should be recognized for what it is: the single most powerful mechanism of legal and organizational powers for economic intervention. (p. 55)

As for whether such intervention is necessary, Michie (1995) argues that:

> The global economy can be imagined to be a self-equilibrating mechanism of the textbook variety, or it can be recognized as subject to processes of cumulative causation whereby if one or more countries fall behind the pack, there may be dangers of them falling further behind rather than enjoying an automatic ticket back to the equilibrium solution path. These two alternative, conflicting views of real world economic processes have very different implications regarding institutional needs and arrangements. (p. xx)

There are, then, two interrelated issues. First, how radically different are current processes from previous ones? And second, what are the policy implications? Michie (1996, p. 124) argued that of the variety on offer, the following description of the globalisation of economic activity is apposite:

> All old-established national industries have been destroyed or are daily being destroyed. They are dislodged by new industries, whose introduction becomes a life and death question for all nations, by industries that no longer work up indigenous raw material, but raw material drawn from the remotest zones; industries whose products are consumed, not only at home, but in every quarter of the globe. In place of the old wants, satisfied by the productions of the country, we find new wants, requiring for their satisfaction the products of distant lands. We have universal inter-dependence of nations. And as in material, so also in intellectual production.

This characterisation of globalisation processes was written more than 150 years ago.[1] Likewise, the difficulties faced by national governments attempting to pursue policies in the face of globalisation have been discussed in detail for decades, and the actual difficulties have been faced up to and tackled, with varying degrees of both commitment and success, for decades as well:

> The real question, then, is not whether is it best to act at the national or international level; it is how best to secure international action. For all to remain frozen until such time as everyone else moves is inadequate, however eloquent the calls for movement being made might be. Action at the local, regional, national or bloc level, far from being a utopian alternative to the real international stage, might in reality prove a prerequisite to cooperation. (Michie, 1996, p. 125)

2. Analysing the global economy

Globalisation is sometimes interpreted or presented as resulting from technological innovation, and certainly such innovation has fuelled globalisation processes. Likewise there have no doubt been demand–pull pressures from globalisation on new technologies, hastening their advent, adoption, diffusion and development. Jeremy Howells has been analysing such processes for many years, and he opens this section by considering 'systems of innovation' within a global economy, both as a theoretical construct and as influencing how successfully economies can adapt and perform within an ever-changing global economic environment.

In Chapter 5, Gary Dymski reviews recent historical experience with international debt crises, with an emphasis on how economists have answered two core questions about these episodes – namely, why do they occur, and what should be done about them? He concludes that:

> For economists who operate on the premise that 'there is no alternative' to market-driven flows of credit and capital, these crises present opportunities for fine-tuning. This is the only way of moving ever closer to the idea of economic efficiency set out in the textbooks. But for economists who regard the structure of global financial flows as flawed, the costs of each crisis episode are cumulative: each crisis leads to more international and intranational inequality and to the further dismantling of national development-oriented institutions (Baker, Epstein and Pollin, 1998). The shape of the alternative is twisted ever more, as are the odds of reaching it, as each new debt crisis unfolds.

The inequality to which Dymski refers is then analysed, in Chapter 6, by Gabriel Palma, who reports the latest data and subjects these to rigorous scrutiny, producing new findings on the distribution of income within countries. The situation in Latin America is, he reports, quite striking in terms of the degree of inequality, to the extent that it is not immediately obvious why this has, up until now, proved sustainable – as Palma puts it, since political oligarchies the world over would no doubt like to appropriate as high a share of national income as possible, 'the key question that still needs to be answered is why is it that it is only in Latin America that they manage to get away with it?'. At the time of writing (January 2003) it is too early to tell whether Brazil's new President will succeed in reducing this inequality in that country.

3. Transnational corporations

Part III analyses the role of transnational corporations within the global economy. Ietto-Gillies provides a comprehensive overview of the role played within the current globalisation processes by transnational corporations. She argues that the dominant drivers of globalisation are firstly, technological innovation in the field of communication and information together with advances in the field of transportation, and secondly, organisational innovation and in particular the organisation of production across countries.

Gerry Epstein also provides data on the role of transnational corporations, and discusses the effect that the operation of transnational corporations has on the economy, and on specific economies that experience either outward or inward investment:

> Despite the fact that there has been a great deal of research during the last several decades on MNCs, there is no consensus on their effects. Still, the evidence that does exist suggests the following: though foreign direct investment can have positive impacts on home and host countries, the likelihood that these positive effects will materialise and be widely shared is greatly diminished by the 'neo-liberal' policy framework that is dominant in much of the world today. I conclude that what is needed instead of more deregulation and 'free' capital mobility, is a more democratic framework of multinational investment regulation to help countries and their citizens reap the benefits that can be associated with international investment. If this was done properly, the tensions that arise between the interests of southern and northern workers might be significantly reduced.

In Chapter 9, Elissa Braunstein reviews the literature dealing with gender and foreign direct investment. This literature covers a variety of topics, such as how women's roles outside the formal market sector can impact upon the profitability of multinational investment. The chapter focuses in particular on the implications of such work for a country's overall development strategy; for any government that is seeking to gain the maximum benefit from such inward investment, understanding the role of gender is key.

4. Labour standards

In its first decade of operation, the International Labour Organisation adopted a convention on minimum wages – Convention 26 'Concerning the Creation of Minimum Wage-Fixing Machinery', 1928. Its concern was to ensure that global trade was not based on cheap labour. In Chapter 10, Peter Brosnan discusses the operation of minimum wage legislation within the context of globalisation – which makes the enforcement of such legislation more difficult but also, perhaps, more necessary.

The impact that this sort of labour standards legislation has is discussed by Ajit Singh and Ann Zammit within the context of economic development more generally. They point to various difficulties, such as the limited proportion of the population for whom such legislation might actually impact, through to the more general problem, that if such legislation hampers economic development, the losers in the long run may include those whom such legislation sets out to protect.

These various factors and arguments are considered and discussed by James Heintz in Chapter 12. He evaluates the danger of negative consequences, and discusses, within this context, current developments in implementation strategies, concluding that:

> Regardless of the implementation strategy, the limitations of any scheme along these lines to introduce global labour standards should be explicitly recognised. Most significantly, only a subset of the world's workforce would receive any benefits, since the standards are aimed at workers who produce goods for export. Workers producing non-traded goods and services would not be directly affected by interventions such as a standardised code of conduct or a social clause. In these cases, the on-going mission of the ILO to encourage states to implement and enforce better domestic standards remains invaluable. Furthermore, adopting expansionary macroeconomic policies could be more strategic for improving the well-being of all workers than a targeted set of labour standards. A coordinated approach involving a range of interventions – both macroeconomic and in terms of international regulation – would also reduce the tensions between better standards and job creation.

5. Europe and North America

One of the reasons for being sceptical of generalised claims about globalisation having created a global market in which individual countries no longer matter, is that much of the supposedly 'global' activities of multinational corporations and international financial markets is actually within and between Europe and North America. In both cases, institutional developments have created new regional structures – the North American Free Trade Area, and the European Union. The rhetoric within the EU has been explicit about productivity and competitiveness. In Chapter 13, Joseph Plasmans considers relative productivity within Europe and North America within the context of globalisation, and concludes that local and regional factors are still of great importance in determining relative productivity levels and growth. The conscious effort to create a single European market, with a single currency, is analysed by Philip Arestis and Malcolm Sawyer.[2] They stress that this has not been simply a technical exercise, nor a politically neutral one:

The establishment of the euro and the European Monetary Union has been undertaken within a specific institutional and policy framework. The institutional framework gives prominence in policy formulation to an undemocratic and unaccountable European Central Bank. It is a policy framework that emphasises the control of inflation over the reduction of unemployment, although it provides a weak instrument (monetary policy) for the control of inflation and generates macroeconomic policies which tend to increase rather than diminish the level and disparity of unemployment.

The equivalent processes within North America are analysed by Jim Stanford in his discussion of NAFTA, where he argues that:

The relatively simple task of eliminating tariffs on intra-NAFTA merchandise trade constitutes a modest portion of the overall NAFTA package. More important has been the NAFTA's attempt to establish a continent-wide regime of deregulated, market-oriented economic development. Indeed, the Mexican government's primary interest in the NAFTA may have been precisely to commit itself publicly and permanently to a broadly neo-liberal development strategy, thus winning the confidence and approval of both international investors and domestic wealth-holders.

In Chapter 16, Charles Craypo and Frank Wilkinson analyse the way in which the US economy relates to the global, in particular through exporting jobs via FDI, and importing labour into the US. Such an analysis is not common, which is surprising given how common and important are the processes being analysed – both to the economy in question, and to the citizens of that country, as well as for the citizens of other countries. This is undoubtedly a weakness of mainstream economics, that it does not even ask the right questions, let alone attempt to answer them. Frank Wilkinson's work, on the other hand, is based on the idea of productive systems:

Where neoclassical theory reifies the market and loosens it from its institutional moorings in civil society, the legal system and the organizations of the state, the productive systems approach sees these institutions as playing a central role in the constitution and development of productive forces. Systems of production exist at a number of levels: the workplace; the enterprise or firm; the industrial sector or inter-firm network; nation states; and transnational trading blocs. (Rubery *et al.*, 2002, p. 2)

Craypo and Wilkinson detail and analyse the way in which US corporations make use of immigrant labour in the US, while at the same time relocating production from the US to other countries:

Deregulated markets, short-term corporate performance objectives and overriding shareholder and executive claims on resources, now dominate the US productive system. These, together with the increasing globalisation of this system, encourage corporations to cut pay and worsen conditions of work – moves that workers are increasingly powerless to resist. When dominant firms drive down labour costs in this way, others are forced to follow suit or risk operating at considerable disadvantage. This builds on a long historical tradition of wage cost competition based on cutting the pay of existing workforces, recruiting other workers who will work for less, or by simply relocating production to more employer-friendly sites. Within the global productive system, US employers increasingly resort to importing low-wage labour and exporting production processes to low-wage countries. Immigrant labour and emigrant jobs have thus become the hallmark of US labour relations and production strategies.

6. Governance

In Chapter 17, Richard Woodward argues that globalisation points to aspects of both continuity and change in world politics. Similarly, in Chapter 18, Mathias Koenig-Archibugi reviews the substantial body of research:

> which shows that the performance of governance functions is not limited to the actions of governments exercising sovereign powers over their jurisdictions, but occurs also at supranational and transnational levels. Governance – understood as the establishment and operation of rule systems facilitating the coordination and cooperation of social actors – is conceptually distinct from government – understood as an organisation in charge of administering and enforcing those rules. ... the absence of world government does not mean that governance is impossible beyond the level of individual states. Global issues such as ozone depletion, the spread of financial crises, and the prohibition of certain kinds of weapons are managed by governance structures that do not conform to the hierarchical model of rule setting and enforcement that is typical of states. The combination of these structures can be said to form a system of global governance.

The key question, of the relationship between globalisation and national economic policy, is then confronted by Simon Lee in his analysis of the UK's Labour Government and its 'third way' – often presented as a response to the constraints of globalisation:

> The third way has not reconciled UK domestic economic policy choices with globalisation in a manner that has been able to insulate domestic modernisation from the consequences of increasing volatility and contagion in global financial markets. ... Long-term stability in monetary and fiscal policy cannot be guaranteed in a world of liberalised financial markets and volatile short-term capital flows.

Tackling these underlying issues will require not just specific policy reforms, such as the introduction of a Tobin tax,[3] but also the reform of the current international economic institutions.

7. International economic institutions

The penultimate part looks at the existing international economic institutions, with Scott Sinclair in Chapter 20 considering the World Trade Organisation (WTO) and its General Agreement on Trade in Services (GATS), which is exerting constant pressure on national governments to open services to foreign commercial providers. The role of the International Monetary Fund (IMF) and the World Bank (WB) are then discussed by John Toye in Chapter 21.[4] Toye considers the pressures that have arisen given the criticisms of these institutions following their damaging roles in the Asian financial crisis.[5]

Mića Panić then analyses the global economic institutions and considers how best they might be reformed in response both to criticisms that they have failed, and more generally to meet the challenges ahead:

> Given the extent of global economic interdependence, the need for a new Bretton Woods is obvious. The objective of achieving global public goods though improvements in national social welfare is as relevant now as it was in the 1940s. However, without the spirit of Bretton Woods – the absence of which is equally obvious at present – it would be impossible to convene such a conference, let alone to agree on a common course of action and implement it. Much more likely, the realities of interdependence may force an increasing number of countries to organise regional 'Bretton Woods' or, following the example of Western Europe, create economic and monetary unions.

8. Policy implications and responses

The chapter by Mića Panić concludes that the policies that are necessary in face of global developments appear to have little chance of being implemented at present because of the political opposition from those who consider the current arrangement beneficial to their own economic interests. In Chapter 23 Ha-Joon Chang examines in detail the policy pronouncements from the world economic institutions, the leading industrialised countries who in any case call the shots within those institutions, and the academic economists and other experts within those countries. The developing countries are of course being told that they must follow the free-market prescriptions espoused by the leading industrialised economies. It could of course be questioned just how far the leading industrialised economies themselves practise what they preach. But more to the point is to consider what they practised when they were at the same stage of development as the developing countries are today. And here there is absolutely no doubt. Today's rich countries grew rich behind protective barriers and domestic intervention. Those who gain a competitive advantage through such policies are of course the first to propose – or demand, if they have the power – free trade. This, Chang argues, is what we are witnessing today. The leading economies, which have manoeuvred themselves into a position of being able to do well in a straight commercial competition with the less developed economies, are now demanding precisely that – the sort of commercial competition in which the rich will become richer, and in which the poorer countries whose industries and firms may not be able to survive such competition will see those industries and firms go to the wall. This will leave those economies no alternative but to import goods from the advanced economies instead – or else invite the multinational corporations from those economies into their countries, to produce domestically.

In Chapter 24, Colin Hines makes the case for rejecting such demands – along with the whole global free-market logic – and instead campaign for an equitable international economic system, along with a proper appreciation of what can be done locally:

> The widespread resistance to globalisation can be built upon to fashion a viable localist alternative. There are already countless people and groups strengthening their local economies from the grass roots up. The greatest spur to consideration of such radical local alternatives at the governmental level will be the need to respond to global economic upheavals and the deflation, the job losses and inadequate consumer demand that will come in its wake. Equally crucial in shaping a different localist imperative amongst politicians will be the pressure that the politically active can bring to bear. This must shift from just fighting separate issue-specific aspects of globalisation to realising that their individual successes can only be secured as part of an overarching change to localisation, but in an internationally supportive manner.

In the final chapter, George DeMartino also challenges the current drive towards a global free-market – what he describes as global neo-liberalism – but focuses on the international trading system and how it might best be reformed. By global neo-liberalism he means the policy regime created during the last quarter of the twentieth century in which 'largely unregulated market forces override the state in directing international trade and investment flows'; this therefore includes 'free trade, the liberalization of international financial markets, the global protection of property rights, and so forth'. DeMartino argues that the resulting system is unstable and unsustainable, and that governments will be forced to intervene: the important question is 'what will come next, after the current experiment with free trade has been abandoned?'

In Chapter 25, DeMartino considers the various alternatives, including the labour standards arguments which are surveyed in Chapters 10–12. From this he argues for a new policy that would create incentives for such standards to be adopted by all trading nations, with good standards rewarded by the tariff structure and poor standards penalised. He deals with the various objections that have been raised to such standard-setting, and recognises also that such measures would only tackle one part of the system that at present is generating such inequalities and instability globally. The other areas in which action is needed are discussed by several of the other authors in the current volume: tackling the international debt crisis (Dymski), dealing with inequality through domestic policy (Palma), encouraging transnational corporations to operate in ways that would provide economic benefit to those areas in which they operate (Ietto-Gillies, Epstein, Braunstein), setting labour standards nationally and internationally (Brosnan, Heintz), reforming NAFTA (Stanford), the European single currency system (Arestis and Sawyer), the international economic institutions (Sinclair, Toye, Panić), reasserting the legitimacy of government (Lee), allowing developing economies to pursue the sort of industrial policies that proved successful for the currently leading countries (Chang), and encouraging local and regional economic development (Hines). For DeMartino, his proposal for reforming the international trading system – to encourage a ratcheting up of standards in place of the sort of social dumping that can lock all into a downward spiral – would be a supportive contribution to such an alternative agenda.

Conclusion

One of the most important conclusions that emerges clearly from a number of the authors is that it is wrong to consider 'globalisation' as representing some natural or technical development that can be then judged as either welcome or otherwise, and reformed accordingly. The facts that international capital markets have been given a free leash to move into unregulated speculation, that the international institutions have been imposing pro-Western policies on the rest of the world, and that multinational corporations have been given increasingly free reign, have been the result of policy design and have been pursued by Western governments and the financial and other corporations involved. At each stage, a range of other options has been available for designing and constructing the international trading, financial and productive systems. Indeed,

> At this juncture, the overriding virtue of the productive systems approach is to re-emphasize the diversity of institutional forms which are present in capitalist systems and the potential solutions to the problem of societal cooperation to coexist. A systems approach cautions against the assumption that changes in national and global trading regimes can in any way be separated from what is happening at the level of the regulatory framework. An emphasis on 'spontaneous' convergence between systems can only obscure the important policy choices to be made in national and global governance. (Rubery *et al.*, 2002, p. 9)

That is, there is an alternative. History has not come to an end; it is still being made. The question is, in whose interests? There is no doubt that over the past 25 years or so, policy has been driven by the interests of the international financial system and the transnational corporations. This has at times been recognised by those responsible, even as they acted, with talk therefore of balancing these imbalances through the introduction of the 'social chapter' to the European Union's Maastricht Treaty on monetary union, and environmental and labour standards clauses in NAFTA. But the main drive has remained a free-market one, despite the inequalities and instabilities that this inevitably generates.

Why has policy taken such a turn, following the much more successful 25 years up to the mid-1970s? In part the answer is of course that there have been powerful interests that have benefited, and in the struggle between economic interests, these have gained the upper hand. It may also be partly due, though, to the inability of mainstream economics to even recognise the above factors, let alone analyse them and propose alternative policies. In the world of textbook neoclassical economics, the free market outcome will maximise economic welfare. It may be acknowledged that there will be losers as well as winners when markets are deregulated, but, the theory goes, the winners could compensate the losers, so all would become better off. And in theory, perhaps they could.

In practice, however, the world works rather differently. The textbook model may provide a useful analytical tool, but it is not a description of reality, and the attempts to change reality to fit the model are misguided and destructive of the sort of social, political and economic institutions that historically have actually created economic growth and social progress. This needs to be recognised for appropriate policy to be generated and pursued. Of course, there would still be powerful interests that would prefer the current free-for-all. But at least such behaviour could be seen for what it is – an attempt by those with economic power to enjoy more of the spoils.

The alternative to mainstream, neoclassical economics has of course continued to analyse the world as it is, and the large literature on alternative economic analysis and policy discussion can only be touched on by the various authors below.[6] Baker *et al.* (1998) set out a comprehensive approach to progressive economic policy in the era of globalisation.[7] And many of the chapters in this volume themselves build upon large literatures. Howells (Chapter 4) discusses the importance of innovation systems, and the policy implications are set out elsewhere (for example Howells and Michie, 1997; Archibugi *et al.*, 1999). Ietto-Gillies (Chapter 7) has set out in detail the role of transnational corporations in the global economy (for example Ietto-Gillies, 2001; 2002). And in particular, the three concluding chapters on policy implications and responses all report work that is developed more fully by the authors' own books: Chang (2002), Hines (2002) and DeMartino (2000).

A 1999 collection on *Global Instability* – with many of the same authors as in this collection – was introduced in the following terms, which applies just as much today, and to the chapters contained in the current volume:

The problems witnessed in today's global economy are not just technical, economic ones. They are also political. Devising new structures of World Economic Governance requires, as a starting point, that this be recognised. This means that to be successful, any alternative needs to not only spell out appropriate policy and institutional developments, it also needs to win sufficient political support to force through the necessary change of course.

In this context, ideological issues also play a role. It is thus necessary to expose the current complacent orthodoxy in mainstream economics, and challenge the fatalistic belief that the new globalised economy rules out any change of course. As many of the chapters that follow demonstrate, the fact that the economy is becoming increasingly internationalised does not dictate the form that this process is taking. The free market, *laissez-faire* agenda is one being pursued by those who benefit from such a deregulated, winner-take-all environment. It is not the only choice. And for the majority of the world's population, it is an inappropriate one. (Michie, 1999, p. 6)

Notes

1. Written in 1847 (published 1848) by Marx and Engels, *The Communist Manifesto*.
2. There is of course a huge literature on the development of the EU and single currency; see for example Healey (1995), Amin and Tomaney (1995) and Moss and Michie (1998).
3. On which, see for example Arestis and Sawyer (1999).
4. On the World Bank, see also Wade (2002).
5. On which, see Stiglitz, 2002.
6. For a critique of the mainstream neoclassical approach, see Kitson and Michie (2000), Chapter 1; this book also includes an analysis of globalisation (Chapter 2) and trade theory (Chapters 3 and 4).
7. The literature on globalisation is also surveyed from the various disciplinary approaches by Power (2001) for economics; Lukens-Bull (2001), human geography; Williams (2001), management and business; Lee (2001), politics; Hills (2001), sociology; Hines (2001), 'critiques and alternatives'; and Archibugi (2001), innovation studies.

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PART I

GLOBALISATION IN QUESTION?

1 The future of globalisation[1]

Paul Hirst and Grahame Thompson

Before we consider the future of 'globalisation' we must define its nature and outline its past. This is a complex and contested concept. If we take growing international interconnectedness – increasing flows of trade, investment and communications between nations – to be what most people mean by the term, then 'globalisation' has been happening for the last 50 years. Moreover, new technologies – long distance jets, satellites, IT, fibre optic cables – have made international travel, media and financial exchanges far easier, enabling dramatic increases in traffic volumes. The key questions are threefold. First, are these economic and social processes linking nations since 1945 unprecedented? Second, are these processes developing at the expense of state and national governance, that is, are national economies dissolving into a global marketplace and relations between states becoming secondary to more complex interactions between a variety of economic, social and political agencies? Third, is international economic interconnectedness set to increase or decrease?

The history of globalisation

Naturally these questions are almost impossible to answer in the scale of a short chapter. We are sceptical about many of the claims in the literature, in particular that national economies are dissolving. We refer readers to what we judge to be the best presentations of both sides of the debate (Held *et al.*, 1999; Hirst and Thompson, 1999).

Here we shall focus on two primary issues: the future of international governance and the likely limits to economic globalisation. The first thing to note is that although we have had a long period of growing international interconnectedness there is no reason to assume that such processes will continue indefinitely or that they have an inherent dynamic that prevails over all countervailing forces. Globalisation has a history. The 50 years between 1950–2000 are not remarkable when compared with the period 1850–1914 – in that period flows of merchandise trade, capital investment and labour migration were all comparable to or greater than those of today (Hirst and Thompson, 1999, ch. 2). Technological change in the form of international telegraph cables unified markets and led to price and interest rate convergence of a kind that has never been equalled since. Financial integration was far greater, and levels of capital export from the major lender countries unprecedented. Economic convergence in prices and wages across the Atlantic was largely achieved by vast flows of surplus labour from Europe to the New World (O'Rourke and Williamson, 1999). This process is not operating on the same scale today. Migration flows are relatively smaller and the pressure in all developed countries is to further restrict migration. If the key engine of international convergence in the first great phase of globalisation no longer operates, that is because it was one of the first targets of an anti-globalisation public policy backlash. Most major recipient countries followed the lead of the USA in the early twentieth century in restricting migration. Globalisation processes were under challenge well before 1914. Many countries introduced protective tariffs, seeking to protect farmers against the competition of American wheat or to shelter emerging manufacturing sectors (James, 2001).

Thus 1914 shattered a world order that was slowly unravelling under the pressure of competing national policies. In the inter-war period attempts to re-create the institutions of the *belle époque*, including the Gold Standard, failed. The result was a period of intense antagonistic competition to monopolise markets and raw materials. The experience of the 1930s confirmed that if free trade has its problems then generalised competitive protectionism is a disaster. This should be borne in mind when 'anti-globalisers' criticise the WTO and favour the 'localisation' of trade. The world order created by the USA after 1945 attempted to address the sources of the earlier crisis and to institutionalise international economic liberalism. One should remember that this was only possible because of the Allied military victory and the unassailable economic dominance of the USA. Globalisation was restored by military force and national policy; it was not a 'natural' state of affairs. It also rested on a huge asymmetry; in that the new dominant power, the USA, was willing to accept the costs of creating the new regime and to tolerate national protectionist strategies on the part of its clients like Japan and South Korea. This was similar to British policy during the Pax Britannica.

The situation is now different. The USA is militarily dominant in a way no power has been in modern history. North America is the world's largest economy, but the US is no longer willing to act as it did in the immediate post-1945 period. The US is a major capital importer, it treats the value of the dollar as a matter of national economic management, (though it can also afford to operate a policy of 'benign neglect' in respect to the international value of the dollar because its exports still only comprise about 15 per cent of GDP), its foreign aid is derisory, and it promotes trade liberalisation in areas where it has a huge competitive advantage, but is unwilling either to open its own markets in key sectors or to allow national strategies of protection for emerging competing industries in developing countries. All the major industrial powers, with the partial exception of the UK, created their manufacturing sectors under a protectionist regime; Germany, Japan and the USA included. Current WTO rules prohibit such strategies and force most developing countries into manufacturing for export markets in relatively low value niches. The implication is that current processes of 'globalisation' are unlikely radically to diminish the gap between the developed and the developing worlds.

If 'globalisation' is conceived as a process that promotes cross-border exchanges and transterritorial agencies at the *expense* of nation states then it would be deeply problematic. If all states, including the most powerful, were to cease to be the primary political actors across borders, being displaced by companies, NGOs, regional governments, networks, international agencies, and so on, then one could anticipate a severe anti-globalisation 'backlash' as nationally-rooted publics experience a loss of the benefits of domestic governance and increased exposure to international pressures. If the majority of states cease to be effective actors, but the G7 still dominate in terms of economic governance and the USA alone dominates militarily, then Western and American dominance will be resented, resisted and challenged both nationally and transnationally in an increasingly unequal and conflictual world. This shows that there are inherent limits to globalisation conceived as a process that leads to the decline of national economies and state power. A truly global market system, in which international competitive pressures and market forces subsume national economies, and in which transnational agencies and networks reduce states to the equivalent of local authorities, would be vulnerable to multiple political and social threats that it had no means to counter: international terrorism, commercial piracy, crime, protest movements and national backlash strategies of local withdrawal from the global system. The complete victory of extreme economic liberalism in both policy and fact would most likely spell the end of the system, not as in 1914 in interstate war, but in a series of terrorist outrages, local economic crises – like that in Argentina – major crises in the financial markets, and the re-politicisation of national governance, leading to the restoration of distinctive local policy regimes.

The open international economy is not a 'natural' state of affairs, to which the world reverts by economic logic when the distorting influences of politics on markets are removed. Rather it depends on state power; economic liberalism has to be instituted and defended. If it is to survive then its negative effects have to be ameliorated by public policy. Economists have had to learn this the hard way, but few really understood the extreme fragility of markets and the dependence of economics on state power before September 11. Globalisation can go backwards: it can be impeded – as the backlash policies of the late nineteenth century showed; and it can be reversed – as the interwar years demonstrated. The current 'anti-globalisation movement' is a noisy sign of widespread dissatisfaction, but the real backlash would come from conventional politicians and would start to show in new state policies. Such policies would include both national measures and the advocacy of changed policies in international forums like the WTO by states and groups of states. Such policies may be difficult to distinguish in the first instance from the re-regulation that is necessary to counter the negative consequences of excessive economic liberalism. A major backlash against international openness by states, and by legitimate and non-legitimate non-state and transnational actors, can only be prevented by a judicious mixture of appropriate force and governance measures that stabilise markets and protect citizens against unacceptable insecurity and risk. Both dimensions of policy are necessary, and both will be expensive – military action and social solidarity need to go together, the latter is essential to underpin and legitimate the former. The future of the open international trading system in the immediate future (the next 25 years) thus rests on appropriate political policies and in the actions of the major nation states, and the USA in particular.

The future of global governance

However, it would be foolish to look at immediate events alone, and not also long-term trends (Hirst, 2001). The threats to global stability are multiplying and are likely to become more severe as the twenty-first century progresses. The most serious are only indirectly connected to the current open international economy but create a context in which at worst it could fail and break down. Many of these threats are unlikely to become critical in the next 30 years, and so are beyond the scope of normal political calculation, yet they require action now if there is to be any prospect of forestalling or even mitigating them.

The most serious is climate change, which is likely to become progressively worse as the century unfolds and to have destabilizing effects by mid-century and catastrophic consequences by 2080.[2] The consequences – turbulent weather, inundations due to rising sea levels, desertification and water shortages, loss of farm land, and the spread of disease – are likely to develop in chaotic and unpredictable ways that will not be amenable to adaptation by the kind of incremental action policy makers are used to. This will affect both developed and developing countries, but the latter are likely to suffer more, as they have fewer resources to respond to the consequences, and they have large populations. A worsening environment is likely to be associated with the displacement of large numbers of climatic refugees, adding to the existing and growing migratory pressures from poorer countries. It is also possible that current UN estimates that the world's population will peak in 2040 and then decline may prove to be wrong, not least because they are based upon optimistic assumptions about economic development. Insecurity and persistent poverty will lead to people having more children rather than fewer – thus population pressures may well be another source of turbulence, making the effects of climate change on the displacement of peoples worse.

The odds are that the current extreme inequality of global income distribution will continue (Wade and Wolf, 2002). That for the majority of the world's poor this will be the result of a failure of domestic economic development rather than direct exploitation by the rich will not make their lot easier to bear. It is prudent to assume that the normal economic processes will not transform the bulk of the world from developing to developed status without the need for other forms of intervention. Most of the population of Africa, and the majority in East and South Asia and Latin America will remain poor – part of the 80 per cent who share just 14 per cent of world GDP. It is highly unlikely that the major developing nations – Brazil, China, India, Indonesia or Nigeria – will effect the same transition to advanced industrialism as Japan or South Korea (Hirst and Thompson, 1999, ch. 5). Uneven industrialisation heavily oriented toward export markets will leave huge populations in excluded rural areas and urban slums.

Such problems, and more immediate ones like transnational crime syndicates or AIDS, are frequently cited by advocates of greater global governance as demonstrating the inherent limitations of the nation state. Yet they are also beyond the scope of action by any foreseeable global or transnational institutions. To cope with climate change or global inequality in a serious way, supranational institutions would require coercive powers over states and the ability to command resource redistribution, chiefly at the expense of the top 20 per cent of the world's population represented by the countries of the OECD. Yet these countries, singly in the case of the USA, collectively in the case of the rest, have the power to resist such coercion and to refuse redistribution. Far from legitimating a move toward cosmopolitan governance and a new international order these emerging global threats all but paralyse political will. If anything they focus political and business elites on the short-term, because to confront the long-term consequences of doing little now is almost unthinkable. For example, the Kyoto accords on climate change, if implemented, would have the effect merely of modestly offsetting the impact and onset of global warming. Hence the resistance in the USA of having to bear the short-term costs of an emissions reduction policy.

Power in governing the international economy is likely to remain in the hands of the wealthy nations and the supranational bodies that they control and fund, like the IMF or the World Bank. It is also likely that the exercise of that power will be challenged by major non-OECD states like China, India and Russia, and by protest movements and NGO coalitions across the globe. It is obvious that the actions of the major powers and the supranational agencies that they control will be less legitimate and that wider forums, like the WTO, will become more conflictual as the less developed nations vigorously defend their interests.

The agenda for global governance is thus constrained by the inherent limits of truly authoritative global institutions, by the perceptions and interests of state elites in the G7, and by the mass attitudes of the populations of the OECD countries. A real world government would quickly become a tyranny – conservative in the defence of entrenched privilege in the hands of the rich, and confiscatory in the hands of the poor, and thus resisted and thwarted by the losers of either policy. The nation states, however powerful, cannot act alone, whist nothing can be accomplished without their active support, legitimation and funding. That means that the agenda for strengthening international governance and mitigating those threats to stability that can be addressed in the short-term involves three dimensions. First, reinforcing those international institutions that can function effectively, and redirecting their policies. Institutions like the IMF are not inherently defective and it, for example, has a necessary role as an international lender of last resort. It is also necessary to expand the scope and power of other less headline-catching international institutions so that they are able to perform extended regulatory tasks, for example, beefing up the Bank for International Settlements' role in supervising national financial regulators so that the supervision of banks and other financial institutions is enhanced, and strengthening the ILO to negotiate new conventions on migration and international labour mobility and raising the floor of international labour standards. Secondly, promoting coordinated state action, whether by treaty or intergovernmental cooperation, for example, to tackle problems like international criminal and terrorist networks, to promote disease prevention and containment strategies, to pursue measures to combat global warming that can in fact be agreed (such as research and subsidies for non-fossil and renewable energy sources) and to raise the level of development aid. Third, to commit the major powers, and the USA in particular, to seek solutions where possible in a multilateral framework and for the powers to seek the widest legitimacy for their actions by strategies of consultation and coalition building.

Such measures would mean that when major global crises do occur, such as a sudden escalation of climate change or a major epidemic, then the states of the developed world can cooperate with others and that at least a minimum regulatory framework to ensure market stability and physical security is in place. Such measures amount to an extended version of 'business as usual', renewing the regulatory framework of multilateral international governance created after 1945. It would also mean a return to a policy of 'embedded liberalism', that is, market openness coupled with strong governance and social protection rather than contemporary economic liberal doctrine which is a mere use of political power to enhance the scope of market forces (Ruggie, 1998, ch. 2).

The prospect of such a policy of enlightened multilateralism on the part of the advanced countries, and the USA in particular, is poor. The main reason for such narrowly self-interested policies is that the present state of affairs is quite unlike 1945. The anti-globalisation movement and the terrorist threat are not a direct challenge to the system like that represented by the USSR and its allied communist parties. The former can still be dismissed as confused protest and indeed, the movement does not have coherent alternatives to current institutions and their policies. The terrorist threat is a matter for police and military action. The international economy in 1945 was at a virtual standstill and thus could be re-built from the ground up. Moreover, the major state elites are in fact satisfied with the high level of control they do in fact have, whilst often preaching impotence in the face of the forces of globalisation to their domestic publics. Global markets are not all-powerful; the scope of action by international agencies, inter-state cooperation and governance by states remains considerable. So far major financial crises have been contained. Concerted action by governments, central banks, financial market authorities and major companies prevented a disastrous panic in the aftermath of September 11. Even in recession, the G7 economies are not faced by immediate economic and social crisis.

One could thus conclude that 'globalisation' in the sense conceived by extreme economic liberals and their radical critics has not happened. The world, far from being an integrated system dominated by ungovernable market forces, is divided into three major trading blocs, dominated by nation states: NAFTA is centred in the USA, Japan is a bloc-sized national economy, and the EU is an association of states. Each bloc follows distinctive policies, and has distinctive problems and institutions of economic management. Most major companies hail from one of the three main blocs, and most companies have the bulk of their assets and the majority of their sales within one of the blocs.

International interconnectedness has not subsumed the distinctive national economies of, for example, Germany, or Japan or the USA. Hence the central powers in the system are neither likely to initiate a backlash against it nor are they likely to act on the scale necessary to counter the emerging global crisis and the current difficulties of the mass of the world's population outside the OECD. One might conclude that the current system is well enough governed and sufficiently beneficial to those on whose behalf it is governed that it will persist until problems accumulate that cause it to fail and a crisis that is beyond governance overwhelms the system. Unlike the 1930s or the period before 1914 the backlash against the international economy is not likely to start with the core states of the G7, but at the periphery.

This may seem pessimistic but it is highly likely that a crisis stemming from climate change, mass poverty in the developing world, and intense migratory pressures will overwhelm global institutions of governance and cooperation in the distant but foreseeable future, sometime in the second half of this century. Before then difficulties and conflicts will accumulate, weakening the will to cooperate and undermining any prospect of solidarity between rich and poor, developed and developing nations. In this context governance will be asserted at the level where the public can put pressure on leaders, in nation states. International agencies will be harder to sustain and transnational politics and institutions will decline in favour of state-based ones. States will seek to protect their populations and to monopolise and control the distribution of key resources. Faced with climate change political processes, rather than markets, will allocate scarce goods like food, shelter for the displaced, water and energy. States will seek to obtain these things by force, as will political movements. Those displaced by climate change are unlikely to be passive. At least some major states will fight over access to water and oil.

This is a bleak prospect, but it emphasises the continued relevance of classic international relations as a discipline, and of realism in particular. The military power of the West is overwhelming. The USA and its allies dominate the seas and international airspace. They thus control the major trade routes and access to the world trading system. The already overwhelming military capacity of the USA is set to increase in the immediate future as the military exploit emergent technologies and utilise space as a new environment for intelligence, communications and weapons directed at earth. However, such power has its limits. The advanced economies are vulnerable to terrorism and will remain so, even if they adopt draconian measures that restrict the liberties of their own populations. Masses of migrants would be hard to contain, even with brutal and repressive policies of exclusion and frontier control. Advanced weapons may be ineffective against determined enemies with strong national cohesion and an effective military leadership with clear objectives. The US, for all its recent victories, has not really faced such an enemy since Vietnam. Thus the bulk of the Iraqi army was ill-trained and poorly motivated, the Serbs increasingly hostile to Milosevic, and the Taliban a hollow regime based on savage repression. Moreover, at least some of the emerging technologies will be easy to copy and adapt by the less sophisticated powers. Intelligent mines and small remotely-piloted vehicles, for example, may make defensive strategies easier and counter Western offensive dominance, making it difficult for advanced armies to occupy territory without heavy casualties (Hirst, 2001).

One should thus assume a highly conflictual world: with constant police action against terrorists, migrants and protestors, low grade wars and incursions by the US and its allies in failed states and terrorist havens, conflicts between less developed states (increasingly over access to resources), the involvement of the great powers on behalf of their clients, and increasingly conflictual relations between major states over resources and trade. In this world order international norms and legal standards will most likely come under increasing pressure in matters of human rights, conflict and war. This will be a process similar to the widespread violation of the Hague Conventions during World War I. States will repudiate human rights conventions and international legal regulation, even as international lawyers attempt to complete the edifice they have been building since 1945. The USA already will not submit to the International Criminal Court, and without it the whole project of subjecting national political actors to common international norms is gravely weakened. Faced with terrorist outrages and masses of displaced persons, many states will be unwilling to continue to subscribe to international conventions and will slip into authoritarian regimes against outsiders, supported by their frightened citizens. Rules that only apply to some, the unlucky and defeated in the case of war criminals, or the lucky who happen to find one of the few liberal havens in the case of refugees, will cease to have general effect or credibility (Krasner, 1999).

If political norms increasingly cease to be accepted or followed, by contrast rules-based economic governance will remain strong. Indeed, this is the most likely dimension of global governance and re-regulation. The WTO is a rules-based organisation and it is impossible to open markets without common standards that apply to all and that are justifiable. Equally, tightening financial regulation and banking supervision, partly to prevent financial crises and partly to control terrorism and money laundering, will extend the scope of regulatory and rules-based supervision by national and international agencies. Companies are increasingly using international arbitration and supranational standards of commercial conduct to resolve disputes that span national jurisdiction. Thus in the short term we may see both more conflict in the political sphere and greater regulation and normalisation in the economic (Weiner, 1999).

Any argument about global governance must allow for the extreme variability of global processes and the variety of global institutions. It is clear that on different dimensions and at different locations governance practices and outcomes can vary widely. We should, therefore, expect combined phenomena of integration and disintegration, increasingly effective governance on some dimensions and retreat on others, different mechanisms for different problems, both localisation and internationalisation. Unless this is recognised, the complexity of short-term outcomes may hide long-term trends toward conflict, localisation and chaos.

The future of the global economy

Even well before the events of September 2001 there were several indications that the rapid globalisation of economic activity experienced during the 1980s and the 1990s may have begun to stall. The rate of growth of the US economy was slowing, Japan's intractable economic problems were no nearer solution, and there was unease in Europe about its future economic prospects as the adoption of the euro loomed and growth faltered. But these essentially cyclical uncertainties were being bolstered by some potentially longer-term structural changes. Thus the world may be experiencing the final years of one of those periodic explosions in internationalisation that throw so much into confusion and seem to herald the complete transformation in the way societies are organised. There is beginning to emerge a serious questioning of the ability of the global economic system to sustain its seemingly as rapid integrationist trajectory.

In this section we examine the potential cyclical and structural constraints on the future growth of economic globalisation. We ask the question 'Are there any limits to economic globalisation?'. The strong globalisation thesis would seem to imply an ever-expanding universe of economic interdependency and integration between national economies, so that the significance of national borders for economic activity eventually disappears. The issues for us here are first, why should this be the case? and, secondly, is it happening?

Globalisation is here defined in strictly economic terms, basically as increasing trade interdependency and investment integration. The strong globalisation thesis contends that macroeconomic and industrial policy intervention by national governments can only distort and impede the rational process of resource allocation by corporate decisions and consumer choices, which are now made on a global scale. All corporate players need to do to prosper is to shake off their nationally orientated bureaucratic style of management, and the government intervention that goes along with it, and enter the new world of open global marketing and production networks. International markets provide coordinating and governance mechanisms in and of themselves: national strategies and policy intervention are likely merely to distort them. The era of effective national economies, and state policies corresponding to them, is over. The market will, and should, decide (Ohmae, 1990; 1995).

We have challenged this conception and we do not think the international economy looks anything like this (Hirst and Thompson, 1999; 2000), but it offers a powerful imagery and should not be ignored. It is thus worth confronting it in its own terms.

A key element in this challenge is to question the extent of contemporary trade globalisation. If we look at merchandise trade flows between the main economic blocs expressed as a proportion of the originating country or bloc GDP then, for the most part, quite low percentages of GDP seem to have been traded in 1998 (see Table 1.1).

Only Western Europe appears anywhere close to being an integrated trading zone, with 18 per cent of its combined GDP traded between the countries

Table 1.1 Merchandise trade flows as a percentage of originating Triad bloc/country GDP (1998)

To	North America	Western Europe[a]	Japan (J)	East Asian Traders[b] (EAT)	J + EAT
From					
North America	3.8	2.0	0.7	1.1	1.8
European[a] Economic Area (EEA)	2.3	18.0	0.4	1.0	1.4
Japan (J)	3.3	2.0	–	3.0	3.0
East Asian Traders[b] (EAT)	10.7	6.9	4.1	na	na
J + EAT	14.0	8.9	4.1	na	na

Notes:
a. European Economic Area (EEA) = EU + Switzerland, Turkey, Norway, Malta, Liechtenstein and the states of the former Yugoslavia.
b. East Asian Traders (EAT): China, Hong Kong, Taiwan, Korea, Malaysia, Thailand and Singapore.
na = not available.

Sources: *WTO Annual Report 2000, Volume II, International Trade Statistics*, derived from various tables; *World Economic Indicators 2000*, World Bank, Table 4.2; *Taiwan Statistical Data Book 2000*.

of Western Europe. Yet this is an artefact of national accounting and the EEA should be treated as a single quasi autarchic trade bloc. The only other relationship that appears significant is that between the East Asian traders and North America, where the former exported just under 11 per cent of their GDP to North America, mostly to the USA. However, look at the relationship between North America and Japan. Only 0.7 per cent of North American GDP was exported to Japan, while Japan exported 3.3 per cent of its GDP to North America. These are still quite small numbers.

Of course there are many objections that could be mounted to this way of measuring the extent of trade 'globalisation', and these are dealt with elsewhere (Hirst and Thompson, 2000; Thompson, 2001). Comparing merchandise trade and total GDP is not comparing like with like as total GDP is made up of many sectors, some of which have been expanding at a faster rate than the merchandise sector. But even when a proper comparison is made, only Western Europe displays a highly integrated trade environment (nearly 81 per cent of merchandise trade relative to merchandise GDP is inter-Western European trade). The other main trading blocs still remain surprisingly un-integrated on this traditional and long established measure of globalisation.

For economists these figures raise the question of the 'missing trade'. Why isn't there more trade in the international system? Broadly, the answer is that the lack of trade is because of the continued significance of national territories and national borders, a point we come back to in a moment.

In economics, national borders are viewed as an impediment and an obstacle to trade. They are an impediment to the development of market forces, so the advent of modern globalisation and a 'borderless world' would be a triumph from the point of view of those supporting the strong globalisation position mentioned earlier. The problem is to overcome these 'barriers' to trade.

How is international trade analysed in economics? When economic modelling techniques are applied to the specifics of international trade, these produce disappointing results in terms of explaining the amount, composition and direction of international trade flows. As just mentioned, these models would predict much higher levels of international trade. This has led to a great deal of soul searching amongst economists, and a resort to analysing 'what is in the data' rather than constructing further theoretical models. Thus despite the seeming sophistication of much international trade theory, when it comes to the empirical side of things the approach is still fairly simple. At heart it relies on operationalising a 'gravity' model.

Empirically, trade is traditionally modelled as positively related to some measure of the 'size' of the communities between which it takes place and negatively related to the distance between them. This is known as a 'gravity model'. But what has interested economists recently is a series of institutional, cultural or political and geographical variables that are also very important in determining trade. These can be expressed as a series of 'control' variables designed to capture other relationships between countries that might stimulate trade between them. These can include such aspects as whether countries share a common border, whether they share a common language, whether they have had colonial connections, whether they belong to a common trade bloc (for example, the EU, ASEAN, NAFTA), what the position is in respect to common jurisdictional standards and the legal enforceability of contracts between them, and finally whether they share a common currency.

The distance variable is the most consistent and significant of the variables explaining international trade (Leamer and Storper, 2001). Indeed, one of the most obvious constraints on an infinitely expanding international division of labour and a 'complete' globalisation is that the effects of distance cannot be entirely eliminated. Although there have been several 'communication revolutions' which have significantly reduced the costs of transporting over distance, eventually these will come up against the basic physical impossibility of total transport cost elimination, so here is one (fairly obvious) 'limit to globalisation' (see Obstfeld and Rogoff, 2001). Table 1.2 expresses the effects of distance

Table 1.2 The effect of distance on economic interactions. Percentage reductions in the value of magnitudes relative to 1000 km

	Trade	FDI	Equity flows	Technology flows (R&D stock)
1000 km	0	0	0	0
2000 km	58	25	45	35
4000 km	82	44	69	72
8000 km	97	58	83	95

Source: Calculated from Venables (2001).

on economic interactions for a range of variables: trade, FDI, equity flows and technology flows. Economic interactions fall away dramatically with distance. For instance, if you add 7000 km distance between any nodal points, 97 per cent of trade disappears.

But an interesting feature of recent trade empirics is the central importance that has emerged for the 'cultural' or 'political' determinants of trade specified by the control variables just mentioned. For instance, once the contributions of, say, migration (which can be approximated by variables such as sharing a border, a common language or colonial experience), and different legal cultures have been accounted for in regression analyses, the specific contribution of GDP as such as a determinant of trade levels is severely limited, and indeed becomes less than 1 in many cases. We stress the significance of this in a moment.

The specific effect of national borders on trade and the globalisation debate can be taken up in the context of these empirical gravity model equations. There has recently been something of a test case analysis of this involving the border between the USA and Canada (McCallum, 1995; Engel and Rogers, 1996; Helliwell, 1998; 2000). If globalisation has emerged, then surely this border would have been one of the first to have lost its pertinence as far as trade, investment and migration is concerned. But it has not. Careful analyses have demonstrated the continued central importance of this border as an 'obstacle' to trade (and other flows) between the USA and Canada. This is the case as tariffs and quotas have been eliminated, NAFTA established, and other barriers removed. What these analyses do is begin to confront the mysteries of the 'missing trade' at the international level. Far from there being an 'excess' of international trade as many critics of globalisation believe from the economists' perspective, there is not 'enough' of it (and this goes for capital flows as well which, whist not discussed here, are addressed in Hirst and Thompson, 2000 and Thompson, 2001).

What most analyses of the growth of international trade do is to look only at international trade without comparing it with what is going on in the home territory at the same time. International trade is expanding but so too is domestic trade, and it looks as though domestic trade is expanding at a similar rate to, or at a more rapid rate than its international equivalent (after accounting for the other control variables). We might need to be a little more cautious here, however, since these analyses were conducted for the very early years of NAFTA. Recent evidence suggests that cross-border US–Canada trade has grown considerably. Also, the full implementation of NAFTA does not take effect until 2008.

But overall, this particular border continues to be a remarkable 'barrier' to trade in and of itself, even after taking account of all the usual variables that might determine trade. What is more, there is evidence that the state boundaries *within* the US act as a 'barrier to trade' (Wolf, 1997), so the idea that it is tariffs and quotas or other at-border international impediments to trade which represent the main obstacles to international integration is further put into question. Moreover, differences in cultural and legal systems between these two countries – which might be thought to inhibit trade, as suggested earlier – also appear small in this particular case. What is more, these results are confirmed in the case of the other OECD countries though admittedly on the basis of less appropriate and reliable data (Wei, 1996; Helliwell, 1998).

In addition, there is good evidence that migration is a significant stimulus to trade (Casella and Rauch, 1997; Rauch, 1999). It is very significant, for instance, in the case of imports into the USA. Migration sets up networks of relationships across borders, making it easier to establish a low transaction cost mechanism for the conduct of international trade (we come back to this in a moment). As long as countries maintain their commitment to regulate their populations in some sense (which is almost a defining feature of the notion of geographical 'territoriality'), then this situation will continue. In particular, in so far as countries continue to clamp down on international migration this could inhibit the further growth of international trade. So here is another potential 'limit to globalisation' and one that shows a major difference between integration processes today and those of the nineteenth century.

It seems that this particular point is crucial in the context of the jurisdictional consequences of borders; the fact that any movement across a national frontier involves the movement from one legal, regulatory and cultural jurisdiction to another. These jurisdictions proscribe, adjudicate and enforce a wide range of norms, rules, habits, networks and similar features, which involve much more than just the 'obstacles' to trade found at the point of the frontier. It is 'behind border' characteristics that are crucial. An interesting suggestion here is that it may be the state of the legal and administrative certainty associated with the enforcement of contracts (with respect to both trade and capital flows) that is the key to the OECD bias in international economic transactions. When a measure to represent this was introduced into the gravity model formulation this was found to account for such a significant proportion of the level of international trade that the impact of income *per se* was less than 1 (Anderson and Marcouiller, 1999). Thus the implication here is that GDP growth has a less than proportionate impact on international trade growth; the bulk of the growth in international trade over the post-World War II period being accounted for by the 'one-off' impact of legal enforceability. This thereby points to a potential optimal level of international trade as this one-off boost to trade eventually exhausts itself.

Another important area of discussion involving gravity model type approaches to international trade revolves around the effects of common currencies on trade. An additional variable that can be included in the gravity model equations is one for countries sharing a common currency. There are 193 independent countries recognised by the UN but only about 120 different currencies operate. Many countries share a currency; and some have done so for a very long time. Under current circumstances, however, the issues are European Monetary Union and 'dollarisation'. In January 2002 12 EU member states adopted the euro. In addition there are a number of countries that have experimented with abandoning their own currency in favour of the US dollar, mainly in Latin America, or who have established a 'hard currency board' approach to monetary management. What are the effects of these policies on trade?

There seem to be very large trade gains to be made by adopting common currencies, as those countries that have done so trade with each other to a much greater extent than those with their own currency (other things remaining equal) (Rose, 2000; Rose and Wincoop, 2001). This has led to a number of suggestions for further dollarisation and even the adoption of a single world currency (Alesina and Barro, 2001; Dornbusch, 2001; Rogoff, 2001). The beneficial effects have to do with the macroeconomic discipline and stability that 'dollarisation' is supposed to instill in (mainly) small and wayward countries. However, these gains are disputed (Persson, 2001; Rose, 2001). On close scrutiny there is little evidence that the suggested welfare and growth benefits have actually materialised (though inflation has been lower) from these policies and we should remain very sceptical about such policy initiatives (Edwards, 2000; 2001). The recent case of Argentina should reinforce this vary cautious attitude towards currency boards and talk of full dollarisation. As the US dollar appreciated in value, the Argentine peso also appreciated in value because it was linked to it via a currency board. This made Argentine exports very internationally uncompetitive independently of what was actually going on in Argentina itself, which was one of the reasons undermining the stability of the Argentinian economy.

But independently of these disputes, as long as countries continue to maintain their own currencies – which for the foreseeable future looks highly likely for most countries – again there will be an added limit to the extension of 'trade globalisation' (Rodrick, 2001).

Let us now consider another way trade is analysed in respect to borders and the long-term impediments to ever greater globalisation, which can be illustrated by the schema of different types of trade shown in Box 1.1.

BOX 1.1 TYPES OF TRADE

1. **THOSE GOODS EXCHANGED ON 'ORGANISED MARKETS'** (e.g. minerals, raw materials, primary agricultural products)
2. **THOSE GOODS EXCHANGED ACCORDING TO 'REFERENCE PRICES'** (e.g. processed raw materials, chemicals, basic standardized components)
3. **THOSE DIFFERENTIATED GOODS AND SERVICES EXCHANGED ON THE BASIS OF 'NETWORKS'** (e.g. complex manufactured goods and services)

Note: This schema is based upon Rauch (1999).

International trade can be divided into three categories. The first is that traded on organised exchanges, like primary products such as minerals and agricultural products, where price is established according to classic market mechanisms. Here one might think of markets like the Chicago grain markets, the London metal exchanges, and the Rotterdam spot market for oil.

The second category is intermediate goods that are traded according to 'reference prices' quoted in specialist publications and the like, such as chemicals and processed raw materials. For the prices of these goods you would consult a reference manual or trade price book. These are readily available in an openly published form.

The third type of trade is differentiated manufactured goods and services where there is no organised market or quoted reference prices. Here we do not find a uniform standard price but rather more 'one-off' pricing, differentiated according to complex networks of supply.

Unlocking the complex determinants of trade with respect to each of these categories is not easy (Rauch, 1999). Although the first, and to a lesser extent the second, of these categories display a high international trade to production ratio so that a high proportion of their output is exported, these are declining in importance as components of total international trade. These categories of trade are also less sensitive to the 'cultural variables' mentioned earlier in the context of the gravity model, so they are more closely correlated with the growth of wealth and income. But what has expanded rapidly is the third category, particularly complex manufactured goods. And this has a relatively low production to trade ratio, when all the other variables that determine trade have been accounted for. The key here is these other cultural, political or geographical influences, which act at the expense of income growth as such. There is a great deal of production but relatively lower levels of it are exported abroad as a pure consequence of income growth, rather than as a consequence of other variables like distance, migration and legal similarities, and so on.

Thus we have a situation where those categories of trade with high income elasticity related production propensity to export are declining in significance, while that category with a lower income elasticity related production propensity for export is increasing in importance. Perhaps this is at least one of the reasons for the relative lack of international trade, as opposed to domestic trade within a country.

The reasons for these different propensities are interesting and important. Where there is an organised market for exchange, as in the case of the first category, the organisation of the exchange is relatively easy and cheap. Transaction costs are low. However, with sophisticated manufactured goods there are no organised markets to facilitate exchanges. Rather they are traded in the context of often one-off, lengthy and complex networks of supply and distribution. Manufacturers have to set up webs of distribution systems, which are often singular and unique for each particular category of good. They require the seeking out of trading partners and the securing of a network of participants, something, it might be added, that migration makes easier. Above all these systems are costly to set up and maintain – transaction costs are high. This may account for the lack of trading in these goods across frontiers relative to their trading at home, and put a limit on the extent of their expansion. It is just too costly, for instance, for US manufacturers to secure distribution systems for their goods in Japan, so there are low levels of US exports to Japan, as shown in Table 1.1 above.

An obvious question here is whether there is any empirical evidence to support these remarks.

Whilst there was a rapid growth in world trade for all the categories of trade mentioned in Box 1.1 over the 1970s and 1980s, there was a downturn in the growth of agricultural exports in the second half of the 1990s. But after a slowdown in manufacturing exports in the same period, these recovered in 1999–2000, mainly as a result of a rapid growth of exports from the emerging economies.

In case this seems deliberately to concentrate upon merchandise trade and leave out trade in services, which are thought to be growing at a faster rate, this latter claim is not in fact true. Trade in cultural goods, for instance, was also falling off in the late 1990s. Trade in services has remained at about 20 per cent of total world trade ever since 1975, so by concentrating only on merchandise trade we have covered the bulk of total world trade.

In this section we have argued three things. First, that far from market exchange sweeping unhindered across the globe there are likely to continue to be real limits to the further expansion of global trade, limits largely established by the continuing salience of national territories and borders.

Secondly, we have argued that the real constraints on any further development of global trade are more likely to be the institutional, cultural and political variables, or the geographical ones analysed above, rather than straightforward economic ones.

Thirdly, there is some limited indication that overall world trade growth has slowed in recent years. Of course this may be mainly for cyclical reasons, but the analysis has also demonstrated that there are a potential set of more structural constraints that even in the medium term could undermine an ever expanding international division of labour and trade integration.

If nothing else, these remarks indicate that there are good and interesting reasons still to take the issues of borders seriously in economics, despite the fashionable insistence that they are no longer significant in an age of globalisation.

Conclusion

In this chapter we have tried to look forward to the future of global governance and the future of the global economy. We have tried to demonstrate three things. That the current state of international interconnectedness is not unprecedented and that previous episodes of integration have generated a backlash and have ended in the regression of international trade and investment. That national states are not being overwhelmed and the future of extended multilateral governance does not look promising. In a turbulent physical and international environment the nation state may become more salient as a means of protection against global forces beyond supranational governance. That there may be inherent limits to the growth of international trade, that borders do matter, and that we may be approaching those limits. These messages are comforting neither to the advocates of the 'Washington Consensus' nor to their 'anti-globalisation' critics.

Notes

1 Reprinted by permission of Sage Publications Ltd (© *Cooperation & Conflict*, NISA – Nordic International Studies Association, 2002).

2. The evidence and probable consequences considered in the 2001 report of the UN Intergovernmental Panel on Climate Change and the 2002 report of the US National Academy of Sciences are compelling and disturbing.

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2 The scope and implications of globalisation

Jonathan Perraton

Globalisation has become arguably *the* buzzword of our times, but for all its resonance in academic and popular discourse it often remains a vague and elusive concept. Is it anything more than a buzzword for journalists and the latest generation of vacuous futurologists? Indeed a growing academic school – ably represented by Paul Hirst and Grahame Thompson in their contribution to this volume and elsewhere (Hirst and Thompson, 1999) – argues that there is less than meets the eye to this phenomenon. Globalisation has been widely used to refer to sharp increases in levels of international economic flows, particularly since the 1970s. Using various definitions, authors have typically claimed either that it heralds the demise of the nation state or that it amounts to nothing new. However, these conceptions of globalisation are typically inadequate and their analysis of empirical evidence consequently misleading. This chapter proposes an analytic approach to globalisation, argues that available evidence does point to a fundamental transformation in the world economy which in key respects is unprecedented, and draws implications for nation states and the welfare of their citizens.

Conceptions of Globalisation

Broadly speaking there are three approaches to globalisation, referred to here as the hyper-globalist, the sceptical and the transformationalist views (Held *et al.*, 1999). For the hyper-globalists contemporary globalisation has created a single global economy transcending and integrating the world's major economic regions. Technological changes and market integration in this interpretation create an imperative towards the de-nationalisation of strategic economic activities so that it is global finance and corporate capital, rather than states, which exercise decisive influence over the organisation, location and distribution of economic power and wealth. Since the authority of states is territorially bound, global markets can escape effective political regulation. In this borderless economy, states have no option other than to accommodate global market forces, whilst multilateral economic institutions, notably the IMF, World Bank and WTO, effectively function to further this globalisation. Whether celebrated in neo-liberal business and journalistic literature (for example Ohmae, 1994; Friedman, 1999) or deplored in radical literature (for example Gray, 1998; Greider, 1997), globalisation is taken to spell the end of national management of economies and, particularly, of the welfare state.

In academic circles this hyper-globalist school has relatively few adherents, but this business school view of the world is highly influential in policy circles and popular discourse. In its weaker form – arguing that increased integration raises gains from pursuing *laissez-faire* microeconomic policies and conservative macroeconomic policies (the 'Washington Consensus'), and also raises the costs of departing from such policies – it is prevalent amongst international economic agencies.

The sceptical view, by contrast, sees contemporary integration instead as 'inter-nationalisation', where recent growth of international flows represents rising interactions between well-defined national economies, rather than the emergence of global economic activity. National economic policy therefore at least potentially remains coherent and effective. In this view current levels of global flows are not unprecedented but are comparable to, or lower than, those during the classical Gold Standard period before World War I. Further, rather than being global, the sceptics argue that increased international economic activity is primarily a phenomenon largely confined to the major developed economies with these states having been the very architects of a more open international economy. Dismissing the idea of a unified global economy, the sceptical position concludes that the world displays distinct economic and political blocs, within which different forms of capitalism continue to flourish. Globalisation sceptics test the claims of the hyper-globalists and find them wanting as an account of contemporary developments – economic activity remains significantly more nationally based than would be the case under a model globalised economy. Often the hyper-globalist view is taken as representative of analyses of globalisation more generally.

The transformationalist view of globalisation proposed here differs from both these approaches in viewing globalisation as a process rather than an end-state. The historical context of globalisation is examined in more detail elsewhere;[1] but the evidence presented below does point to levels of integration that are qualitatively higher than in earlier periods. Globalisation can be conceived as a process, or set of processes, which embodies a transformation in the spatial organisation of social relations engendering a shift in the spatial reach of networks and systems of social relations to transcontinental patterns of human organisation, activity and the exercise of social power. More specifically here we focus on the emergence of global product and financial markets and the international organisation of business. This entails a stretching of economic activity across frontiers, regions and continents. The growing extensity[2] of economic activity is combined with an intensification, or the growing magnitude, of interconnectedness and flows of trade, investment, finance and so on so that domestic economic activity is increasingly enmeshed with activity elsewhere. This growing extensity and intensity deepens their impact such that the effects of distant events can be highly significant elsewhere and specific local developments can have global consequences. In this sense, the boundaries between domestic matters and global affairs become increasingly fluid. Networks and infrastructures have emerged to facilitate these interactions, and institutions have emerged to regulate them. Such developments are rarely uniform and typically display clear patterns of hierarchy and unevenness. Globalisation is not a singular condition, a linear process or a final end-point of social change. Although the impact of globalisation processes is affected by the extensity and intensity of the processes, it cannot simply be read off from them. Globalisation theory should not be seen as a substitute for established social science approaches to assessing the impact of social relations, but instead it complements them by illuminating the specific role played by the intercontinental dimension of social relations and indicating how established tools should be modified and applied to understanding these relations. Globalisation does not simply denote a shift in the extensity or scale of social relations and activity. Fundamentally, argue the transformationalists, it also involves the spatial reorganisation of economic, political, military and cultural power. Globalisation can thus be understood as involving a shift or transformation in the scale of human social organisation that extends the reach of power relations across the world's major regions and continents. It implies a world in which developments in one region can come to shape the life chances of communities in distant parts of the globe.

Herein lies the key contrast with the hyper-globalisation and sceptical approaches. Both these views share a remarkably similar conception of globalisation as an end-state, the sceptics testing this notion against the evidence and finding it wanting. Conceiving globalisation as an end-state is problematic for two reasons. First, this all too often leads to conflating global markets with perfect markets so that when global markets do not operate as textbook perfect markets this is erroneously taken as evidence against globalisation. Secondly, there seems little reason to think that processes of social change like globalisation have a single putative end-point. This leads to the analysis above where it is assumed that globalisation inexorably leads to one outcome and cannot be altered by policy choices. Both the hyper-globalist and sceptical approaches use similar conceptions of economic globalisation in terms of perfectly integrated international markets, the sceptics claiming to test the assertion of the hyper-globalisation school that such markets have arisen. It is not simply that reality by definition does not confirm to this ideal type – it is also the wrong model. This is a concept of an equilibrium end-state. However, an equilibrium of frictionless international capital mobility would be expected to produce very low, not very high, cross-border financial flows and transactions. Such a model is therefore unhelpful in explaining the huge volume of cross-border transactions and periodic turbulence in international financial markets. Focusing on perfect international markets fails to explain non-market integration by multinational corporations (MNCs), since MNCs exist precisely because of imperfections in international markets. This concept is severely limited as an analytical tool. Fundamentally, it is unhelpful to study economic processes in terms of a single implied end-point, given the likelihood of multiple equilibria. The end-point concept of globalisation implies a unilinear, even inexorable, process. Rather globalisation can be seen as a process of emergence of global product markets and global organisation of production. This both covers several areas of economic activity and also has multiple causes. Market dynamics are important, but globalisation cannot simply be reduced to this. Nor can it simply be explained in terms of new technology: global financial markets emerged in the nineteenth century with the telegraph – the 'Victorian internet' (Standage, 1999) – but modern technology has been central to moving the volume of goods traded and to processing the vast level of transactions on contemporary international financial markets as well as providing the communications infrastructure for organising international business.

The sceptics are right to point out that markets are not protean entities but require a legal framework, and that global markets have emerged as the result of deliberate political decisions by key states to liberalise. These observations do not, though, mean that globalisation is a myth, for several reasons. Continuing regulation of markets by governments does not mean that they can control the outcomes of these markets; regulators themselves are often playing catch-up with developments in the markets, particularly in global finance (for example Germain, 1997). Nor does the fact that governments deliberately deregulated mean that it would be a simple task to reverse this. Whilst in an important sense deregulation entailed *re*regulation – regulations were not simply removed but new ones devised and implemented – the national dimension to this is often over-stated in sceptical accounts. There is evidence of growing uniformity in business regulation, at least across developed countries (Braithwaite and Drahos, 2000). In part this is due to links between national regulators and the emergence of an international epistemic community amongst them, in part it is the result of formal integration agreements either regionally (for example the Single European Market or NAFTA) or globally through the WTO and in part it reflects regulatory arbitrage from international competition. Thus a global architecture for international markets is emerging.

Globalisation as a multi-dimensional process with multiple causes can be expected to have multiple possible outcomes. The limitations of the unilinear conception of globalisation can be seen in the use of convergence measures to 'test' globalisation trends. Typically such analysis is either naïve – assorted variables are presumed to converge with globalisation for no clear theoretical reason and anything less is taken as evidence against globalisation – or predicated upon models assuming perfect competition. Even modern neoclassical models of globalisation assuming imperfect competition and scale economies show that integration can result in agglomeration and spatial unevenness, and inequality in processes which imply multiple equilibria, and they do not propose simple convergence stories (Krugman and Venables, 1995; Fujita *et al*., 1999). Less orthodox accounts based on the pioneering work of Stephen Hymer on multinationals make similar predictions on the basis of profit-seeking activity by oligopolistic MNCs (for example Kozul-Wright, 1995). Globalisation processes do not necessarily imply homogenisation or convergence in conditions across countries – international transactions are driven precisely by differences in countries' domestic conditions. Moreover, hierarchy and unevenness in the nature of global systems may be perpetuated, accentuated or modified by globalisation. Whether incomes, growth rates, interest rates and other economic conditions and policies are expected to converge as a result of globalisation depends on the theoretical approach adopted and the nature of the globalisation process.

Empirical evidence

International trade, finance and foreign direct investment have grown rapidly since the war and these are considered below. One omission here is international migration, which was a key component of globalisation processes in the classical Gold Standard period. The forces leading towards globalisation of product and financial markets, particularly improvements and cost reductions in transport and communications, are likely to have a similar impact on international labour movements (Stalker, 2000). These have also facilitated international movements of people. The impact of other globalisation trends on migration is more ambiguous. Trade and/or capital flows can in principle substitute for migration, and if globalisation leads to income convergence across nations this might be expected to reduce pressures for migration. In practice these trends are more likely to lead to increased migration. Trends towards convergence of countries' incomes per head, such as they are, are too slow to offer any immediate prospect of major erosion of international wage differentials between North and South (see below). Further, there appears to be a non-linear relationship between global income differentials and migration pressures. Some domestic industrial development is often necessary to provide potential migrants with internationally marketable skills. Increased international economic integration spreads information more widely about global opportunities so that international labour flows have become more responsive to demand shifts in recipient countries. Thus development through international economic integration seems more likely to increase migration than to reduce it. Globalisation of product and financial markets reflects political decisions to liberalise as well as falls in transport costs. By contrast, recipient countries largely can and do control labour inflows and face few pressures to relax their controls. Such a conclusion may be over-hasty. The key pressure for liberalisation in developed countries is an ageing population combined with births falling below replacement rates.

International trade

International trade has reached unprecedented levels relative to output, leading to global goods and services markets and the transformation of product and labour markets. Trade has grown to unprecedented levels in the post-war period, as shown by Table 2.1. Trade is clearly higher relative to output than during the classical Gold Standard period. More detailed evidence at the level of countries also points to structural breaks in many countries' trade–GDP ratios in the 1970s (Ben-David and Papell, 1997). These figures are for merchandise trade only. Figures for trade in services are more patchy and only available more recently – but they too show an upward trend. Trade in goods and services grew more rapidly than GDP over the 1990s and is now equivalent to about 29 per cent of world GDP from around 19 per cent in 1990 (WTO, 2001: 1).[3]

Table 2.1 Export–GDP ratios, 1870–1998

	Merchandise exports as per cent of GDP (1990 prices)					
	1870	1913	1929	1950	1973	1998
France	4.9	7.8	8.6	7.6	15.2	28.7
Germany	9.5	16.1	12.8	6.2	23.8	38.9
Japan	0.2	2.4	3.5	2.2	7.7	13.4
UK	12.2	17.5	13.3	11.3	14.0	25.0
United States	2.5	3.7	3.6	3.0	4.9	10.1
World	4.6	7.9	9.0	5.5	10.5	17.2

Source: Maddison (2000: 363).

Given the post-war growth in non-tradable services, much of it in the public sector, it is useful to compare these figures more directly to value-added in the goods sectors as Table 2.2 does for selected countries. Except for the slightly anomalous case of Britain, there is a clear increase in goods trade relative to goods output. The integration of the United States into the world economy is particularly notable.

Table 2.2 Merchandise trade as percentage of merchandise value-added, 1890–2000

	1890	1913	1960	1970	1980	1990	2000
France	18.5	23.3	16.8	25.7	44.0	53.5	68.0
Germany	22.7	29.2	24.6	31.3	48.5	57.8	78.5
Japan	10.2	23.9	15.3	15.7	25.8	18.9	27.5[a]
Sweden	42.5	37.5	39.7	48.8	72.9	73.1	87.5[b]
UK	61.5	76.3	33.8	40.7	52.6	62.8	63.5
United States	14.3	13.2	9.6	13.7	30.9	35.8	48.3[c]

Notes: a: 1999; b: 1998; c: 1997.

Sources: Feenstra (1998); World Bank, World Development Indicators data base; US *Economic Report to the President*, 1999.

Of course, these figures should be interpreted with care as they compare gross trade figures relative to measures of value-added. Indeed firms are increasingly able to divide the production process into different stages and locate them according to comparative advantage – variously referred to by different authors as 'commodity chains', 'fragmentation', 'global production networks' or 'slicing up the value chain' (Feenstra, 1998; Krugman, 1995) – thus increasing trade in inputs and semi-finished manufactures. This has significantly increased the import content of manufactured goods in developed countries (except Japan), leading to the development of interdependent production processes across countries. Some estimates indicate that 30 per cent of manufactures trade may be in components (Yeats, 2001).

Transport costs and protectionist barriers fell through the post-war period, but a series of key qualitative changes in the 1980s and 1990s have paved the way towards a global free trade regime. Developing countries abandoned protectionist policies, partly as a result of pressure from multilateral institutions; the collapse of the Comecon system and liberalisation in China and Vietnam brought former command economies into the world trading system; the completion of the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) led to the establishment of the World Trade Organization. This means that a majority of the world's population and economies are now operating under a broadly free trade regime (Sachs and Warner, 1995), which will increase further with China's accession to the WTO. Within the picture of global trade liberalisation there are important exceptions, particularly in agricultural goods in which the least developed countries have a comparative advantage.

An extensive trading system has thus developed since World War II. Although there are some regional patterns to trade, interregional trade has grown alongside intra-regional trade and indicators of the relative intensities of intra-regional and interregional trade do not indicate a clear trend to regional concentration (Andersen and Norheim, 1993). Regional trading arrangements generally appear to be reducing rather than increasing global barriers to trade. The result of this is that trade has led to national markets for goods and services becoming increasingly enmeshed and to global ones emerging.

For much of the post-war period the growth of trade was largely driven by the growth of intra-industry trade as developed countries' markets for manufactures became increasingly enmeshed. However, since the mid-1980s developing countries' share of world trade has risen continuously largely due to increased manufactured exports. Their share of world merchandise exports is now 30 per cent and their share of world manufactured exports stands at 27 per cent, up from 17 per cent in 1990 and 10 per cent in 1980 (WTO, 2001: 3–4). Export growth through their incorporation into the world economy has been central to the development of these newly industrialising economies (NIEs). The growth of these NIEs has led to increased differentiation between developing countries in terms of income levels, wages and the products they export. This growth has been highly concentrated on a small number of countries, and markets for primary commodities, which still predominate in the least developed countries' exports, have stagnated since the 1980s. Moreover, even the markets for manufactured exports are limited and it is questionable how far the export performance of the NIEs could be emulated by developing countries on a wide scale without leading to falling terms of trade (Rowthorn, 2001).[4]

Whilst global markets have emerged for many products, the nature of these markets remains under-researched. Some, particularly in primary commodities, are clearly organised on exchanges. Even these are often less perfect than often supposed, with degrees of cartelisation, and some manufactures markets are cartelised too (Strange, 1996: ch. 11). But other markets, particularly for manufactures, are not so clearly instituted. Intra-industry trade by its very nature entails imperfect, often oligopolistic, competition. The limits to international price convergence – largely due to fluctuations in the exchange rate from financial globalisation – are sometimes taken as evidence against global markets, but this can be analysed in terms of pricing behaviour of oligopolistic companies in international markets (Brinkman, 1999).

The growing extensity and intensity of trade has been matched by the establishment of the WTO, providing an institutional architecture for world trade. Whilst the GATT provided a skeleton framework for governing trade, the WTO is both more invasive as it moves into harmonization of trade in services, intellectual property rights and investment measures, and has greater powers over national governments. The WTO operates quite clear and stringent rules in its thrust towards global trade liberalisation. The General Agreement on Trade in Services (GATS) may be particularly significant since some authorities argue its provisions could be used to open up public sector service providers to market competition. Further, by a two-thirds majority the WTO can vote to bring any new subject into its ambit. The more invasive nature of the WTO regime and its shift to deeper harmonization than the GATT regime is indicated by references to dispute panels: whilst there were around 120 references to the GATT disputes panel over 1948–90, since 1995 there have been 268 references to the WTO disputes panel (October 2002 figures). At the level of industrial policy, the institutionalising of free trade through the WTO has profound effects on national policy options. Many of the trade and industrial policies that were operated by developed countries during their industrialisation – and several newly industrialising economies like Korea and Taiwan in the post-war period – are now no longer permissible under WTO rules – as Ha-Joon Chang points out in his chapter in this volume (Chapter 23) and elsewhere (Chang, 2002).

The impact on macroeconomic policy is considered below as an ensemble with the other aspects of economic globalisation. Textbook trade theory predicts that product market integration would lead to some convergence of factor incomes, although not necessarily to the point of factor price equalisation.[5] Increased interindustry trade, on some estimates, has had an important impact on the fortunes of groups in the trading countries through increased specialisation in production, so that as industrialised countries have lost markets for low skill-intensive products, demand for their high skill-intensive products has risen.[6] This has led to large falls in demand for, particularly, male manufacturing workers in developed countries, whilst wages for highly skilled workers have tended to rise and differentials widen. Fragmentation of production globally is likely to increase these effects. Considerable debate has ensued over how much of the shift in demand away from low-skilled labour in developed countries can be attributed to increased trade with developing countries and the ensuing specialisation. Most such studies take a simple view that this is attributable either to such trade or to skill-biased technical change. Many such studies that indicate small effects from trade are poorly specified in terms of the underlying theory and contain biases that are likely to reduce the estimates.[7] If there have been such productivity changes in the workforce that many economists claim, then they need to explain why there is scant evidence of them at the macro level in aggregate productivity figures. Moreover, this debate has tended to downplay the role of changes in wage bargaining institutions, declines in trade union power amongst some countries and trends in minimum wages.

Further, focusing on the effects of developed–developing country trade overlooks the effects of trade in general. As Rodrik (1997) points out, increased trade acts to raise the elasticity of demand for labour; similar effects would be expected from foreign direct investment, considered in the next section. Whilst the North–South trade effects flow from orthodox trade theory of comparative advantage determined by relative factor supplies, the increased elasticity of demand for labour result does not assume such trade and can also be derived from a post-Keynesian approach (Galbraith and Berner, 2001: especially chs 1 and 8). Increased elasticity of demand for labour has a number of key consequences: it reduces the ability of labour to extract rents in production processes and increases the incidence of taxes and other measures on labour (and other immobile factors). This doesn't mean that welfare states or environmental measures become unaffordable because they make the country 'uncompetitive'. Indeed amongst developed countries, more open economies tend to have larger welfare states (Rodrik, 1997). This is perhaps not surprising: whilst openness offers the standard gains from trade it also exposes citizens to greater risks. A functioning welfare state financed by progressive taxation can cushion citizens against external fluctuations and, in a rough-and-ready way, ensure that the gainers partially compensate the losers. However, this integration does tend to shift the costs of welfare states onto labour at a time when the demands placed upon them are increasing.

Thus far there are only a few studies of the effects of increased trade on the elasticity of demand for labour (for example Slaughter, 2001). Although firms' mark-ups on costs have declined in the 1990s as they face greater competitive pressure, this has not led to a rise in labour's share of national income as might be expected with low and stable inflation rates; instead labour's share of national income has stabilised or declined in developed economies (BIS, 2001: 20). Other evidence also indicates that increased trade between developed countries can have a significant impact on labour. Whereas it has often been supposed that intra-industry trade benefits all factors of production, there is no theoretical necessity for this and in practice such trade does appear to induce significant adjustment (Brülhart and Hine, 1999).

Whilst much of this work has focused on the impact of trade on developing countries, increased specialisation between developed and developing countries may limit any further effects of this trade on developed countries' labour markets. However, amongst developing countries increasing trade appears to have had a significant impact on labour markets in developing countries (Wood, 2002). As differentiation between developing countries has grown, the impact on incomes and wage inequality increasingly depends on their relative position.

Multinational corporations and foreign direct investment

Foreign direct investment by multinational corporations has grown faster than trade, let alone income, since World War II and sales by foreign affiliates of MNCs are now more than double global exports (see Table 2.3). MNCs account for a significant minority of private GDP, particularly in manufacturing, and, on some estimates, a majority of world trade (with a quarter or more of world trade being between branches of the same company). As major international borrowers and savers, MNCs have been central to the development of global finance. Although FDI remains a minority of total investment, it is growing and significant, as Table 2.4 shows. These figures are partially misleading as the majority of the FDI between developed countries is in the form of mergers and acquisitions, but this is much less true for investment in

Table 2.3 Sales and output of foreign affiliates of MNCs, 1982–99

	1982	1990	2000
Foreign affiliates' sales/world exports ratio	1.16	1.25	2.23
Sales of foreign affiliates/world GDP (%)	23.2	25.5	49.2
Gross production of foreign affiliates/world GDP (%)	5.3	6.6	9.9
Exports of foreign affiliates/world exports (%)	30.0	26.6	50.8

Source: UNCTAD (2001: 10).

Table 2.4 FDI flows as a percentage of gross fixed capital formation, 1982–99

	1982	1989–94 average	1995	1997	1999
World					
Inward	2.5	4.1	5.3	7.5	16.3
Outward	1.7	4.9	5.7	7.4	15.4
Developed countries					
Inward		3.7	4.4	6.1	17.0
Outward		5.5	6.7	8.9	19.4
Developing countries					
Inward		5.2	7.7	10.9	13.8
Outward		2.4	3.3	3.9	3.3

Source: UNCTAD (2001: 10, 312–3)

(and from) developing countries. These figures are by their nature guesstimates; data at the national level indicates that in the manufacturing sector foreign affiliates now account for around a quarter of output in the EU and around 18 per cent in the USA, although foreign investment in Japan remains very low.[8] Figures on MNC production of services is patchy, although the tertiary sector now accounts for around 42 per cent of FDI stocks (UNCTAD, 2001: 257).

Following economic liberalisation, FDI in transition economies has often accounted for a significant proportion of their national investment levels. Most FDI flows to developed countries, but the share of developing economies has risen to 21.4 per cent now from 17.1 per cent a decade ago (UNCTAD, 2001, p. 256); inflows to China account for around half of this increase and ten economies account for three-quarters of all FDI inflows to developing countries (*ibid.*, p. 52). In some developing and transition economies MNCs play a key role in production, investment and technology transfer and have played a key role in embryonic industrial clusters and in facilitating export growth. Nevertheless, FDI typically flows to countries where the developmental process is already established and the conditions for sustained growth are in place rather than playing a catalytic role in development (cf. de Mello, 1997).

Scepticism over the significance of these developments has been expressed on several grounds. Globalisation sceptics stress that MNCs often have the majority of their sales and assets in their home country, along with their core operations, and argue that they remain essentially national companies with international operations (for example Hirst and Thompson, 1999, ch. 3). Amongst the largest 100 MNCs, foreign operations are substantial, accounting in 1999 for 41.7 per cent of their assets, 49.2 per cent of sales and 45.6 per cent of employment (calculated from UNCTAD, 2001, p. 94). Overseas operations are hardly marginal or peripheral to many MNCs. A related criticism is the claim that MNCs are retreating from operating truly global strategies not least because of the low profit rates on many overseas operations (for example Rugman, 2000). There are several comments that can be made here. As we have noted, FDI flows continue to grow rapidly; there is no overall slowdown in the growth of MNCs' overseas operations. Part of the trend identified can be attributed to companies aiming to focus on their core competencies; this will not necessarily result in lower international production, but may lead to foreign affiliate production being replaced by outsourcing. A retreat from diversified global production to more focused operations has not necessarily meant a departure from a global strategy (OECD, 2001). The point about relatively low profitability of MNC operations is not new, having been carefully documented in Kapler (1997); in part this reflects the heightened global competition. Inward FDI is a key source of international competitive pressure (Baily and Gersbach, 1995); MNCs have both created and are subject to global competition. Focusing on individual companies tends to miss the wider picture: whilst individual MNCs vary in their capacity and strategy for operating production internationally, overall they have increased the responsiveness of output to changes in national conditions. FDI continues to grow and MNCs continue to expand their overseas operations. MNC activity and intra-firm trade remain central to the production and trade of many key industries (OECD, 1996).

The growth and power of MNCs is examined further elsewhere in this volume. The growth of international production has several key consequences. As noted above, increased FDI generally, not just to low-wage countries, is expected to have similar effects as increased trade on raising the elasticity of demand for labour; available evidence is consistent with this (Hatzius, 2000). This is beyond the effects of outsourcing and relocation of production to low-wage, developing and transition economies. International production tends to undermine national industrial policies and wider social arrangements. Part of this is formal: although attempts to negotiate a global regime for MNCs have so far failed, several WTO measures act to limit countries' policy autonomy. In particular WTO agreements over Trade in Intellectual Property Rights (TRIPs) and Trade-Related Investment Measures (TRIMs) act to limit countries' ability to ensure technology transfer from inward investment and impose performance requirements on MNCs – tools that were used successfully by countries in their post-war development (Lall, 2002). Liberalisation of the inward investment regime has largely proceeded through bilateral agreements: during the 1990s between 80 and 150 regulatory changes to FDI regimes were introduced annually; the vast majority of these made the regime more liberal (UNCTAD, 2001, ch. 4). Governments have fewer policy levers over MNCs.

Arguably the key issue is the generation and diffusion of technology. Elsewhere in this volume Jeremy Howells discusses the various forms of globalisation of technology. MNCs have often dominated the most technologically dynamic industries and accounted for the majority of private R&D expenditure, including a growing proportion abroad by foreign affiliates. This has been central to their growth. Companies undertake overseas production where they possess a specific advantage best exploited within the firm through multinational production, rather than exporting from the home base or licensing the technology. Multinationals' growth *qua* multinationals has been based on their ability to generate and exploit technological advantage internationally: not merely did they generate specific advantages through technology creation, their multinational nature enabled them to exploit this advantage around the globe. For much of the post-war period this advantage was typically generated by innovation networks in the company's home country and then diffused world-wide. Increasingly, however, MNCs cannot rely solely on their domestic base for generating technological advantage and have responded by diversifying their innovatory capacity internationally. Rising costs of innovation and the need to tap into overseas innovation networks have led to increasing numbers of joint-ventures and strategic alliances between MNCs for the generation and diffusion of technology. Such developments are particularly common in industries with high levels of recurrent R&D expenditure. Cross-border strategic alliances grew rapidly in the 1980s and continued to grow in the 1990s, often between companies from different continents (OECD, 2001). One key result of globalisation is that for all but the G7 countries foreign R&D had a greater impact on productivity than domestic R&D (Frantzen, 2000); FDI, as well as trade, is an important conduit for this. The international dispersion of technology undermines national industrial and technology strategies.

MNC activity acts to erode the corporate tax base. Differences in corporate tax rates do appear to have significantly affected FDI flows, and corporate tax rates (both headline and effective rates) have declined – from an OECD average of 44 per cent in 1988 to 36 per cent in 1997 – whilst the cross-country variance has fallen over the past decade amongst advanced countries (Gropp and Kostial, 2000). In part governments have responded by broadening the corporate tax base but cutting rates on the most mobile capital. These developments do not make welfare states unviable.

Global strategies increase the exit options of MNCs without necessarily making them footloose. Since technological advantage is necessarily temporary, these developments do not necessarily make national industrial policy ineffective; indeed by attracting FDI it may enhance them. Nevertheless MNC activity appears to have led to a shift in industrial policy away from national industrial development strategies and towards an emphasis on offering inducements for inward FDI.

Both the hyper-globalisation and sceptical schools postulate one ideal form of a globalised MNC and compare this with specific firms. This ignores the overall effect of global production and competition arising from MNC activity. Multinationals' ability to produce abroad and response to global competition continues to place constraints upon national economic and industrial strategies.

The globalisation of finance

For many, the most potent example of globalisation is the extraordinary level of international financial transactions. Particularly since the demise of the Bretton Woods system, international finance has grown exponentially to almost astronomical levels for some products. The level of transactions is extraordinary, as Table 2.5 shows.[9] Whereas in the early 1970s the ratio of

Table 2.5 Cross-border transactions in bonds and equities (% GDP)

	1975	1980	1985	1990	1995	1998
USA	4	9	35	89	135	230
Japan	2	8	62	119	65	91
Germany	5	7	33	57	172	334
France	–	5	21	54	187	415
Italy	1	1	4	27	253	640
Canada	3	9	27	65	187	331

Source: Bank for International Settlements, *Annual Report*, 1999, p. 118.

foreign exchange trading to world trade was around 2:1, by the early 1990s this ratio had risen to 50:1 and is around 70:1 today (Eatwell and Taylor, 2000: 3–4); the majority of these foreign exchange positions are held for less than a week. The gross flows are less dramatic, the difference being indicative of the degree of volatility in international financial markets, but Table 2.6 shows a general rise in cross-border capital movements.

Against this evidence globalisation sceptics cite the close correlations between national savings and investment rates as evidence of the continued importance of national capital markets. However, this correlation declined over the 1990s (BIS, 2001: 32), and a high correlation between national

Table 2.6 Gross foreign direct investment plus portfolio investment flows

	Annual average per cent of GDP					
	1970–74	1975–79	1980–84	1985–89	1990–95	1996–2000
Canada	1.7	3.4	3.6	6.1	7.2	12.6
France	–	1.3	2.1	4.1	7.2	19.4
Germany	1.2	1.3	1.7	5.2	6.3	17.7
Italy	0.9	0.3	0.6	1.7	5.7	15.6
Japan	–	0.6	2.6	5.9	3.7	4.6
Sweden	1.0	1.2	1.7	5.0	7.0	27.3
UK	3.6	4.0	5.4	14.4	11.9	28.6
USA	1.0	1.5	1.4	2.9	3.3	9.3

Sources: 1970–95: IMF, *World Economic Outlook*, May 1997; 1996–2000: calculated from IMF, *Balance of Payments Statistics Yearbook* and *International Financial Statistics Yearbook*, 2002.

savings and investment shares can still be consistent with high international capital mobility if the two are jointly determined and/or the government targets the current account. Further, high net capital mobility would only be expected if there were significant differentials in rates of return between countries and these have largely been eliminated, in part due to past capital flows. Whilst investors still retain a home bias towards domestic assets, gross flows of capital have grown, consistent with a high degree of enmeshment between national capital markets. Moreover, this is consistent with much of these flows being speculative: the variance of national current accounts is estimated to be excessive for consumption smoothing amongst developed countries (Ghosh, 1995; Shibata and Shintani, 1998).

Turning to price rather than volume data, the story is clear, as all but very short-term interest rates are now determined in globally integrated markets. When currency can be sold forward, any difference between rates is exactly offset by the difference between the current and forward exchange rate for the period the asset is held, so that returns are equalised when expressed in a common currency (covered interest rate parity holds). Outside of this condition, returns are not equalised so that exchange rates do not exactly move to offset differences in interest rates (uncovered interest rate parity does not hold). Over the longer term there is evidence of convergence of real interest rates amongst the major advanced economies, implying some convergence in the costs of capital (Fujii and Chinn, 2001). The failure of exchange rates to move to offset differences in interest rates, at least in the short run, is due both to variations over time in the premium over standard interest rates that the markets demand for holding assets denominated in particular currencies, and to operational features of the foreign exchange markets. Market operators use forecasts of exchange rates based both on an analysis of economic fundamentals and trend spotting in data series ('chartism'). Since there is a range of opinions amongst traders this creates the conditions for high volumes of trading and possibilities for speculation. In particular, chartism can lead to speculative bubbles that drive the exchange rate away from its equilibrium value, the short-term focus of most traders leading to a relative concentration on such movements.

More generally, capital markets are becoming more integrated so that global and international industry-specific factors appear to be becoming more important and national factors less important in stock market movements (Brooks and Catao, 2000). Convergence of interest rates and integration of capital markets has led to narrowing of differences in the cost of capital (Stulz, 1999).

The position of developing countries is more complex and the integration of their financial systems with global markets is less. Developing countries would be expected to pay a premium on developed country interest rates to reflect their greater default risk, but this becomes counter-productive when it simply increases the probability of default and thus decreases the expected return; at this point credit rationing operates to prevent further lending. Since debtors continue to repay past loans at rates determined in the global market and agents within them can move funds to international markets, developing countries remain part of global financial markets. After effectively being excluded from international financial markets after the debt crisis in the 1980s (see further Gary Dymski's Chapter 5), flows to developing countries resumed on a significant scale in the 1990s. The 1997 East Asian currency crisis disrupted these flows again, although there are clear signs of a resumption since; the flows remain concentrated on leading economies in Asia and Latin America and the leading transition economies.

What are the policy implications of these developments? The sanguine view is that the only restrictions global finance imposes on national governments is to stop them pursuing policies that are unsustainable, or at least harmful, anyway. This view is hard to sustain after the exchange rate crises since the late 1990s. Standard economic analysis since Mundell–Fleming indicates that, in the absence of capital controls, countries can choose between fixing their exchange rate or pursuing an independent monetary policy. Capital controls were largely abolished amongst industrialised countries by the 1990s and there was widespread capital account liberalisation amongst developing and transition economies under pressure from international agencies and in an attempt to attract private finance. However, the Mundell–Fleming dichotomy is ceasing to be an accurate representation of policy choices available to national authorities. Financial globalisation has rendered fixed exchange rate systems unsustainable.

Earlier crises were typically caused by unsustainable policies, but the 1990s saw the emergence of 'second generation' crises where a speculative attack raises the output and employment costs of maintaining a currency peg so that governments are forced to abandon otherwise sustainable pegs. With 'third generation' crises it is a build-up of foreign debt that becomes unsustainable; whereas 'second generation' crises are typically triggered during an economic downturn (as with European Monetary System countries over 1992–93), 'third generation' crises can occur with booming economic activity and sound fiscal and monetary positions (as with the East Asian countries in 1997). Furthermore, whereas the effects of 'second generation' crises are largely benign – countries' output and employment rise following post-crisis devaluation – 'third generation' crises may be contractionary since the post-crisis devaluation raises the domestic currency debt burden and can lead to widespread business bankruptcy. In either case, even if there are imbalances in the economy's fundamentals the question remains as to why the markets provide large inflows of capital for years before suddenly and sharply reversing these flows – the too much, too late thesis (Willett, 2000).

The logic of this is that countries' choice is now limited to floating rates or full monetary union (Eichengreen, 1994). Whilst increased capital mobility (and openness to trade) has acted to reduce national policy autonomy in the expected ways (for example Webb, 1995), it has also weakened countries' ability to pursue independent monetary policies with floating exchange rates. In orthodox economics accounts, integration raises the inflationary costs and reduces the impact on output of expansionary macroeconomic policies (for example Lane, 1997), but the effects of globalisation go beyond this. Financial innovations and global flows have weakened both national authorities' control over monetary aggregates and their ultimate relationship to target variables. Turbulent capital flows lead to exchange rates diverging from values consistent with either interest rate differentials or the relative costs of producing goods and services. Thus, for example, recently exchange rates between major currencies have been significantly affected by cross-border mergers and acquisitions (BIS, 2001: 87–88). The result of this is that exchange rates cease to be an effective equilibrating mechanism or an effective policy tool; this has been seen in dollar overvaluation in the mid-1980s and various episodes with sterling over the past 20 years (Cobham, 2002).

Whilst variations in government spending, taxation and general macroeconomic policy point to a continued range of national policy options, the response of markets increases the uncertainty policy makers face in the response to macro policies. Markets' response to government policies depends on their assessment of the economic credibility of the government; as such there is no set market response to particular policies. Rather than global financial markets imposing particular policies on national governments, they have significantly changed the costs associated with particular policies and instruments through their effects on interest rate risk premia and exchange rate movements; at times these costs may be so high as to make the policy prohibitively expensive. Moreover, governments do not face clear policy rules, but uncertainty over market reactions as markets have periodically supported policies before turning suddenly and sharply against them. This induces policy caution amongst governments and tends to lead to a deflationary bias in macroeconomic policy (see also Blecker, 1999). With developing countries this is accentuated by the IMF's bias towards deflationary policies, which after the 1997 East Asian crisis even drew criticism from the World Bank (Stiglitz, 2002). The instability of contemporary financial integration inhibits rational planning for firms and governments and raises systemic risks; John Eatwell and Lance Taylor point to a number of possible policy responses to reduce this instability (Eatwell and Taylor, 2000). The aftermath of the East Asian crisis has put capital controls back onto the agenda and whilst national regulatory authorities have largely played catch-up with international financial integration, potential leverage remains: banks remain dependent on national central banks to act as crisis managers and lenders of last resort.

The effects of financial globalisation go beyond its impact on macroeconomic policy. State direction of finance, a key policy tool of developmental states and several industrial countries, is sharply undermined. Grahl (2002) argues that the level of international financial transactions observed is not simply speculative, but indicative of the emergence of a global financial system. Whilst much finance may still be raised nationally, global finance provides the key alternative source and use for funds and as such sets benchmark rates of return. The exit possibilities offered by global financial markets undermine the 'voice' based systems of national finance often claimed to underlie continental and East Asian alternative forms of capitalism to the Anglo-Saxon variant.

By starting from a conception of a perfect international capital market under which there would be few, if any, speculative flows, both the hyperglobalisation and sceptical views miss key features of contemporary financial globalisation and its differences from earlier episodes. Interest rates are now determined globally, and although national differences remain in other financial markets they are increasingly affected by global developments. Above all the speculative nature of much of these flows not merely severely limits government freedom for manoeuvre, but does so in a manner that is unpredictable.

Consequences and policy implications

Economic globalisation has been interpreted here as both a rise in economic activity that is world-wide in scope and a growing intensification of economic flows and activities across societies and between people, a process of both growing extensity and intensity. Global product and financial markets have emerged or are emerging. Multinational corporations operate global business strategies and have created global competition. This has had a profound effect on growth, labour markets and incomes and the macro- and microeconomic policies that governments can pursue. These changes are driven by a combination of technological change, deliberate policy choice – albeit often under pressure from regulatory competition and/or multilateral agencies – and market processes and entrepreneurial activity: it is the market processes that are important here more than particular states of competition. These processes do not necessarily lead to convergence in incomes.

The evidence presented so far indicates that globalisation processes and their institutionalisation, particularly through the WTO, have weakened the effectiveness of national governments' traditional macroeconomic and microeconomic policy instruments. Furthermore, increased trade and factor mobility may be expected to increase the elasticity of demand for labour and thereby reduce labour's bargaining power. There are several possible responses to this.

The benign view of globalisation sees it as boosting growth and development throughout the world. Openness to trade and investment boosts growth, and growth raises the income of the poor and thereby reduces poverty, the argument runs (for example Dollar and Kraay, 2002). There are several grounds for some scepticism here. The link between growth and economic openness and liberalisation is weaker than this account suggests (cf. Mosley, 2000). Moreover, the widespread shift amongst developing countries to greater openness noted above has coincided with a slowdown in their growth rates compared to earlier in the post-war period; this may in part be due to deflationary biases in the global economy. The link between growth and poverty reduction is not as automatic as this account implies. Accounts of this sort typically assume a simple catch up or convergence story where poorer countries are expected to grow faster than richer ones so that income differentials will narrow over time (usually conditional on countries maintaining open, liberalised economies). However, as noted above, work in the 'new economic geography' has shown how integration under external scale economies can lead to spatial inequalities. Other evidence indicates that apparent estimated income convergence processes may actually be leading to a 'twin peaks' distribution of income levels with the emergence of two (or more) groups of countries at different income levels (Quah, 1997). This is at the level of countries; at the level of individuals, claims that global inequality fell between the 1980s and 1990s are not supported by the evidence (Milanovic, 2002; Wade, 2001).

This is not, however, to endorse the radical version of the hyper-globalisation position. Whilst this highlights inequities in global exchange – notably developed country governments preaching trade liberalisation whilst maintaining barriers to products (particularly in agriculture) – it is too limited a perspective. Trade and international capital flows do provide important potential gains, even though these have often been exaggerated, and their distribution – both between countries and within them – remains uneven. Despite the pressures of globalisation, countries are still able to maintain welfare states, whilst globalisation does offer possibilities for growth by developing countries even though this is much less automatic than triumphalist accounts suggest. The global problems this perspective highlights – notably environmental degradation and persistent poverty – are just that: global. They would not cease if globalisation processes were reversed; nor is the record of autarchic societies encouraging. The 'take-it-or-leave-it' view of globalisation informs many politicians, opinion makers and activists in a way that is misleading and unhelpful in its prescriptions. Conceiving globalisation as either an inexorable force we must live with or something to be resisted as we retreat to small-scale local economies does not provide useful guides as to how we might manage market failures on a global scale.

The key problem here is the perspective that globalisation processes necessarily entail a particular trajectory of free market liberalisation. It is here that the sceptical position, whilst significantly underestimating the scope and impact of globalisation processes, makes several key points. National governments do retain key powers. In some respects states, especially developed countries, have more power than ever before, but the demands placed upon them are also unprecedented. The sceptical position recognises that markets are not protean entities but require governance. The key limitation of their position here is an under-emphasis on the global pressures that transform markets and an overemphasis on the efficacy of national governance of markets.

Increasingly what is needed is imaginative proposals for governance of global markets to deal with inequalities and global market failures. Although the main international economic agencies have been seen as operating to promote 'Washington consensus' policies, there are signs that the World Bank at least is shifting (Stiglitz, 2002) in part as a result of external pressure from governments and citizens' groups. Economic globalisation is a contested process and it has been accompanied by a significant internationalisation of both political authority (as governments cooperate with others in decision-making) and a corresponding globalisation of political activity. This multilateral system institutionalises a process of political coordination amongst governments, intergovernmental and transnational agencies – public and private – designed to realize common purposes or collective goods through making or implementing global or transnational rules, and managing trans-border problems, for example the WTO. Of course, it is scarred by enormous inequalities of power, and remains a product of the inter-state system. But it has, nevertheless, created the infrastructure of a global polity and new arenas through which globalisation itself is promoted, contested or regulated. Further reform and integration of institutions is desirable; in this context the decoupling of trade issues from environmental and labour issues may be helpful. The late twentieth century has seen the emergence of global economic processes of an unprecedented scale becoming deeply enmeshed with national and local economic processes. The nature of these processes has radically changed the costs and benefits of particular economic activities and national economic strategies. The task of political economy in an era of globalisation is to adapt existing theoretical tools to explain these developments and to suggest what policy tools may be effective for managing them.

Notes

1. See Baldwin and Martin (1999), Bordo *et al.* (2000), Held *et al.* (1999), Perraton (2001).
2. An explanation of the term 'extensity' is located in Chapter 7 (p. 140) of this volume.
3. These figures of course are for recorded trade; the United Nations (UNDP, 1999: 5) estimated that the global illegal drugs trade alone was equivalent to 8 per cent of world trade in 1995. More generally, global links and technologies have aided the 'dark side' of globalisation with the emergence of global criminal networks (Strange, 1996: ch. 8).
4. Nor is it clear that export growth would facilitate economic growth to the same extent as in the NIEs.
5. Note that here the comparison with the classical Gold Standard period doesn't help the sceptical argument much: O'Rourke and Williamson (1999) found significant convergence in factor incomes through trade during that period.
6. See Wood (1994; 2002), the Policy Forum on 'Trade and Labour-market Adjustment' in *Economic Journal*, **108**(450) (1998) and *Oxford Review of Economic Policy*, **16**(3) (Autumn 2000).
7. The main potential sources of underestimating the trade effects are that: studies typically only consider manufacturing and not trade in services; technical progress may in part be induced by foreign competition; and intra-industry shifts in labour demand may be induced by trade through out-sourcing.
8. OECD, *Measuring Globalisation: The Role of Multinationals in OECD Economies*, 2001 volume (Paris: OECD).
9. Figures for the UK are probably even higher (cf. Held *et al.*, 1999, p. 224).

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3 Measures of globalisation and their misinterpretation[1]

Bob Sutcliffe and Andrew Glyn

Almost everybody seems to believe that globalisation is happening at a headlong pace, and is the defining characteristic of contemporary capitalism. Some like it, others see it as the source of all evil. But most see it as both unprecedented and irresistible. In an earlier paper (Glyn and Sutcliffe, 1992) we analysed indicators of economic internationalisation in their historical perspective and found reason for serious scepticism with regard to the image of world capitalism presented by those who believe that it has been unprecedentedly transformed by globalisation; similar points have been made by a variety of authors from various perspectives (Sachs and Warner, 1995; Hirst and Thomson, 1996). This chapter seeks to reinforce this 'globalo-scepticism', paying particular attention to why different statistical measures of recent trends suggest alternative conclusions and to which of them are the most meaningful.

We do not question that globalisation in one of its meanings – the world-wide spread of capitalist relations in production and distribution – has been a major feature of the last 50 years. This has taken the form of the decline in peasant production, the absorption of domestic workers, mainly women, into the paid labour force and most recently the decline of state productive activity in both communist and non-communist countries.

The globalisation debate, however, is mainly couched in terms of another concept: the increasing international integration of economic activity. This is seen to have been the central event of the current epoch of world social and economic development. Some see it as the whole process of post-World War II development, others more as a phase in that development which has been especially marked since the late 1970s and is associated with other features of that period such as the growth of neo-liberal economic ideology.

It is our opinion that the degree of globalisation in this sense, as well as its novelty, has been greatly exaggerated. Consider the following two paragraphs:

1. An ever-increasing proportion of the world's production is sold outside the countries where it was produced. International trade has grown more than production in every year since 1945. And over the whole period

since then foreign investment has grown even more rapidly than trade. Capitalist corporations operate increasingly in more than one country; and the value of the world-wide sales of MNCs and of their associated companies comes to more than one third of the gross product of the world. The number of MNCs has risen from 7000 in the early 1960s to more than 60 000 in the year 2000.

2. The immense majority of what is produced in the world is consumed in its country of production, as it was in 1913. This percentage may grow because services, which are traded less than goods, are increasing disproportionately. The largest MNCs now produce a lower percentage of output in the USA than they did in 1977. The value of the sales of branches of US and Japanese MNCs is growing more slowly than the world economy as a whole. No more than 12 per cent of the world's capital stock is foreign-owned; foreign investment is not much greater in relation to world output than it was in 1913.

Which of these two cameos corresponds to the real face of capitalism today? The answer is that this question is like the famous optical illusion puzzles in which one line looks longer than the other when they are really exactly the same length. Both the sentences are based on exactly the same body of information. They simply select and present it in a different way. To reach the right answer you have to use the right technique for looking. When assessing quantitative indicators, there can be differences of opinion over whether some measure is large or small, whether some trend shows an important or an unimportant change. But a precondition for such debate is an analysis of what indicators are most appropriate. Many people seem to have an exaggerated impression of the present degree of globalisation, in most of its dimensions, and of its rate of increase, in at least some respects. Our objective in what follows is to lay out as clearly as we can what seem to us to be the best measures of globalisation, focusing on trade, foreign direct investment and importance of multinationals (the internationalisation of financial flows is less contentious).

International trade in goods and services

Probably the most widely known 'fact' about the world economy today is that never has so much of world output been exported to other countries, in other words trade as a proportion of production is unprecedentedly high. In his authoritative overview of historical trends Maddison (1995, pp. 37–38) measures the degree of trade integration by the ratio of merchandise exports to GDP at constant prices. This gives dramatic results for Europe in particular – the export ratio declining from 16 per cent in 1913 to 9 per cent in 1950 before rising to 21 per cent in 1973 and 30 per cent in 1992. It appears that the importance of trade has tripled since 1950 and now far exceeds its weight in the economy reached at the end of the classical free trade period, and such figures are widely quoted in discussions of globalisation (see Rodrik, 2000 and Bourguignon *et al.*, 2002).

A rising share of exports, measured in constant prices, implies that the volume of exports has grown faster than the volume of production overall, a comparison frequently made to demonstrate the growing importance of trade. For example exports grew by 5.1 per cent per year for the EU-15 over the period 1970–99 against the 2.4 per cent per year growth rate for GDP (OECD 2001: tables 3.1 and 4.8). Such constant price comparisons, however, exaggerate changes in the weight of exports in the economy.

This is because the prices of exports rise systematically more slowly than do prices for output as a whole. For the EU-15 over the period 1970–99 the deflator for exports rose by 4.3 per cent per year whilst the GDP deflator rose by 5.8 per cent per year. So over this period around half of the discrepancy between export and GDP volume growth was offset by a slower growth of export prices. The fall in the relative export prices reflects the faster than average growth of labour productivity in the export sector compared to the economy as a whole. For example, over the period 1960–94 labour productivity in EU manufacturing, where exports are concentrated, grew at 4.1 per cent per year whilst GDP per person employed increased at only 2.7 per cent per year. This relatively rapid productivity growth in the export sector means that the share of employment devoted to exports grew systematically more slowly than the share of exports in output at constant prices. It is the share of export at current prices which most closely reflects productivity gains and thus the share of resources devoted to exporting activity. This measure shows a less dramatic change than the constant price figures.

In fact, in 1999 the shares of exports in GDP at current prices exceeded the levels of 1913 by a comparatively modest degree (Table 3.1). This is true for the OECD countries in total and for the USA, Europe and Japan taken separately. Whilst such an historical perspective is interesting its relevance to discussions about constraints on post-1945 systems of national economic management may seem limited (see Bairoch and Kozul-Wright, 1996 for discussion of the pre-1914 period). Much more significant from that point of view is the post-war period experience. Despite the recovery of world trade in volume terms, trade shares recovered quite slowly in the 1950s and 1960s when manufacturing productivity was growing very fast and thus the relative prices of exports were falling. Export shares then increased markedly in the early 1970s as OECD countries exported more to oil producers and developing countries to pay for the higher cost of oil. In the last quarter century, with globalisation apparently in full spate, export shares have risen only by one quarter in the USA and the EU and in Japan have actually fallen.

Table 3.1 Exports as percentage of GDP, 1913–94

Current prices	1913	1950	1960	1974	1989	1999
USA	6	4.6	5.2	8.5	9.4	10.7
EU	22	16.7	19.1	25.9	28.0	32.1
Japan	20	11.8	10.7	13.6	10.6	10.4
OECD	16	10.5	12.3	17.0	18.0	22.1

Source: OECD 2001 for 1974 and later years; linked to OECD, *National Accounts of Member Countries*: figures for 1913 assume that the differences as compared to 1950 are equal to those estimated by Maddison for Merchandise Exports only (1991: Table F7).

Whilst the ratio of current price exports to GDP is the best measure of the trend in the importance of production for overseas markets it is subject to one upward bias. Exports include an import content so that their value exaggerates the value-added contributed to them by the domestic economy. Thus before comparing exports to GDP the import content should really be subtracted. A crude adjustment suggests that some 26 per cent of European GDP was devoted to export production in 1999 rather than 32 per cent in the unadjusted data.

The upshot is that the best simple measure of the trend in the direct importance of trade for the domestic economy is the export share at current prices. This shows a relatively modest rise over the past 25 years, contrary to the exaggerated impression derived from constant price series. Even the current price export shares exaggerate the level of trade dependence because of the inclusion of the import content of exports.

The export share shows the proportion of economic activity which has to compete internationally on world markets. In a developed country with a classical structure of imports – raw materials, food and fuel – they represent interdependence but are complementary to domestic production, not in competition with it. But now imported manufactures represent an additional competitive pressure on substantial sections of the economy over and above that derived from export markets. Table 3.2 shows that the classic division of labour has been unwinding for OECD countries as the share of imported food and materials slipped down; over the past decade falling oil prices have even reduced the share of imported energy to below that of 1964. Thus the share of manufactures in total OECD imports grew over the past 40 years from one half to four-fifths. As Feenstra (1998) has emphasised many of these manufactured imports are intermediate goods – semi-finished and components.

The impact of international competition within domestic economies is most clearly displayed in the degree of import penetration of the domestic market for manufactures (Table 3.3).

Table 3.2 Product composition of OECD imports

	Food	Materials	Energy	Machinery	Other Manufacturing
1964	18	16	11	19	34
1974	12	11	22	21	34
1989	9	6	10	34	41
1998	8	4	7	40	41

Source: OECD 2001: Tables 12 and 13.

Table 3.3 Import penetration of domestic markets for manufactures, 1913–99

	1913	1950	1963	1974	1989	1999	From 'South' 1999
USA	3	2	3	6	14	21	9
Japan	34	3	4	5	5	6	5
Europe	13	6	11	17	21	29	8

Note: The figures represent imports as a percentage of apparent consumption (production plus imports less exports). Data for Europe are simple averages of UK, Germany, France and Italy

Source: 1913–63 Batchelor *et al.*, 1980: table 3.3; 1974–1999 authors' calculations from OECD Stan Database, 1998 and 2001 editions. There are minor breaks in the series after 1950 and after 1963 and for Germany after 1989. The figure for imports from South (non-OECD plus Korea and Mexico) are derived from totals for 1999 and share of South in 1996 reported in Landesmann *et al.*, 2000.

Increasing import competition was noticeable even in the 1950s and, with the important exception of Japan, it has continued unabated with import market shares doubling in Europe after 1974 and rising more than threefold in the USA. Most of this competition comes from other OECD countries. Imports from the 'South', however, have grown rapidly and now take nearly one tenth of domestic markets in the USA and Europe.

The basis for the general impression of sharply increasing international integration through trade surely lies in this growing penetration by imports of domestic manufacturing markets. But manufacturing only constituted 18 per cent of OECD employment in 1999 (ranging from 15 per cent in USA to 24 per cent in Germany); for OECD this represents a decline of one third as compared to 1974. Does globalisation amount, therefore, to increasingly fierce competition about a diminishing and relatively small, but publicly highly visible, sector?

The significance of manufacturing is underplayed by its share of employment since other sectors contribute substantially to manufactured commodities. So part of the output of agriculture, mining, energy, construction, transport and finance and business services is dependent on the success of domestic manufacturing. Thus bits of these sectors are, at one remove, subject to the international competition within manufacturing markets. Data for the UK in the mid-1990s suggest that the inclusion of intermediate inputs increases the weight of manufacturing by one half as compared to its contribution to value-added or employment. If we extended the calculation to include the value of agricultural and mining output (which is extensively, if far from freely traded internationally) it would seem that around 30 per cent of the UK economy is directly or indirectly contributing to the production of internationally traded goods.

Of course some services are traded directly as well. In the mid-1990s OECD exports of commercial services were about 25 per cent of exports of goods and for the USA the figure was 35 per cent. But these are concentrated in a narrow range of specialised services (international transport, international finance, consulting and so forth) and are irrelevant for the mass of domestic service producers (tourism is one exception, being in competition with a broad range of domestic services). There is no obvious way of quantifying what part of services is seriously internationalised; but any plausible estimate would leave a majority of employment in OECD countries, possibly a substantial and probably a growing majority, largely untouched by international competition. Outside agriculture, mining and manufacturing only a small proportion of workers are subject to international competition directly or indirectly through services provided to traded goods sectors. Wholesale and retail trade, community, personal and social services, utilities and construction together employ some 60 per cent of employment in the OECD as a whole, rather more in the USA (calculations from OECD *Labour Force Statistics*). These sectors are almost wholly insulated from international competition through trade; in Japan where the proportions employed in these sectors is rather less, there is exceptionally little import competition in manufacturing.

The impact of internationalisation through trade, therefore, is quite complicated. For one section of the economy, manufacturing production and its suppliers, together with some specialised enclaves in the services sector, internationalisation has intensified considerably in the USA (from a very low level) and in Europe, but much less in Japan. For the rest of the economy, covering probably a growing majority of those in employment, international competition is of little direct relevance, though even the 'sheltered sector' is affected by the macroeconomic consequences of the success or otherwise of the traded goods sectors.

One reason for the impression of pervasive internationalisation is that a substantial part of the sheltered sectors deals with imports even if it does not compete with them. Thus the retail sector, for whom international competition is largely irrelevant, sells an increasing proportion of imported products (or products which copy foreign products – witness the croissantification and bagelisation of UK supermarkets), garages service imported cars, insurance companies cover imported VCRs and so on. Many services deal with and are ancillary to goods even if they are not involved in their production, so that the increasing internationalisation of goods production may be highly relevant to them. Their position on the domestic market may even be threatened if they do not keep as abreast of information on new overseas sources of supply as their domestic rivals. This overseas competition in the goods in which they deal increases both the informational complexity and unpredictability of their business. But the economic consequences of this relationship to the world economy are shallower than when maintenance of their position on the domestic market depends on their costs relative to those of overseas producers.

Foreign direct investment

Foreign direct investment (FDI) rose rapidly in the final decades of the twentieth century. UNCTAD's *World Investment Report 2002* calculates that the inward stock of FDI in developed countries increased from 4.8 per cent of GDP in 1980 to 8.1 per cent in 1990 and jumped to 17.1 per cent in 2000 (for outward FDI the figures are 6.2 per cent, 9.6 per cent and 22.1 per cent). Although the increase seems impressive, comparing a stock of FDI to GDP does not directly measure its significance. For the OECD countries the ratio of non-residential capital stock to GDP lies in the range 2–3. In order to allow for historic cost valuation of FDI (meaning its undervaluation in current cost terms), we will take the minimum figure of 2 as a rule of thumb, thus assuming that the share of FDI in the domestic capital stock is about one half its ratio to GDP. This suggests that foreign ownership of productive capital does not amount to much more than 10 per cent of the total for the OECD countries. Using the same rule of thumb, the figure for the developing countries would give a higher figure of about 15 per cent. According to these estimates less than 10 per cent of the world's non-residential capital stock is foreign-owned (UNCTAD 2001, Annex Table B6).

Another, probably more reliable, method of arriving at this result is by looking at the figures for flows of FDI compared to the corresponding flow of domestic investment (Table 3.4). These figures are not subject to the accounting biases caused by historic cost valuation. They show what the share of the capital stock represented by FDI would be if the flow continued at that rate.

In recent years the proportions of capital expenditure represented by FDI, as shown in Tables 3.4a and 3.4b, have varied within the range of 3–22 per

Table 3.4a Foreign direct investment, 1990–2000

% of Gross Domestic Investment	WORLD		Developed countries		USA		Japan		European Union	
	90–95	96–2000	90–95	96–2000	90–95	96–2000	90–95	96–2000	90–95	96–2000
Inward	4.1	12.6	3.6	12.8	4.3	12.4	0.1	0.5	5.5	21.8
Outward	4.8	10.2	5.5	15.2	6.1	8.8	2.2	2.1	7.7	30.5

Source: UNCTAD 2002: Annex Table B5.

Table 3.4b Foreign direct investment, 1990–2000

% of Gross Domestic Investment	DEVELOPED						DEVELOPING					
	1990–95	96	97	98	99	2000	1990–95	96	97	98	99	2000
Inward	3.6	4.8	7.4	11.0	16.5	22.0	5.7	9.1	11.1	11.4	13.4	13.4
Outward	5.5	7.3	8.9	13.9	20.1	25.0	2.5	3.8	4.0	3.1	3.5	5.8

Source: UNCTAD 2002: Annex Table B5.

cent: at first higher in developing than developed countries, though now the reverse and lower in Japan than in the rest of the OECD. The relative size of FDI was generally less in the early 1990s than it had been in the late 1980s, but then, as the tables show, rose very rapidly in the second half of the decade. In the year 2001 FDI once again experienced a sudden collapse, the value of the flow being less than a half of the previous year; only a small part of this fall has been attributed to the effect of the September 11 attack (UNCTAD 2002, Chapter 1). These figures are consistent with the previous rough estimate that FDI as a proportion of capital stock world-wide cannot be more than 10 per cent and is almost certainly less than this: the foreign share of current investment in developed countries has only exceeded this level in the latest three available years.

Is 10 a large or small percentage? It has certainly grown over the last three decades and especially rapidly in the second half of the 1990s. But it is still a good deal smaller than is commonly supposed. It is now probably greater than its previous historical peak, though not by a large margin. Estimates of the size of foreign direct investment before its collapse after 1913 suggest that it amounted to between 7 and 9 per cent of world output, somewhat below today's figure (Maddison, 1995; Bairoch and Kozul Wright, 1996).

There are a number of reasons why the weight of foreign investment may be still less than these figures suggest. One is that the recent flow of FDI to developing countries has been concentrated in very few countries. Over one third of the higher figure for inward FDI to developing countries during the 1990s is accounted for by China alone. And most FDI into China comes not from developed countries but from other overseas Chinese capitalists in other Asian developing countries so it does not correspond to the common image of FDI as Western multinationals expanding throughout the world.[2] In addition, not all FDI consists of the construction of new production facilities by overseas companies, thus generating a clear increase in competition through internationalisation. Well over half of FDI inflows into OECD countries represent cross-border mergers and acquisitions. In the year 2000 the estimated value of cross-border mergers and acquisitions was over 90 per cent of the value of the total FDI flow. Some, but by no means all, of these mergers and acquisitions result in international intrusion into the competitive structure of the industry, just like a new plant or office. Other acquisitions are closer to portfolio investments, involving a change in ownership but with relatively little impact on industry behaviour. So that is another reason why FDI does not always have the results which are commonly ascribed to it. In addition, a considerable part of the acquisitions were the result of privatization policies which must tail off as state sectors decline: so the relative amount of FDI for this reason is likely to flag.

The sectoral composition of FDI is less biased towards manufacturing than foreign trade. In the 1990s around one half of outward FDI from major home countries was in the services sector (two thirds in the case of Japan). Obviously FDI can reach into parts of the service sector immune from direct competition from imports (for example Macdonalds) and this represents some qualification to the remarks above about the insulation of large parts of the services sector. As yet, however, the impact on services overall is still very much smaller than for manufacturing.

Firms

Both popular and scholarly perceptions about globalisation are based to a great extent on perceptions about firms. It is the multinational corporation (MNC), as agent of globalisation, which plays a starring role in nearly all the theoretical approaches to the contemporary world economy. The MNC, however, can be hero or villain. By some it is regarded as the modern incarnation of the finance capital which the classical Marxist writers on imperialism regarded as so important and by others as the confirmation that the age of which Hilferding, Bukharin and Lenin wrote has been superseded.

Firms are seen as the centrepiece of globalisation either because they are large and getting larger relative to the world economy or because they are multinational and becoming more so. As to the size of firms and their concentration it remains extremely difficult to find satisfactory estimates of the degree of concentration of national (let alone world) output by numbers of firms. Firms are usually ranked in terms of the size of their turnover. This is not the same as their contribution to the value of production since it is a gross and not a net (value-added) figure. Companies in which raw materials or semi-finished goods constitute a large part of costs, and that buy these inputs from other firms will have a turnover greatly in excess of their net contribution to such aggregates as the GNP. But, despite this elementary fact, most assessments of the relative size of large firms or MNCs in the world economy are carried out by comparing turnover with GNP. This is not comparing like with like and will give us an exaggerated number. One often quoted conclusion is that the world is 'controlled' by the largest 200 companies (defined by total sales) which had a turnover equal to 24.2 per cent of World Product in 1982, rising to 31.2 per cent by 1995 (Clairmonte and Kavanagh, 1994; Clairmonte, 1997). This calculation is misleadingly presented as the 'share of the 200 in world GNP' and is often referred to with such misleading phrases as 'the large MNCs control more than a third of the world's production'. Such figures are based on double-counting: the sales of one corporation include the value of those products and materials which it has bought from suppliers. But an estimate of a firm's contribution to the national product is a much more difficult figure to obtain and, in the absence of a large amount of research, the only way to calculate it is by means of another rule of thumb, this time relating value-added to sales. We will probably not be far wrong if we take a ratio of 3:1 as the average ratio of sales to value-added.[3] Applying this to the estimates of the importance of the 200 largest firms we would arrive at the conclusion that they accounted for about 10 per cent or less of World Product instead of the frequently heard estimate of nearly one third. This figure is broadly consistent with the estimate that in the year 2000 the 100 largest firms ranked by value of foreign assets (almost all of which are included in the top 200 firms ranked by turnover) owned (at home and abroad) assets worth about $6300 billion (UNCTAD, 2002) which amounts to a little under 10 per cent of the world's capital stock (estimated by the rule of thumb mentioned in the previous section).[4] Even this figure must be an upper limit since it includes the assets of affiliates which are not wholly owned by the parent companies.

In the debate about globalisation large firms and multinational corporations have become virtually interchangeable concepts. But figures for the concentration of world production in a certain number of firms do not in themselves imply anything at all about the multinationality of those firms. All the firms could in principle be purely national in their operations. So it is necessary to look at data specifically about multinationality.

A corporation could be classified as an MNC according to where it sells, where it produces, whom it employs, who owns it, where it has its offices and so on. There is no official definition and so one source may be using completely divergent criteria from another. What is most nearly coming to be an official definition of an MNC is that which is used by UNCTAD's annual *World Investment Report (WIR)*. In a series of annual reports on international production and investment the *WIR* has come to use the following very inclusive criterion: a firm which has at least one foreign subsidiary (defined as a firm in another country with more than 10 per cent of the equity owned by the parent company). This means that a company with only one marketing subsidiary of which it owns only 10 per cent of the equity is regarded as a multinational.

It is not surprising to learn that on the basis of that broad definition there are no fewer than 64 592 MNCs in the world at the last count, having between them at least 851 167 foreign affiliates, an average of 13 each (UNCTAD, 2001); many of these MNCs would not have enough affiliates to put them in the category of multinational as alternatively defined by the Harvard Business School (subsidiaries in at least six countries). If the *WIR* definition is far too inclusive to define an entity which many say is qualitatively changing the world, it is still important that the number of firms that are thus weakly defined as MNCs rose from around 7000 in 1960 to nearly 65 000 in 2001. There is no doubt that in some sense that is a sign of more international or globalised times, although a high proportion of this growing number of affiliates cannot be more than marketing agencies for the products of the parent.

Most of the MNCs defined in this way are not giant companies. The *WIR* figures do not allow any estimate of the average size of the parent companies. The average turnover of their foreign subsidiaries, however, is just under $22 million, and on average they each produce value-added of about $4 million and employ 62 people (UNCTAD, 2002, Table 1.1, p. 4 and Annex Table A.1.3, p. 272). Since nearly 60 per cent of the subsidiaries are in developing countries which account for only 30 per cent of the stock of foreign capital this implies that the above world average figures should be roughly halved for the developing countries and multiplied by about six for subsidiaries in the developed countries, which account for 12 per cent of the subsidiaries and nearly 70 per cent of the investments. (The missing figures are accounted for by Central and Eastern Europe).

The *WIR* estimates (generalising from US and Japanese data) that the gross output produced by these subsidiaries (in GDP terms) was equal to a little under 11 per cent of the world's GDP in the year 2000. The World Bank (1997a), using a different methodology, reached the compatible estimate of 7.5 per cent for 1995. The distribution of this output by sectors is shown in Table 3.5. Employment in their subsidiaries amounts to 1.5–2 per cent of the world's active population, which probably means about 4 per cent of employed labour.

These numerical estimates of the importance of multinational corporations are neither large nor small in themselves. They are large in relation to recent past experience, much less so in a longer term comparison, and quite small in relation to presumptions common in discussions of globalisation.

Table 3.5 National and 'global' production (percentage of total world GDP)

Sector	Agriculture	Industry	Services	Total
Location of output:				
National	5	26	61	92
Global	0	5	2	7
Total	5	31	63	100

Note: National production is production by enterprises in their own country, 'global' production is production of foreign-owned enterprises. Totals do not equal 100 due to rounding.

Source: World Bank 1997a and 1997b.

A common perception about multinational firms is that they are increasingly developing globally integrated production in which the firm produces final products from components which it manufactures in plants in many different countries. There are a number of widely publicised examples of this and a number of spectacular failures of such a strategy. The spread of integrated production implies a rising proportion of international trade taking the form of intra-trade between branches of the same firm. Despite this common view it is extraordinarily difficult to find satisfactory estimates of the importance of this trade. The only authoritative figures seem to be for the USA and Japan between 1983 and 1999 (UNCTAD, 1997; OECD, 2002). The *World Investment Report* has estimated that intra-trade in the USA rose between 1983 and 1992 from 33 to 36 per cent of exports and from 35 to 40 per cent of imports; and in Japan intra-trade rose from 22 to 28 per cent of exports and fell from 15 to 14 per cent of imports. A more recent survey by the OECD calculates that between 1990 and 1999 US intra-trade rose for exports (from 33 to 36 per cent) and fell for imports (from 44 to 39 per cent); for Japan there was a sharp rise, however, during the 1990s (from 17 to 31 per cent for exports and from 15 to 24 per cent for imports). The OECD report speculates that the intra-firm percentage has risen especially fast in trade between a few middle-income countries and richer countries (especially Mexico and the USA due to the *maquiladoras*). While intra-trade is important and growing, it is much smaller than is claimed by widely read writers on globalisation who frequently quote much higher figures (up to 92 per cent for US trade) with no basis in fact (Reich, 1993, p. 114). The figures quoted above suggest that intra-firm transactions may account for about one third of international trade, a figure which has been circulating for at least 30 years, though with very little empirical backing. The figures for the USA are fairly stable, though those for Japan are rising. This fact is connected with the nature of intra-firm transactions. The bulk of this intra-trade is almost certainly not the result of globally integrated production but of the increasing use of marketing subsidiaries by multinational corporations, especially in industries such as electronics, computers and vehicles; for example, two-thirds of US imports by foreign-based multinationals are of this kind (OECD, 2002, p. 163).

All the figures quoted above do not tell us very much qualitatively about the institution of the MNC which so many people think defines our age. The history of the species depends on how it is defined. Observations about MNCs are based on many different definitions. If the MNC is a company that sells its product in foreign markets then there are hundreds of thousands of them and they have been common for centuries. If it is one with marketing subsidiaries abroad, then there are tens of thousands of them and they have existed for many decades. If it is one with production subsidiaries abroad then there are thousands of them and they have existed for many decades. If it is one that practises international integration of production then there are probably a few dozen of them, though they are so often remarked upon and described that you would think that there were more. If it is one with significant ownership in more than one nation then there may also be a few dozen at the most. If it is a company with more than one basic national origin, then there are probably two (Royal Dutch Shell and Unilever) and they have both existed for many decades. If it is a company that is so international in ownership, production and management that it no longer has a basic nation state then we are not convinced that there are yet any: such a beast would be a future mutation (Ruigrok and van Tulder, 1995).

There is in our view rather little evidence here for the view that the multinational corporation has suddenly transformed the world. Rather there is the continuation of very long-term tendencies towards industrial concentration going on at a speed of 'glacial drift',[5] and considerable evidence that more and more firms, especially medium and small ones are beginning to operate at an international level. Despite general perceptions to the contrary, the tendency is not so much that some predefined beast – the largest and most famous of the multinational corporations, such as Shell, Nestlé, Unilever or General Motors – have been controlling very much more of the world economy, but that the nature of the beast has been changing; globalisation has meant more that a growing number of companies have global interests rather than that a given number of companies directly control more of the globe.

Finance

Our review of the facts about globalisation has concentrated on issues of production. There is less dispute about the huge expansion of international financial flows; cross-border bank lending and transactions in bonds and equities have grown spectacularly (BIS, 1997). The daily turnover of the foreign exchange market, now more than $1500 billion, is six times the total gross central bank intervention during the 1992 ERM crisis (Eichengreen and Wyplosz, 1993). Such explosive growth of international financial transactions renders exchange rates wholly dependent on shifts in market expectations.

However, many such transactions represent reshuffling of existing portfolios and do not increase the degree of internationalisation of ownership of financial assets. The UK case is interesting as a medium sized country with a highly developed, and internationally very integrated capital market. By the end of 2001 37 per cent of UK company equities were owned abroad as were 18 per cent of UK government bonds. UK life assurance and pension funds held 22 per cent of the assets in the form of foreign equities and bonds. In each case the percentages had increased very sharply over the past 20 years, though households still hold virtually no overseas financial assets. It is still the case, however, that the majority of portfolios are invested in financial assets emanating from the domestic economy and that the majority of domestic financial liabilities are due to domestic residents. It is possible to envisage a situation where ownership of financial capital is so internationalised, and portfolios are so diversified, that clearly identifiable national blocs of capital will cease to be very significant. We are certainly not there yet.

Conclusions

Historical economic trends are often exaggerated. Globalisation is one. We do not mean that there has been no important process of globalisation going on in the last 50 years. But we are certain that at the present time its extent and significance have been misinterpreted; and in general the misinterpretation has leaned in the direction of exaggeration. The exaggeration has resulted from a number of interpretive tendencies:

- inappropriate statistical measures have been used (for instance, the use of constant price data to measure the importance of trade, or comparison of the turnover of firms with national output figures);
- upward trends have been assumed for variables where very few reliable observations exist (such as the percentage of intra-trade of multinationals in total trade);
- recent and present measures of globalisation have been taken to indicate a situation that is historically unprecedented, whereas the world economy might be better seen as restoring normality after a long mid-century global crisis rather than changing itself into something completely new;
- the growth of some variables has seemed remarkable in absolute terms while relatively they are much less impressive (as in the case of foreign direct investment);
- little attention has been paid to the analytical reasons for limits to globalisation (such as the growing importance of services);
- counter-globalisation tendencies have been ignored (such as the growing restriction on human migration);
- insufficient argument has been made that recent quantitative changes have resulted in qualitative ones.

This short chapter has left aside the qualitative questions in order to examine critically some of the commonly held quantitative notions about international economic integration, in the hope that this will do something to clarify what is today surely the central debate in international political economy. We do not wish to suggest that globalisation is neither large nor important. But we do wish to say that a look at the quantitative evidence shows that it is a gradual rather than a sudden process and that it has not in general reached unprecedented levels. Exaggeration on both these scores will lead to inappropriate interpretations and political reactions to globalisation.

We do not believe that any specific political conclusions follow from this chapter. But it does suggest some very general points. The main one is that the exaggeration of the degree of globalisation has given rise to (or has been used to justify) a sense of impotence among many on the left. Globalisation seems to explain why national political plans always go wrong: it is because the national state has lost independence due to globalisation. The future of left politics, therefore, seems to depend uniquely on the possibility of building an international political movement to combat globalised capital and the de facto international state. And since to many that prospect seems very difficult and distant, the implication is political impotence for the foreseeable future. In our opinion this fatalistic perspective would be wrong even if globalisation has advanced much further than we believe it has. It is not true that the consolidation of the national state rendered local institutions powerless and local politics redundant. No more should globalisation render redundant the politics of smaller units including the national state. But changing global structures will tend to alter the political areas in which local or national autonomy exists. There is no reason to suppose that it will eliminate their importance.

Nonetheless, any degree of globalisation (including that which existed before it became a buzzword) does seem to us to demand greater internationalisation of political perspectives and action, whether it be international trade union action in relation to multinational corporations or international cooperation of progressives over human and civil rights, especially when these have a clear international dimension, such as questions of asylum rights, immigration rights and so on. There is a marked imbalance between the globalisation of the movement of money and things and the opposite tendency in the movement of people. It seems to demand some redress: people should be able to move more freely, and at the same time they should find it easier to acquire democratic rights when they do move. Globalisation demands now (as it always has done) that the concept of citizenship, both from the point of view of rights and from the point of view of participation in the political process, also be globalised. The concept of international citizenship has begun to be discussed but it lags far behind the development of the ideological justification for the globalisation of money and capital markets. None of this seems to us new but globalisation at any pace makes it more urgent. It is not an alternative to national or local political action but a complement to it.

Notes

1. This is an extensively updated and slightly abridged version of our article 'Still underwhelmed: indicators of globalization and their misinterpretation' which appeared in the *Review of Radical Political Economics*, **31** (1), 1999.
2. Newspaper reports suggest that substantial inflows of FDI into China actually originate within China itself, masquerading as FDI in order to obtain tax breaks.
3. This is intermediate between an estimate for the USA of 2.8:1 (Laffer, 1969) and a ratio of 5:1 given implicitly by UNCTAD 2002 (Table 1.1, p. 10) for all foreign affiliates). DeGrauwe and Camerman have directly calculated this ratio for several large firms and find it to be between 3.5 and 4.5:1 for manufacturing and about 3:1 for services (de Grauwe and Camerman, 2002).
4. These figures plainly refute many common exaggerated impressions and claims such as the one that '[s]ome 400 multinational corporations own two-thirds of the planet's fixed assets...' (Robinson, 1996, p. 20).
5. The phrase was the conclusion of M.A. Adelman writing in 1951 ('The measurement of industrial concentration', *Review of Economics and Statistics*, **33**, November 1951: pp. 295–6), and was still regarded as appropriate by F.M. Sherer and David Ross in 1990 (*Industrial Market Structure and Economic Performance*, Boston: Houghton Mifflin Co., 1990).

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PART II

ANALYSING THE GLOBAL ECONOMY

4 Systems of innovation in a global economy

Jeremy Howells

1. Introduction

The systems of innovation approach has proved valuable in highlighting the place of *context* in the innovation process and in turn introducing and underlining the role of wider socioeconomic processes and institutional arrangements in innovative activity that were so often neglected in the past. From a nationally-based starting point, in terms of National Systems of Innovation (NSI: see Freeman, 1987; 1988; Lundvall, 1988; Edquist, 1997a), the systems of innovation approach has been considerably extended as a conceptual construct. Thus, Chris Freeman (1987, 1) originally defined the systems of innovation concept (from a national perspective) as 'the network of institutions in the public and private sectors whose activities and interactions initiate, import, modify and diffuse new technologies'. The concept and definition has been widened and developed over time (see reviews by Lundvall, 1992b; Nelson, 1992; Nelson and Rosenberg, 1993; McKelvey, 1994; Freeman, 1995; Edquist, 1997b; Archibugi et al., 1999), but it is these institutional and infrastructural settings (which were initially reviewed at a national level), which frame the search, exploration and learning processes involved in innovation, that remain the foundations of the approach and its perspective (Lundvall, 1992b, 12; Galli and Teubal, 1997, 351–3) at whatever scale. Thus, in spatial terms the application and conceptualisation of the approach has moved in terms of its exploration and development as a concept, both 'up', to Global Systems of Innovation (GSI; see, for example, Spencer, 2000), and 'down', both to Regional Systems of Innovation (RSI; see Cooke *et al.*, 1997; Howells, 1999) and to Local Systems of Innovation (LSI; see, for example, Acs *et al.*, 1998). It has also been applied within a more non-spatial, 'localised' sense via a sectoral perspective in terms of a Sectoral Systems of Innovation framework (SSI; Breschi and Malerba, 1997; see also Carlsson and Stankiewicz, 1991; and Carlsson, 1995 regarding technological systems).

From a global perspective all these developments of the systems of innovation model serve to suggest that innovation, far from taking a uniform, rootless and spaceless nature, is influenced by its context and will remain highly uneven, distinctive and differentiated in form. Thus, 'Innovations are not evenly distributed over the whole economic system at random, but tend to concentrate in certain sectors and their surroundings.' Schumpeter (1939, 111). This has been acknowledged at a geographical level where it has been long recognised that innovation and its processes are highly differentiated across space (see, for example, Ullman, 1958, 193).

This chapter explores the special attributes of the system of innovation approach, how the approach has developed over time and what contribution it provides in terms of aiding our understanding of the global economy. The analysis will conclude by highlighting the gaps that still remain in our conceptual and analytical frameworks both in terms of the approach itself and in relation to the issue of globalisation more generally.

2. Systems of innovation: its contribution and development as a conceptual approach

What insights and attributes does the system of innovation approach bring to the study of innovation? It is argued here that the system of innovation approach brings five attributes that are useful and insightful to the study of innovation in a globalising world. These five qualities are briefly outlined below.

2.1. Context

Firstly, as noted earlier, the development of the systems of innovation approach has been important in highlighting the context of the innovation process and in turn factors that shape local innovation contexts (Carlsson and Jacobsson, 1997, 268). Certain environments are conducive to innovation, others not (Tödtling, 1995). The systems of innovation approach has sought to identify those elements of the system, such as institutions and the technical infrastructure, that are significant factors in helping to shape the innovation process. However, in evolutionary terms there is also the Darwinian issue of selection processes at work here. On the one hand, good innovation environments make it more likely that innovations will be generated and succeed, leading to a strong process of cumulative causation and positive feedback processes. On the other, though, certain system attributes (associated with the emergence and growth of institutional rigidities; Hodgson, 1989, 89–91), may stagnate and ossify, leading to negative 'lock-in' effects and thus negative feedback processes within national or regional systems (Staber, 1996, 299).

2.2. Scale

Innovation context is therefore an important issue that has been highlighted by the approach, but also as the approach has been developed it has highlighted different system levels or scales (Oinas and Malecki, 1999). Although national systems of innovation still remain the most significant level at which such institutional contexts operate (Nelson, 1993, 518), other levels, international, regional and local, are also important foci for certain aspects of the innovation process and are worthy of study (Metcalfe, 1995, 41; McKelvey, 1997, 202; Cantwell and Iammarino, 1998, 403; Cantwell and Janne, 2000, 245). No single systems 'level' is necessarily the 'best' to view the whole innovation process. It is therefore useful to consider a variety of different system levels in helping to understand and explain innovation activity.

2.3 *Interaction and inter-connectedness*

Important in the innovation process, too, is interaction within the system (Lundvall, 1988; 1992c; Johnson and Gregersen, 1995) and the inter-connectedness of the different systems (Bunnell and Coe, 2001, 577). In this latter respect, the appropriate level at which different elements of the innovation process interact in relation to its overall task environment (associated with its geographical, sectoral, technological contexts) is an important consideration. Different national systems of innovation will increasingly trade on their particular strengths and specialities within the global economy (Niosi and Bellon, 1994; Shin, 2002). As such, different innovation systems will become more integrated and inter-dependent of each other over time, although many will still remain marginalised and largely detached from the global economy.

2.4. *Dynamic and evolutionary nature*

The systems of innovation approach can be firmly rooted in evolutionary traditions (Andersen, 1996; Saviotti, 1997; McKelvey, 1997). McKelvey (1997, 219) argues that three evolutionary elements should exist in a properly functioning system of innovation, namely: a retention and transmission of information; a generation of novelty leading to diversity; and a selection process amongst alternatives. These evolutionary functions in turn shape – but are also shaped by – individual and collective innovative activities (McKelvey, 1997, 201). Thus, the decisions and actions of agents within the system are enabled as well as limited by other agents and institutions in the innovation system (Lundvall, 1992b, 10).

2.5. *Variation, diversity and unevenness*

In combination with its emphasis on context and acknowledgement of evolutionary change, the system of innovation approach by its nature, acknowledges that there will be variation and diversity within and between systems. Indeed innovation is a central element in creating this diversity, with the generation of novelty leading to such diversity (McKelvey, 1997, 209). However, not only is diversity evident between national innovation systems, for example, it is also a desirable feature and manifestation of economic development and international specialisation (Patel and Pavitt, 1994, 92). Institutions play a clear and pivotal role in creating such diversity by enhancing (or diminishing) the ability of the system to generate and exploit new ideas (Carlsson and Jacobsson, 1997, 272). Diversity between systems therefore occurs, although within an innovation system a strong selection process in terms of technological trajectory or sectoral specialisation may 'lock in' a system (Wijnberg, 1994) and through this inertia actually reduce its variety (Metcalfe, 1995, 29).

3. Systems of innovation and the global economy: conceptual insights

The previous section outlined what particular insights the systems of innovation concept has contributed to the study of innovation, but how does it contribute to our knowledge and understanding of the global economy?

In a world that is continually changing and raising critical questions for development and growth (Dicken, 1998), the systems of innovation approach has, early on, sought to provide key answers and solutions. The systems of innovation approach has always had a strong policy focus and has sought to identify and suggest policy mechanisms that can help develop and enhance national and local system capabilities for this purpose – see especially the contributions in Lundvall (1992a) and Edquist (1997a).

However, the approach also warns against providing generic solutions to the problems of performance and developments within systems of innovation. The issue of variety and context suggests that although generic sets of policy mechanisms should be made available and considered for particular innovation systems, their selection, structure and application should vary. Strong socio-cultural, institutional and regulatory differences still remain between national systems (Bartholomew, 1997). As such, it is often misleading to assume that there is a single ('best-practice') ensemble of policies to deploy for particular nation states or regions (see Gertler's (2001, 6) discussion of this in the context of firm-level strategy). It is dangerous trying to transpose policies into different system environments. This point is emphasised by Wijnberg (1994, 319) who notes that: 'A crucial element of every systemic approach is to question the utility of copying particular elements of systems without having other elements in place that interact in an essential way with the elements copied.'

Secondly, the emphasis in the approach on diversity within and between innovation systems argues against the neoclassical, 'hyperglobist' hypothesis of globalisation (see Shin, 2002, 419). Instead it supports a more uneven, partial (indeed sometimes reversible) 'transformational' process of the globalisation of innovation which is highly variable over space and time. Individual systems of innovation will experience highly different forms of globalisation, whilst some systems may be largely excluded from the process of globalisation. Much of the variability in the state and condition of innovation systems has been seen with respect to national systems of innovation systems. However, at least in more developed parts of the world, variance at the regional level may be even more significant and persistent over time (Oughton *et al.*, 2002, 99).

Thirdly, the systems of innovation approach has been successful in recognising and evaluating the 'negative': namely, the *lack* of certain agents, resources and competencies and the identification of system *failures* and *obstacles* within the innovation system. This is compared with other agglomeration and economic development models, associated with industrial clusters and districts, which have tended to focus on highly successful, but fairly unique high technology districts and regions (which in turn have been difficult, if not impossible, to copy and replicate elsewhere). In part this respect of the 'negative', or what is lacking, may be because there has been a focus on what elements there should be for a system to exist and be successful. It has therefore been used in a diagnostic sense to identify system failures (Patel and Pavitt, 1994, 90–92) and obstacles which are hindering the overall innovative performances of national economies.

Missing elements, in terms of key agents or institutions, and the lack of links between them, suggest a partial or deformed system prone to failure or poor performance. This has obviously received attention in relation to developing or transitional economies (see, for example, Chang and Kozul-Wright, 1994; Radosevic, 1997), but is of particular interest at the *sub-national* level. Here the question is not only what elements and links within the innovation system are missing, but more fundamentally what elements and links should a regional or local innovation system possess if it is to be considered a functioning innovation system compared to the more comprehensive national innovation system arrangement. More specifically, 'What is the irreducible minimum of a system of innovation, below which it cannot be considered to exist or operate?' (Howells, 1999, 81). Paradoxically 'proper', fully functioning sub-national systems of innovation may actually be much rarer occurrences than generally supposed (Evangelista *et al.*, 2002, 184). This may have conceptual implications in terms of what elements and links a regional or local innovation systems should be expected to possess, but also suggests the practical qualities of the approach in highlighting what needs to be done in these regions or localities if they are to reap the full benefits of innovation and economic development.

4. Conclusion

It has been argued above that the systems of innovation approach has had a great capacity to evolve and be extended over time. The approach has proved flexible and has been able to accommodate other emerging areas of interest in innovation research, for example, in networks and distributed innovation processes (although see below), which have clear systemic elements to them.

However, challenges remain to the approach and its utility in analysing the changing global economy. Critics would argue that these qualities of flexibility in interpretation and ability to encompass other conceptual developments are also weaknesses, in making the approach too opaque and lacking in specificity and testability.

In part this weakness is reflected in the ongoing problems of measurement and empirical analysis within the approach (Archibugi *et al.*, 1999, 7–9). In terms of analysis and measurement there have been some shifts in the foci of analysis within the study of systems of innovation. In terms of the 'objects' (see Archibugi and Michie, 1995) of innovation, what empirical analyses there have been remain largely centred on R&D and patent activity, although a wider set of indicators is now starting to be introduced and used (based on, for example, statistics from the Community Innovation Survey; see Evangelista *et al.*, 2002, 181). Similarly, although the firm remains the most important 'subject' of system of innovation analysis, due to its coordinating role in organising search and innovation processes (McKelvey, 1997, 205), there have been few empirical attempts to analyse networks within an innovation system context. This remains an important omission as a much more thorough understanding of the relationships, communities and networks in innovation systems need to be undertaken if the process of innovation is to be fully understood within such systems (Saxenian, 1998, 29; Bunnell and Coe, 2001, 578).

Equally, for an approach that espouses a dynamic and evolutionary perspective, the study of systems of innovation remains fundamentally rooted in *nodes* or *points*, rather than in *flows*. This means that in a geographical sense it is much harder to map innovation *processes* and that the analysis tends towards a *static* rather than a *dynamic* analytical framework (although changes in node patterns over time can provide a partial perspective on system dynamics). This introduces a further weakness of the approach in its treatment of knowledge and with it, the role of individuals. There has been a continuing confusion over the difference between information and knowledge, in that knowledge requires individuals to receive, absorb and understand information (McKelvey, 1997, 207) and in this sense it is only individuals that can possess knowledge (Howells, 2000; 2002). All too often the interaction between knowledge and innovation has been considered heroically at much more aggregate levels. The mobility of individuals and the extra-local transfer of knowledge (see Audretsch and Stephan, 1996; Zucker and Darby, 1996; Zucker *et al.*, 1997; Almedia and Kogut, 1997) is one field of inquiry that needs much more research and which would yield a much richer understanding of the nature of links and relationships within systems of innovation.

Nevertheless, despite all these problems, the approach remains robust and flexible and has shown its ability to evolve and develop over time. However, it may be in its more pragmatic and applied qualities, especially in highlighting the 'negatives' in innovation systems where the contribution of the systems of innovation approach to the global economy may be truly felt in terms of helping the poorer and more marginalised systems and peoples of the world to overcome their problems.

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5 The international debt crisis

Gary A. Dymski

Introduction

This chapter reviews recent historical experience with international debt crises, with an emphasis on how economists have answered two core questions about these episodes: why do they occur, and what should be done about them? The past eight years, a period of virtually unregulated cross-border financial flows, have witnessed eight major episodes of international debt and currency crisis: the 1994–95 Mexican 'tequila' crisis, the 1997–98 Asian financial crisis, the 1998–99 run on the Brazilian real, and the 1998–99 Russian ruble/long-term credit crisis, the 2000 Turkish crisis, the 2001–2 meltdown of the Argentine economy, the 2002 attack on the Brazilian real, and the 2002 Uruguayan collapse. International debt crisis has become a defining feature of the contemporary world economy (Eatwell and Taylor, 2000).

International debt crisis arises when the sum of a borrower nation's cross-border repayment obligations cannot be met without radically altering expenditure levels or renegotiating repayment terms. Because both parties to cross-border debt contracts are not covered by a common contract law, lenders expect that borrowers' national governments bear residual repayment responsibility. Cross-border debt also typically involves exchange risk. If the debt contract is denominated in the lender's currency, then the borrower takes on exchange risk, and vice versa. A currency crisis arises when overseas payment obligations cannot be met at prevailing exchange rates. Most cross-border debt contracts are written in lenders' currencies, so international debt and currency crises often coincide.

From the inter-war period to the end of Bretton Woods

International debt crises have a history nearly as long as international debt flows. Bordo, Eichengreen and Kim (1998) argue that financial integration has followed a U-shaped pattern: it was at very high levels until the early twentieth century, collapsed between the wars, and then has gradually returned to pre-1914 levels. The breakdown of cross-border financial obligations and the collapse of banking systems in the 1930s depression generated numerous studies – notably those of Charles Kindleberger. His 1937 volume identified four motivations for cross-border capital movements, of which three are potentially destabilising. He observes that shifts in perceptions about exchange-rate stability can lead to changes in motives and hence to capital-flow reversals. Kindleberger emphasises the link between fear and capital flight, which he terms 'abnormal capital movements': 'the same forces that induce people to attempt to expatriate their capital make them unwilling to lend freely at home' (p. 157). Abnormal capital movements pose a problem for borrower nations: 'the balance sheet position of the country may be weakened if short-term liabilities are acquired in exchange for assets not readily available' (p. 157). The key to limiting fear and speculative pressure is a hegemonic global financial centre willing and able to serve as an issuer of reserve currency and lender of last resort (Kindleberger, 1973; 1974).

The United States became the financial hegemon with the 1944 establishment of the Bretton Woods system of fixed exchange rates. Initially, tight regulation of banks combined with central-bank vigilance minimised worries about the destabilising consequences of cross-border lending. Indeed, the Marshall Plan demonstrated the benefits of international lending.

By the late 1960s, financial crises emerged as regular characteristics of business-cycle dynamics (Wolfson, 1994). These events led Minsky to set out his financial instability hypothesis (1975), which asserted that agents are led by a combination of uncertainty and competitive forces to overvalue assets and become overleveraged in upswings; they take on excessive debt, which makes them financially fragile. Cash-flow precommitments for debt repayment reduce the economy's margin for error, eventually leading to a downturn.

The end of the Bretton Woods dollar-standard system in 1973 exposed nations and firms to exchange risk for the first time in four decades. With the re-emergence of exchange-rate volatility, economists also renewed their attention to financial disruptions across borders. Kindleberger (1978) demonstrated that historically, Minskian financial instability often crossed national borders. Krugman and Taylor (1978) developed a cross-border Minsky model. Krugman's 1979 paper gave rise to a literature on currency crises. His 'first-generation model' (FGM) suggests that if a nation's macroeconomic structure is unsustainable in the medium run, speculators can start a currency crisis in the short run by making payment demands that precipitate a currency collapse. If cross-border lending had occurred, international debt crisis would follow. The Minsky/Kindleberger model suggests the opposite course of events: an international debt crisis can trigger a currency crisis. Which triggers which will depend on which market (currency or debt) moves first.

The Latin American debt crisis

These theoretical speculations were soon put to the test. The end of the Bretton Woods system coincided with the first of two oil price shocks in the 1970s. These events generated stagflation and high interest rates, forcing some bank borrowers into market-based financing. Banks had to seek out new loan customers. Meanwhile, national restrictions on international capital movements were lifted: floating exchange rates created 'the overwhelming need to hedge against the costs that fluctuating exchange rates imposed upon the private sector' (Eatwell and Taylor, 2000, p. 2). The banks found their new loan customers by recycling the revenues of oil exporters, especially to oil importing nations. A key component of this 'petrodollar' recycling was large-scale bank lending to Latin America. In an era attuned to the 'limits to growth' (Meadows, 1981), this lending seemed eminently justified by these nations' resources and growth prospects. As Citibank's Walter Wriston put it, countries don't go bankrupt.

Competitive pressures among megabanks, together with these lenders' 'disaster myopia' (Guttentag and Herring, 1984) led to a rapid build-up of bank loans to Latin America. This lending momentum came to a stop when Mexico's August 1982 debt moratorium triggered the first international debt crisis in 50 years. The unprecedented nominal interest rates of this period, combined with global stagnation, generated debt moratoria, renegotiations, and adjustment programmes throughout Latin America.[1]

The Latin American debt crisis occurred just as principal–agent theory based on asymmetric information was coming into fashion, as were microfoundational explanations of macroeconomic phenomena.[2] Asymmetric information models of the credit market assert that borrowers may have informational advantages of two kinds over lenders: information concerning their competency, which affects their probability of success (their 'type'); and their plans for using and repaying the loans they receive, which affect the likelihood of repayment (their 'effort'). Lenders' optimal response is to ration credit and/or to use signalling mechanisms to screen borrowers.

The paradigmatic microfoundational model of the non-payment of Latin American loans is Eaton, Gersovitz and Stiglitz (1986) who argue that debt repudiation is a feasible outcome because of the lack of a common contract law. They also accept Wriston's view, writing that 'the resources of the debtor are likely to be adequate to repay the loans regardless' (p. 485). The borrower country, conceptualized as a unitary agent, compares the relative utility of repaying its debt and of defaulting on its debt; as a rational agent, it defaults when the utility from default is larger. The debt 'crisis' of non-payment is thus due to inadequate debtor 'effort' (not 'type'), that is, to realized moral hazard. The solution is to increase the penalty for not repaying until it exceeds the value of the principal lent, and to improve the overseeing of lending to developing countries. These authors conclude, 'it is surprising that there has been as much lending to developing countries as there has been, not that there is not more' (p. 512).

This model illuminates some aspects of the Latin American debt crisis, but obscures others. First, the under-assessment of risk – 'disaster myopia' – is dismissed out of hand, since lenders and borrowers are viewed as fully rational. Second, to operationalize rationality, credit risk is treated in a simplified way, ignoring its institutional and historical precedents (why didn't this crisis arise in 1979?). Third, the 'enforceability' model also has overly simple depictions of the 'agents' in this principal–agent game. On the lenders' side, the focus on one lender ignores the competitive pressures among banks. The borrowers, in turn, were not unitary agents with complete control over national wealth (their 'collateral'); instead, they were firms, state enterprises and political leaders, all with different objectives and time horizons. Modelling a unitary 'borrower' precludes any attention to the evolving roles of various 'sub-agents' in determining each borrower country's 'moves'.

Some alternative explanations addressed these limitations. As noted above, the 'disaster myopia' explanation of overborrowing emerges once the postulate of rationality is relaxed. This view constitutes the microfoundational side of the Minsky/Kindleberger model. Indeed, Kindleberger developed his own account of what had happened (1989). Darity and Horn (1988) developed an overlending model in which developing nations are locked out of primary markets, except in periods of excess liquidity. The late 1970s and early 1980s were such a period; during that time the multinational banks 'pushed' credit onto less-developed countries because of their competition for market share (Joint ECLAC, 1989). So the root of the Latin American debt crisis is uneven global development and market segmentation, not borrower recalcitrance.

Dymski and Pastor (1990a, 1990b), in turn, develop a model that replaces the 'unitary agent' borrower-nation with several 'players' in borrower countries. In their account, repayment to external lenders may be problematic because it requires the regressive redistribution of national income, threatening political leaders' legitimacy and also the continued worker effort on which national output depends. Repaying debt amidst a crisis can have longer-run costs in political legitimacy and economic productivity.

Other authors have developed alternative explanations that put this crisis into historical perspective. Vos (1994) observes that overlending tends to arise because of the oligopolistic nature of overseas lending markets, competitors' goal of enhancing their market share, and lenders' tendency to under-assess risks. Most current LDC borrowers have defaulted in the past, more than once. Eichengreen and Lindert (1989) found that credit markets learn nothing: when lending resumes, former defaulters are treated the same as those who made payments. This volume also finds (as does Vos) that lending tends to be clustered among certain borrowers, leading to undue concentrations of risk.

From the Latin American debt crisis to the East Asian financial crisis

Concern with the causes of the Latin American debt crisis soon gave way to scholarship on sovereign debt renegotiation and the pricing of securitized soverign debt. Aggarwal (1996) summarises this vast literature and interprets it using bargaining models. This literature identified several problems associated with debt 'overhang'. Claessens and Diwan (1990) showed that an overhang of external public debt can generate illiquidity and disincentive effects. Making payments on existing debt can restrict investment and dampen growth, due to a liquidity shortage. This shortage arises, in turn, because expectations of a continuing future debt burden reduce incentives for current investment and dissuade external lenders from new financing. Cohen (1990) noted that when existing debt is offloaded by lenders into a secondary market (as happened from 1987 onward with the Latin American crisis), any primary-market (new) debt can be obtained only at the price prevailing in the secondary market. That is, lenders cannot be more optimistic than whichever wealth-owners already hold a borrower nation's pre-existing debt. Borrowers in this circumstance are subject to double market discipline.

By the end of the 1980s, Latin America itself was in the midst of its 'lost decade', with stagnation accompanied by hyperinflation, devaluation and regressive redistribution. Still, a re-evaluation of international capital and credit flows to the developing world was underway. Sachs (1989), for example, asserted that developing countries could avoid renewed debt crisis by adopting proper macroeconomic policies.

Large-scale financial flows resumed. Cross-border lending to East Asia increased: from \$161 billion in 1985, to \$204 billion in 1990, to a peak of \$534 billion in 1997. Lending to the transition economies of Europe grew next: from \$134 billion in 1990 to a high of \$275 billion in 2000.[3] After 1990, cross-border lending to Latin America also recovered: the nominal value of claims on Latin America grew in every year except one (1999) after 1990 – from \$250 billion in 1990 to \$746 billion in 2001.

The character of cross-border financial flows was evolving. Between 1985 and 1995, about 45 per cent of cross-border claims on developing countries were held by banks; after 1995, bank share plummeted, reaching 20 per cent in 2000. By contrast, banks' share of developed-country cross-border claims has climbed from 16 per cent in 1985 to 33 per cent in 2000. Banks' reduced role in cross-border lending was paralleled by an increasing role of non-bank private-sector lending, much of it taking the form of bonds.[4] Bank lending also shifted toward short-term commitments, and away from long-term lending. Foreign direct investment in developing countries has moved away from greenfield development and toward privatizations and portfolio investments.[5] A final significant shift involves the entry of many large overseas banks into developing economies (Dymski, 2002).

The Mexican 'tequila' crisis of 1994–95, involving a run on the peso, came as a rude awakening. Mexico had become a favoured locus for capital inflows because of its financial liberalization, its improving macroeconomic fundamentals, and its investment prospects, all linked to the 1992 North American Free Trade Agreement. This crisis exposed and, to some extent, triggered many credit-related problems in Mexican banks; the Mexican government was forced to subsidise sell-offs of leading Mexican banks to offshore owners. Since it was such a surprise, this crisis created substantial interest in what was termed the second-generation model (SGM) of currency crises (Obstfeld, 1994). The SGM showed that non-linearities in the behaviours and beliefs of agents in capital, credit and currency markets could in themselves give rise to currency crises, especially when a nation's macroeconomic fundamentals fell into a 'grey area.'[6] The SGM thus raised the possibility, commonly observed in non-linear systems, that small changes in beliefs and fundamentals could unleash cumulative cascades and also set off contagion effects in other countries.

Reflecting on this episode, Calvo, Goldstein and Hochreiter (1996) emphasised the need for policies protecting borrower countries – especially the maintenance of adequate reserves and provisions for orderly workouts. Stronger measures, such as exchange and capital controls, are rejected. Goldstein and Reinhart (1996), in turn, argued for 'early warning systems' for investors and creditors. Both suggestions anticipate that enhancing information and guarantees will suffice to limit contagion and bandwagon effects.

This calming prognosis was amplified in a World Bank report on capital flows to developing nations (World Bank, 1997), which reviews both the 1980s Latin American debt crisis and the 1994–5 Mexican currency crisis. This report admits that financial opening and cross-border financial flows entail macroeconomic and financial risks, but argues that these risks are manageable and are outweighed by prospective efficiency and output gains. This volume takes as given that 'there is no alternative' to financial liberalization: developing nations' governments can monitor and oversee financial risk; but blocking financial opening would only distort incentives and worsen riskiness in the longer run.

A more troubling interpretation based on Minsky was available, though it did not sway many in this period: the volatility and reversibility of capital flows make economies receiving systematic capital inflows increasingly vulnerable to bad news, downturns, or shifts of investor opinion. So the Mexican crisis is not anomalous, but instead prefigures problems in other nations receiving capital inflows. FGM models of currency crisis indicated that speculators are expected to attack the currencies of nations with non-viable macroeconomic structures. Having current-account deficits is one signal of such 'non-viability'. However, these deficits are often linked to capital-account inflows. This happens, for example, when a nation favoured by overseas investors has many unfinished investment projects, has a politically influential (and financially flighty) upper class interested in conspicuous consumption, and must import many intermediate and consumer goods. But then, virtually any developing nation that becomes a favoured offshore investment/loan target will, by virtue of accepting capital inflows, create the macroeconomic circumstances that will later justify speculative runs on its currency.

The Asian financial crisis and its aftermath

East and Southeast Asia became favoured venues for cross-border financial flows through the 1990s, as noted above. The Asian financial crisis, like the tequila crisis, was a surprise: as Obstfeld (1998) wrote, the free flow of capital across borders should induce macro discipline and reduce the likelihood of policy mistakes. Instead the opposite seemed the case, as this crisis hit the global financial system like an iceberg. The slow-motion detonation began in Indonesia and Thailand, then moved north-east to South Korea and the Philippines; longer-run effects then followed, including growth slowdowns in Taiwan, price declines in global equity markets, and speculative attacks on Brazil, Russia and Turkey.

The Asian crisis unleashed a vigorous and unresolved debate in the realms of both policy and economic research. Turning first to policy, the International Monetary Fund (IMF, 1998; Guitián, 1998) argues that while borrower nations caught in this crisis may have had sound macroeconomic strategies, they were vulnerable because of their improperly supervised banking systems. Specifically, developing countries are especially vulnerable to financial instability because they lack a fully-developed set of financial instruments and institutions: information on borrowers is incomplete, so overseas investors' uncertainty is higher than elsewhere (Knight, 1998). The solution is tighter regulation and further financial-system development and opening.

The World Bank (1999) takes a far more sceptical view of market forces, rethinking some of its positions in World Bank (1997). This report attributes the global financial crisis in the developing world not just to weaknesses in domestic financial systems and oversight but also to international capital market imperfections, which can lead to contagion effects, liquidity crises and panics. A rethinking of global financial architecture is advocated. Other policy voices have gone even further. For example, UNCTAD (1998) argues that slow global macroeconomic growth combined with unstable 'hot money' flows are at the root of the East Asian crisis. UNCTAD (2000, Chapter 4) challenges both the appropriateness of the IMF's orthodox policies and the advisability of financial liberalization.

This crisis also has profoundly shaken economists' ideas about international debt crises. For neither the FGM nor the SGM fit the East Asian case, and economists had before 1998 frequently cited the Asian economies' success in using government-led arrangements to asymmetric-information-related incentive problems (Stiglitz and Uy, 1996, and Stiglitz, 1996) and achieve high growth rates (Singh, 1996). Indeed, one of the first reactions to the Asian crisis, by Krugman (1998), argued that rampant moral hazard in Asia's state-controlled banking systems was its root cause.[7] Numerous analysts (Chang, Park and Yoo, 1998; Crotty and Dymski, 1998; Wade, 1998; Wade and Veneroso, 1998) objected that external factors – such as the stagnant global macroeconomy, unstable global financial markets, the power of Wall Street, and IMF policies – had played the key role. Stiglitz himself reacted immediately in a speech (Stiglitz, 1998) defending the prerogative of developing nations to regulate markets and maintain independent (including non-neoliberal) strategies (see also Stiglitz, 2000). Kregel (1998) shows that the Asian crisis can be understood as an outbreak of Minskyian financial instability. Corsetti, Presenti and Roubini (1999) acknowledged that speculation and contagion effects were important, but asserted that moral hazard and poorly-designed economic policies triggered these effects. Clearly, there is no consensus here.

The Asian crisis launched new empirical and theoretical research, much of it focused on the empirical importance of FGM and SGM factors. This research has verified the empirical significance of contagion effects. For example, Demirgüç-Kunt and Detragiache (1998) find that financial liberalisation increases the probability of banking crisis, and that financial crises' contagion effects are large and costly. And since much of the lending in Asia involved intermediation by domestic banking systems, some research has focused on this link in the international lending chain. For example, Hardy and Pazarbasioglu (1998) find that variables capturing the vulnerability of the banking and corporate sector predict subsequent crises, but macroeconomic variables do not. A historical investigation by Williamson and Mahar (1998) also finds that financial liberalisation and financial crises coincide.

As in the years after the Latin American crisis, debt repayment has attracted attention. Krueger (2002) points out that debt repayment has to be rethought because of the shift away from lending by a few large banks, and toward non-bank financing of cross-border debt. There are also more complex interactions among sovereign and private-sector obligations; indeed, sovereign bankruptcy has even been discussed (White, 2002).

The continuing experiences of debt and currency crises (Brazil, Russia and so on) have perhaps affected researchers. Increasingly, even work by market-oriented economists comes to sceptical conclusions about the liberalisation of financial flows.[8] For example, Espinosa-Vega *et al.* (2000) argue that developing economies may grow faster if they impose some restrictions on cross-border capital movements; and Calvo (2000) demonstrates that opening up derivatives markets for developing economies can reduce economic welfare. Agénor's survey (2001) finds that financial integration is generating many efficiency losses: undue concentration of lending, while some nations are credit-starved; procyclical access to global financial markets; and procyclicality in short-term flows.[9]

Because principal–agent conflicts and asymmetric information exist at several levels of the global economy, models often show that any policy which fixes one set of problems may generate others. For example, Vives (2002) argues that while dollarisation and short-term debt exert discipline over borrower nations' macroeconomic policies, these measures may lead to excessive liquidation of otherwise viable projects. Chang and Majnoni (2002), in turn, show that whether contagion effects or fundamentals generate financial crises (that is, whether FGM or SGM factors dominate) depends on whether the fundamentals are 'weak'.

This research by market-oriented economists has reached no conclusion. Since these economists use Walrasian equilibrium as an index of how markets are *supposed* to work, they are reluctant to drop it as a benchmark (Crotty and Dymski, 1998). At the same time, recent experience has made them uneasy about this reference point. In consequence, debate proceeds uncertainly, with participants sometimes talking past each other. An example is banks' self-assessments of risk: the notion that regulatory standards are inadequate guides to bank safety because of proliferating off-balance sheet commitments and regulatory capture. Barth *et al.* (2001), among others, advocate cross-border mergers and bank self-assessment of risk as means of promoting financial and macroeconomic stability. But articles in the 2002 special issue of the *Journal of Banking and Finance* edited by Szegö demonstrate the infeasibility of bank risk self-assessments.[10]

Economists who do not operate from neo-liberal premises increasingly regard cross-border debt crises as one element of a global trap for developing nations. Eatwell and Taylor (2000) point out the inescapability of the 'trilemma', wherein liberalised capital markets, a fixed exchange rate, and an independent monetary or fiscal policy are not mutually consistent. In the neo-liberal story, in which an 'alert private sector chastizes an inept government' (p. 106), the trilemma can be avoided because floating exchange rates are a viable means of achieving equilibrium (Reinhart, 2000). When the viability of floating rates is rejected, then the trilemma looms as an inescapable obstacle to development, once financial markets are liberalised. Crises cannot be traced to inadvisable fiscal or monetary policies in any simple way. Eatwell and Taylor argue that both the public and private sectors generate positive financial feedbacks. They sketch out what they term a Frenkel/Neftci cycle. It begins with capital inflows, which spill over to the macroeconomy via the financial system. As the current account worsens, the interest rate is raised. Financial fragility and risks rise in a scenario in which 'fiscal deficits and moral hazard did not play a significant role' (p. 149).

So under capital inflows, the trilemma takes a special form: as noted, the very fact of these inflows creates the preconditions for a panic. In many cases, domestic policy cannot erase the problem. Uncovered-interest parity becomes a trap for nations with continuing external debt obligations (such as Brazil).[11] Leaving domestic interest rates at current levels will do nothing to stop creditors who are pulling their funds away. But widening the world/local interest-rate spread to hold funds or attract new capital only signals the greater likelihood of exchange-rate collapse. Under the current rules of the game, there may be no alternative to domestic stagnation and regressive redistribution as the price of inflows of overseas capital and credit.

Conclusion

Economists have suggested five answers to the question of what causes international debt crises: perverse macroeconomic policies; problems in cross-border creditor–debtor contracts; problems in creditor–debtor relations within borrower countries; perverse interactions among cross-border creditors; problems in the global structure of cross-border financial flows. These five causes lead to five parallel responses to the question of what should be done: fix macroeconomic policies; fix the rules governing cross-border financial contracts; fix the rules governing creditor–borrower relations within borrower countries; improve information; or fix the rules governing cross-border financial flows in the global economy.

In the Latin American debt crisis, economists who were broadly sympathetic to market forces focused on the first two causes (and solutions), while those sceptical of such forces emphasised the fifth. In the Asian crisis, market-oriented economists emphasised the third and fourth factors, since the first two were largely resolved. Market sceptics, whose ranks increased in relative terms, again pointed to the fifth cause, the overall structure of the global system. Meanwhile, international debt crisis is becoming continuous for developing nations, not episodic.

Despite universal acknowledgement of the high cost of international debt crises, these are likely to recur, once cross-border lending recovers again, as it has before. For economists who operate on the premise that 'there is no alternative' to market-driven flows of credit and capital, these crises present opportunities for fine-tuning. This is the only way of moving ever closer to the idea of economic efficiency set out in the textbooks. But for economists who regard the structure of global financial flows as flawed, the costs of each crisis episode are cumulative: each crisis leads to more international and intra-national inequality and to the further dismantling of national development-oriented institutions (Baker *et al.*, 1998). The shape of the alternative is twisted ever more, as are the odds of reaching it, as each new debt crisis unfolds.

Notes

1. Cline (1984, 1996) provides valuable overviews of this crisis. The academic literature on the Latin American debt crisis is surveyed by Eaton and Taylor (1986).
2. The most important of these articles was Stiglitz and Weiss (1983).
3. These statistics were calculated by the author from data series published by the Bank for International Settlements, and are available on request.
4. The shift to bonds represents a return to the historical pattern of the 1920s (Vos, 1994).
5. For Latin America and the Caribbean, see ECLAC (2001).
6. Masson and Agénor (1996) suggest the peso crisis was generated more by SGM-like than FGM-like factors.
7. Krugman (1994) previously registered his scepticism of the Asian 'model'. Chang (2000) is a thoughtful rejoinder to the idea that moral hazard characterizes this model. Bustelo, Garcia and Olivié (1999) is the most comprehensive review of the literature on the Asian financial crisis.
8. This distinction between 'market-oriented' and 'market-sceptical' economists is arbitrary; in practice, there is a continuum of opinion among economists about how well markets work.
9. Interestingly, these characteristics of contemporary cross-border lending, which reflect lenders' risk aversion, are precisely those of which Kindleberger warned in 1937.
10. For example, Daníelsson argues 'since market data is endogenous to market behavior, statistical analysis made in times of stability does not provide much guidance in times of crisis. ... the empirical properties of current risk forecasting models are found to be lacking in robustness while being excessively volatile.' (2002, p. 1273)
11. Under uncovered interest parity, the domestic interest rate should in equilibrium equal the world interest rate plus any expected currency devaluation. This is a commonly cited criterion for assessing the soundness of national economic policy.

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6 National inequality in the era of globalisation: what do recent data tell us?

Gabriel Palma[1]

1. Introduction

The issue of the effect of greater international economic integration on national inequality has always been particularly controversial in economic theory. For example, as soon as Samuelson developed his trade-related factor–price–equalisation theorem in the 1960s – that an increase in trade should have a positive effect on both international and national distribution of income (the latter because an export expansion should increase the relative income of the (cheap) abundant factor and reduce that of the (expensive) scarce factor in each country) – it immediately became one of the most debated hypotheses in development economics. And now, 40 years later, the issues addressed in the Samuelson theorem are again at the core of the globalisation debate on the effects that the globalisation-induced increase in trade and international economic integration would have on national and international income distribution and factor movements.[2] In fact, of all of Samuelson's economic hypotheses, there is probably none that is influencing US foreign policy today as much as the one that postulates that an increased level of trade between two countries should reduce the incentive for labour to move across frontiers. In the case of its relationship with Mexico, for example, following the 1982 'debt crisis' the US – always frightened that worsening economic problems in Mexico could turn the usual flow of Mexican immigrants into a tidal wave – gave Mexican exports increasingly preferential access to its market, a process that led to the creation of NAFTA.[3]

As is well known, one of the main problems with the debate on trade and income distribution has been the difficulty of testing alternative hypotheses, especially in their time series formulation, due to the low quality of the available income distribution data. However, recent developments in household-survey data have made substantial improvements in this direction (at least from a cross-section point of view). Moreover, over the last decade some institutions like the OECD and the World Bank (WB) have made a sustained effort to collect and process these surveys.[4] The latest relevant WB publication, for example, now provides a relatively homogenous set of data on personal income distribution for 112 countries.[5] However, the WDI data set still has some important problems. For example, although most data refer to income distribution, some still refer to consumption expenditure (particularly in sub-Saharan Africa). This mixture of data makes regional comparison more difficult, as the distribution of consumption tends to be more equal than that of income (usually about 3 percentage points on the Gini scale). However, the degree of accuracy of these surveys is of course still a problem.[6]

Another problem is that, quite surprisingly, the WDI data set still reports income (or consumption) distribution only in terms of quintiles; for deciles, it only reports the shares of deciles 1 and 10. Although this is a marked improvement over the traditional WB's Deininger and Squire data-set (D/S)[7] – which so far does not report data for a single income decile – it is still clearly unsatisfactory; as will be discussed in detail below, crucial distributional information is lost when data are aggregated in quintiles (particularly in the top one).

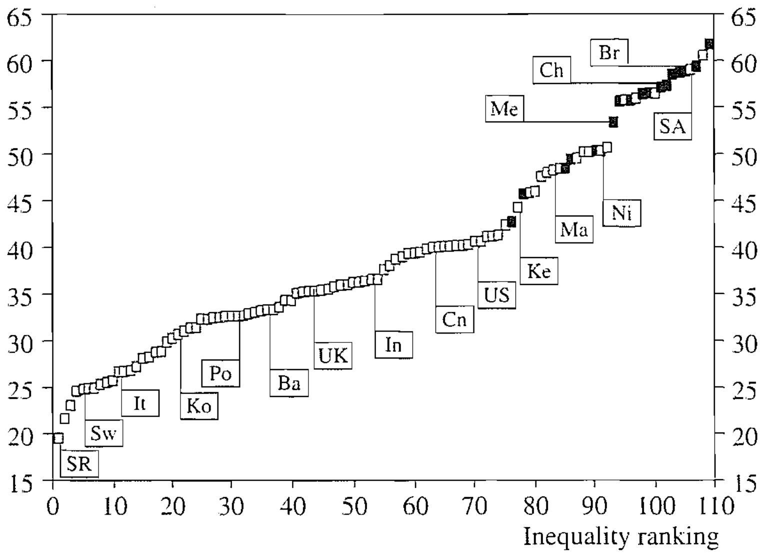
At the same time, the Research Department of the Inter-American Development Bank (IADB) has constructed a slightly more up-to-date income distribution data set for several Latin American countries; it uses the same methodology (primary household-survey data) and data-aggregation (quintiles and deciles 1 and 10) as the WDI.[8]

The main aim of this chapter is to use these new WB and IADB data sets to take another look at national income inequalities in the era of globalisation. Throughout this chapter, unless otherwise stated, the IADB data set will be used for Latin America and the WDI one for the rest of the world. The total number of countries included in this study is 109.[9]

2. Inequality ranking

Figure 6.1 illustrates how these 109 countries are ranked according to their Gini indices of inequality in the second half of the 1990s. Among the many issues arising from this graph, two stand out. First, in the second half of the 1990s there is a particularly wide range of inequality across countries – from a very low Gini index of 19.5 per cent (Slovak Republic) to a high one of 62.3 per cent (Paraguay); and second, all Latin American countries are clearly grouped at the very top end of the inequality ranking – with a median Gini of 56.7 per cent (mean value of 54.7 per cent), its degree of inequality is well over half as much again as the overall median value for the rest of the sample (92 countries), and more than 40 per cent higher than that for the 'developing-non-Latin-American' group of countries (51 countries: this group excludes OECD and ex-communist countries). In addition, within the whole group of 109 countries, the median-country-inequality ranking for the 17 Latin American countries is 100!

Another important issue arising from this ranking is the extraordinary difference between the English-speaking and the non-English-speaking OECD (the latter including continental Europe and Japan) – with median Ginis of 36



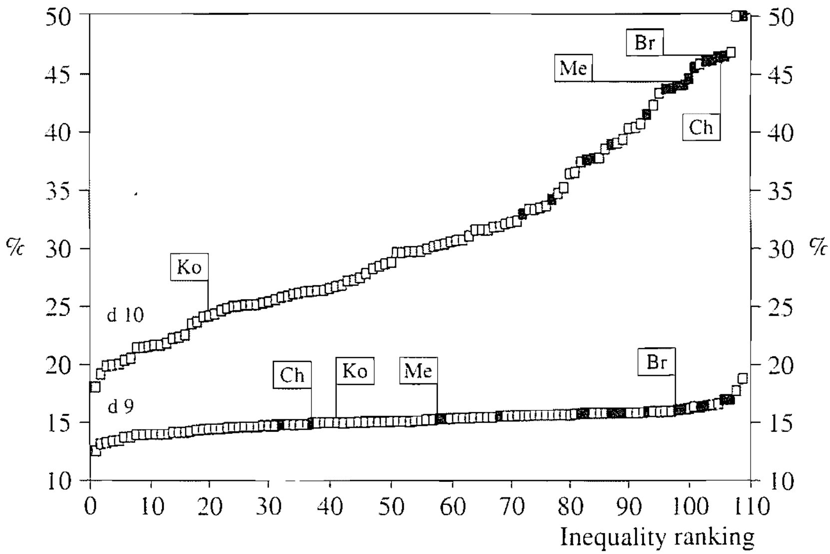
Notes:
Countries are ranked according to their degree of inequality (1 to 109); Latin American countries are shown in black (this will also be the case in similar graphs below). Throughout this chapter, Gini indices are reported on a scale from 1 to 100.
Br = Brazil; Ch = Chile; Me = Mexico; SA = South Africa; Ni = Nigeria; Ma = Malaysia; Ke = Kenya; US = United States; Cn = China; In = India; UK = United Kingdom; Ba = Bangladesh; Po = Poland; Ko = Korea; It = Italy; Sw = Sweden; and SR = Slovak Republic.

Figure 6.1 Most recent data on Gini indices of personal income distribution in 109 countries

and 27.1, respectively. The same phenomenon is found between the ex-communist countries of the former Soviet Union and those of Central Europe – with median Ginis of 34.4 and 27.5, respectively.

An analysis of the different income quintiles confirms the well known fact that the main source of inequality across countries is the large variance in the income share of the *highest* earning group – in this sample the range for the share of the top quintile spans from 31.4 per cent (Slovak Republic) to 64.8 per cent (South Africa). The median value for the income share of this quintile for the whole sample is 45.6 per cent – 55.2 per cent for Latin America and 43 per cent for the non-Latin American group.[10]

However, Figure 6.2 shows an equally important but surprisingly less well-known fact: the large variance of the income share of quintile 5 across countries is made up of two *very* different components – the contrasting shares of deciles 9 and 10.[11]



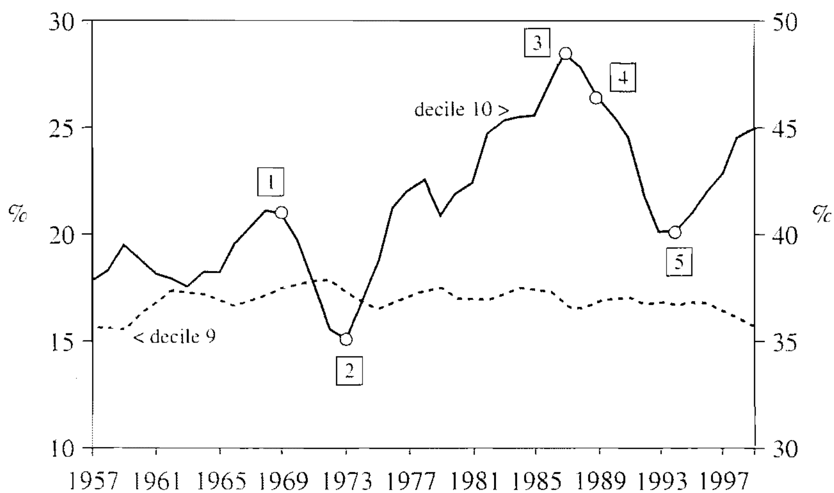
Notes:
Each ranking is made independently from the others. Unless otherwise stated, this will be the case for all similar graphs in this chapter.
In this, and other graphs below, the data for Brazil, Mexico and Chile will be highlighted, as these are the three Latin American countries that from the point of view of the relationship between income distribution and income per capita present the worst income distribution (see Figure 6.15 below). Data for Korea are shown as a comparison.
Br = Brazil; Ch = Chile; Me = Mexico; Ko = Korea.

Figure 6.2 Most recent data on income share of deciles 9 and 10 in 109 countries

While the range for the income share of decile 9 in these 109 countries only extends across 5.6 percentage points (from 12.6 per cent in India to 18.8 per cent in South Africa), decile 10 has a range 6 times larger (from 18.2 per cent in the Slovak Republic, to 50.8 per cent in Paraguay). This extraordinary difference between the dispersion of these two deciles is reflected in their standard deviations – while that of decile 9 is just *0.9* percentage points (around a mean of 15.2 per cent), that of decile 10 is *8.1* percentage points (mean of 31.4 per cent); that is, relative to their own means, the standard deviation of decile 10 is more than 4 times larger than that of decile 9.

This phenomenon is also corroborated by the fact that while the median values for the share of decile 9 in the Latin American and non-Latin American groups are quite similar (15.9 per cent and 15.4 per cent, respectively), those for decile 10 are very different, with the Latin American share more than half as much again as the median value for the rest of the sample (44.1 per cent and 28.4 per cent, respectively). In other words, one of the key elements (if not the key one) needed to understand the effects of globalisation on national income distribution is the effects it has on the share of decile 10.[12]

Figure 6.2 also indicates that the key characteristic of the income distribution of most Latin American countries is its 'winner-takes-all' nature.[13] In the case of Chile, for example, while its decile 10 is ranked as the 104th most unequal within these 109 countries, its decile 9 is only ranked 38th (its ranking is even better than Korea's!). Figure 6.3 clearly illustrates this phenomenon: after the 1973 coup d'état (which also marks the beginning of trade liberalisation and a rapid process of integration of the Chilean economy into the world economy), when income distribution had one of the fastest ever recorded deteriorations, it was only decile 10 that benefited from this.



Notes:
Three-year moving averages [1] = election of Allende; [2] = Pinochet's coup d'état; [3] = the year before Pinochet's plebiscite (seeking a mandate to remain in power for another 8 years); [4] = first democratic government (centre–left coalition) after Pinochet lost his plebiscite (and had to call for presidential elections); [5] = second democratic government (same political coalition, but different distributive policies).

Source: Ruiz-Tagle (2000) Unless otherwise stated, this will be the source of all historical data of Chile.[14]

Figure 6.3 Chile: income shares of deciles 9 and 10, 1957–99

While decile 10 increases its income share by *50 per cent* between 1973 and 1987 (from 34 per cent of national income to no less than 51 per cent), that of decile 9 remains at around 17 per cent.[15]

A similar phenomenon to the one found in quintile 5 (between deciles 10 and 9) can also be found (though in a milder form) at the other end of the income distribution, between the shares of deciles 2 and 1.[16]

As a result, what really ends up differentiating most income distribution across countries in the era of globalisation – and best highlighting the extreme inequality found in Latin America – is the ratio of the income-shares of deciles 10 and 1.

Figure 6.4 clearly shows the difference between the ratio of deciles 10 to 1 and that of 9 to 2; however, this huge difference is mainly the result of what happens in the last third of the sample – comprising mainly Latin American and sub-Saharan African countries. The resulting ranges of both rankings are very different: while the range of the ratio of deciles 10 and 1 extends from 3.6 to 114, that between deciles 9 and 2 only spans from 1.9 to 10.9.[17]

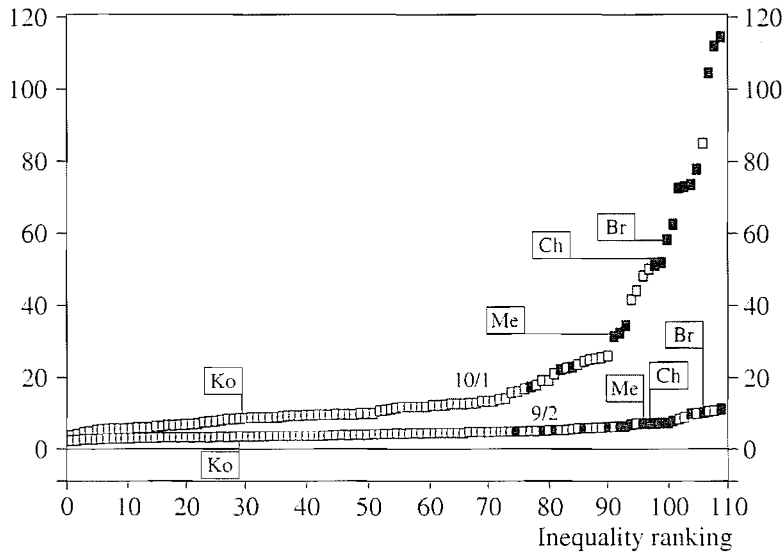


Figure 6.4 Ratio of income shares of deciles 10 and 1, and 9 and 2 in 109 countries

Of the more straightforward statistics for measuring inequality, this is the one that probably best reflects the degree of income inequality found in Latin America, and the extraordinary degree of income polarisation of this region.

At a median value of 58.1, this Latin American ratio is *4.7 times* the median value for the 51 non-Latin-American LDCs, and more than 6 times the median value for the 92 non-Latin-American countries of the sample (9.6); it is also the statistics that differentiate most Latin American inequality from that of sub-Saharan Africa (the latter's median value, at 19.3, is only one-third that of Latin America).

This huge polarisation of income between the two extreme deciles in Latin America contrasts sharply with the ratios comprising income groups within these two extreme deciles (see Table 6.1).

Table 6.1 Median values per region for different income ratios

	d 10/1	d 9/2	q 4/2	q 3/2
Latin America	58.1	7.0	2.7	1.6
Non-LA LDCs	12.5	3.9	2.0	1.4
Sub-Saharan Africa	19.3	4.8	2.1	1.4
East Asia – 2	15.9	5.1	2.3	1.5
Caribbean	13.8	4.3	2.1	1.4
OECD – 2	11.8	4.0	2.0	1.4
North Africa	9.6	3.8	2.0	1.4
Ex-communist – 2	9.6	3.7	1.9	1.4
South Asia	8.3	3.3	1.8	1.3
Ex-communist – 1	6.2	2.8	1.7	1.3
East Asia – 1	8.4	3.3	1.8	1.3
OECD – 1	6.0	2.7	1.6	1.3
All	11.6	3.9	2.0	1.4
LDCs	14.2	4.7	2.2	1.5

Note: Regions as in Appendix 1. Non-LA LDCs = non-Latin American developing countries (51 countries); d10/1 = ratio of deciles 10 and 1; d9/2 = ratio of deciles 9 and 2; q4/2 = ratios of quintiles 4 and 2; and q3/2 = ratio of quintiles 3 and 2.

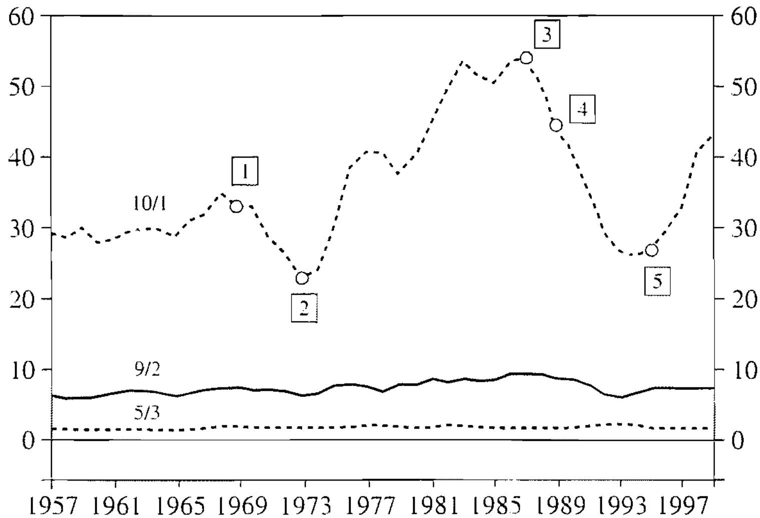
The fact that Latin America's greater degree of inequality *vis-à-vis* other regions of the world decreases rapidly as the comparison refers to income groups closer to the middle of the distribution (that is, within deciles 8 and 3) makes it hard to understand why so many theories explaining Latin America's excessive inequality refer to phenomena found in the *middle* of the distribution. For example, two influential theories in this respect are the 1960s import-substituting-industrialisation-related-'labour-aristocracy' hypothesis, and the 1990s trade-liberalisation-related 'asymmetric demand for labour' hypothesis.

The first, used extensively during the 1960s and 1970s, particularly in circles connected with the WB, argues that one of the main causes of inequality in Latin America at the time was the price distortions created by import-substituting industrialisation (ISI); these would distort the value of sectoral marginal productivities, allowing for artificially higher real wages in manufacturing (that is, producing higher wage differentials than would otherwise exist in the economy).[18] However, then as now there was little to differentiate Latin America from the rest of the world – developing and developed, ISI and non-ISI – in terms of the income distribution among groups that would include 'aristocratic' and non-'aristocratic' labour (say quintiles 4 and 2, or 3 and 2).

The second theory, which is basically a recycled version of the previous 'labour-aristocracy' hypothesis, is used extensively today to explain the increase in inequality in many Latin American countries that implemented trade and financial liberalisation. As the increase in inequality, which followed greater integration with the world economy at a time of a growing globalisation, runs contrary to what was predicted by the proponents of the 'Washington Consensus' before the implementation of these reforms,[19] it is now argued that this development is the result of the (previously unforeseen) fact that trade liberalisation is responsible for introducing new techniques of production with a high requirement of skilled workers. It was, therefore, unwittingly to blame for higher wage differentials in reformed-countries.[20] However, as is obvious from previous graphs and Table 6.1, what really differentiates Latin American income inequality (long after trade liberalisation and increased economic integration with the rest of the world) is located at the very end of the distribution of income – hardly the place where either skilled or unskilled workers would be located. Therefore, even if trade liberalisation was responsible for the introduction of new techniques of production with 'asymmetrical labour demand', these data indicate that it is unlikely that this would account for a significant amount of the region's huge income inequality.

The case of Chile is a good example of this issue. Even though Chile implemented one of the most radical trade liberalisation policies in the developing world, and in spite of the fact that this policy has now been in place for nearly three decades (it began in 1973), it seems to have had little effect in the relative income distribution of skilled and unskilled labour (proxied in Figure 6.5 by the ratio of deciles 9 and 2, or 5 and 3, depending on what is understood by these two categories of workers). This graph indicates that massive political upheavals, radical economic reforms and greater integration within the world economy have tended to produce significant effects at the extreme ends of the income distribution, but few relative effects elsewhere.

Moreover, the Chilean experience also indicates that 'policy matters'. Income distribution did improve massively with the progressive distributional



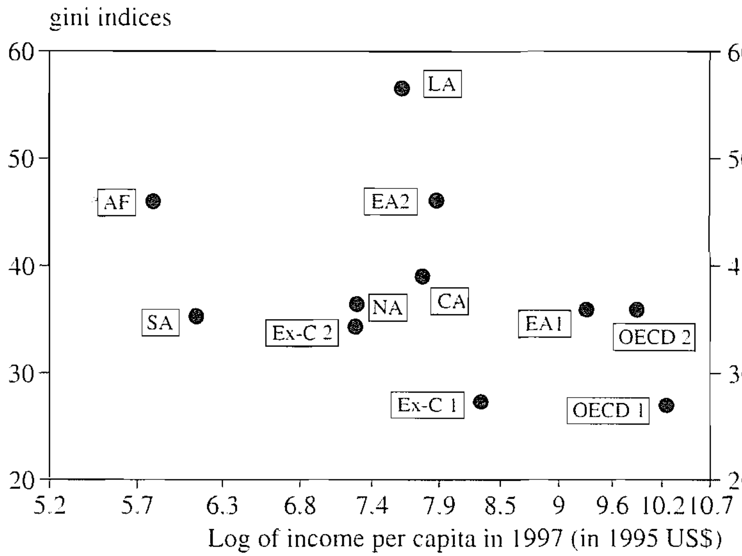
Notes:
Three-year moving averages. [1] = election of Allende; [2] = Pinochet's coup d'état; [3] = the year before Pinochet's plebiscite (seeking a mandate to remain in power for another 8 years); [4] = first democratic government (centre–left coalition) after Pinochet lost his plebiscite (and had to call for proper presidential elections); [5] = second democratic government (same political coalition).

Figure 6.5 Chile: ratio of income shares of deciles 10 and 1, 9 and 2, and 5 and 3, 1957–99

policies of the first democratic government (1989–93), even though this government continued the process of greater integration of the Chilean economy into the world economy; however, when the second democratic government (1993–99, formed by the same political coalition) abandoned these progressive distributional policies, the ratio of decile 10 to 1 returned to where Pinochet left it in 1989.

3. Income inequality and income per capita

The best known way of comparing income distribution across countries (and of ascertaining, for example, whether Latin America's inequality really is 'excessively' large), is to do so from a point of view which is relative to the level of income per capita. This approach started with Kuznets in 1955 and has dominated distributional debates ever since. Figure 6.6 shows the regional averages for the whole sample.[21] This graph indicates that there seem to be four 'layers' of inequality across countries. First, a more equal layer containing the ex-communist countries of Central European and the non-



Notes: Regional figures are median values. Regions as in Appendix 1.

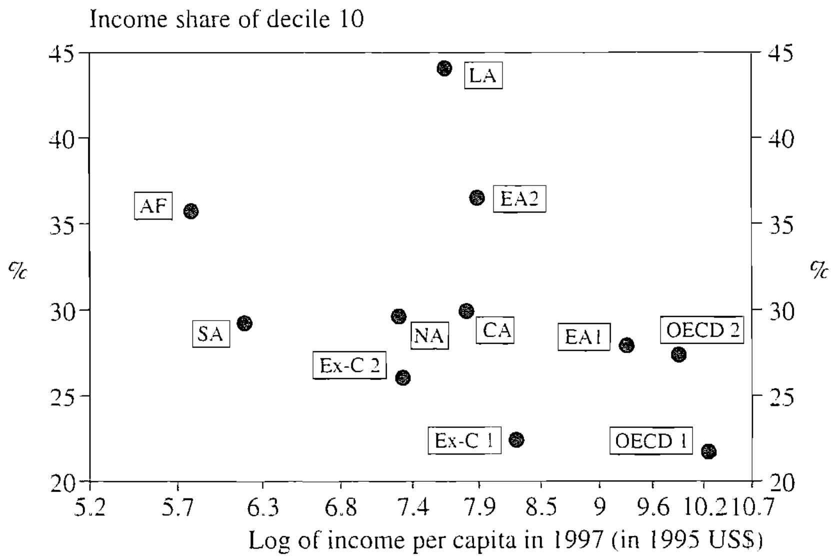
Sources: Income distribution as above; income per capita according to the World Bank's WDI data set (data are for 1997, in 1995 US$ terms). This will also be the case for the remaining graphs in this chapter.

Figure 6.6 Regional Gini indices and log of income per capita

English-speaking OECD; second, a layer containing a great variety of regions, comprising about three-quarters of the world population; third, one that only includes sub-Saharan Africa and East Asia '2' (the 'second-tier' NICs); and fourth, Latin America, in a world of its own, well above every other region in the world (even those with similar income per capita, like North Africa, East Asia '2' and the Caribbean).

However, as discussed above, it is also important to look 'inside' this Gini-picture. As expected, Figure 6.7 shows that there is a particularly close resemblance between the distributional structure of the world looked at from the Gini perspective and from that of the income-share of decile 10.

The strong similarity between the world's distributional structure according to the Gini index and that of the income-share of decile 10 (clearly resulting in both cases in four 'layers' of inequality) is, of course, the result of the way in which the Gini index is calculated.[22] In turn, this particular structure of income disparity across the world is also reflected in the income-share of the bottom 4 deciles.



Notes:
Regional figures are median values.
Regions as in Appendix 1.

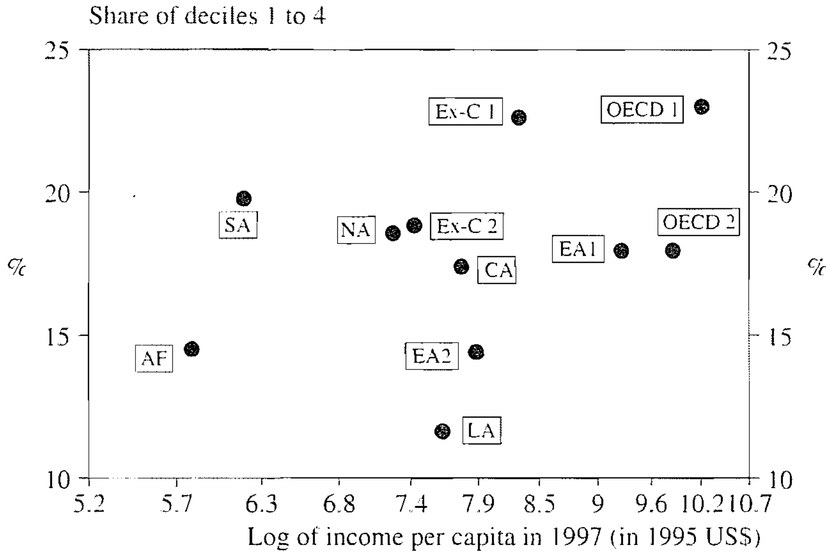
Figure 6.7 Regional income shares of decile 10 and log of income per capita

Figure 6.8 shows that the regional distributional structure of deciles 1 to 4 is the mirror image of that of decile 10. Therefore, the Gini-picture of the world's regional inequality is reproduced both at the very top and at the bottom of the regional distribution of income. However, when one looks at the other 50 per cent of the world's population, those located within deciles 5 and 9 – the 'middle classes' – the regional distributional picture, rather unexpectedly, changes completely: from one of huge disparity to one of remarkable similarity (see Figure 6.9).

Furthermore, this homogeneity in the income-shares of deciles 5 to 9 is even more amazing in the 30 per cent of the population contained in deciles 7 to 9 (the 'upper middle' groups) (see Figure 6.10).

Table 6.2 presents a set of statistics of the whole sample, which emphasise the extraordinary contrast between the world distributional-heterogeneity at the top and bottom of the income distribution and the homogeneity in the middle.

Of all the statistics in Table 6.2, the coefficient of variation is the one that best shows the above-mentioned distributional contrast – the figures for both

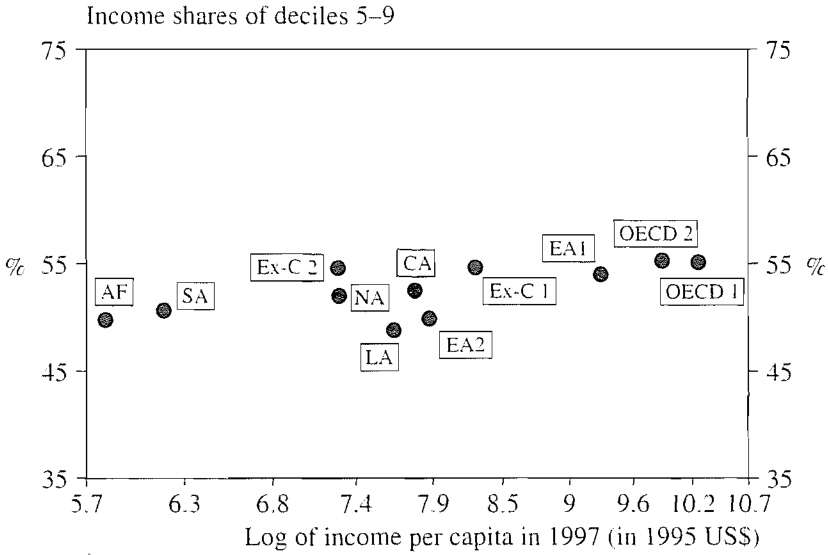


Notes:
Regional figures are median values.
Regions as in Appendix 1.

Figure 6.8 *Regional income shares of deciles 1 to 4 and log of income per capita*

decile 10 and deciles 1 to 4 are nearly four times greater than those for deciles 5 to 9. Furthermore, they are nearly *seven* times larger than those for deciles 7 to 9. This indicates that the 'middle classes' across the world (particularly the 'upper middle classes') seem to be able to benefit from a distributional 'safety net'; that is, regardless of the level of income per capita of the country, the characteristics of the political regimes, the economic policies implemented, the structure of property rights, or whether or not they belong to countries that managed to get their prices 'right', their institutions 'right', or their social capital 'right', the 50 per cent of the population located between deciles 5 to 9 seems to be able to count on about half the national income. In other words, regardless of the politico-institutional settlement in which they live, they tend to acquire a 'property right' on half of national income.

No such luck for the bottom 40 per cent of the population; in their case, issues such as those mentioned above can make the difference between getting as much as *one-quarter* of national income (as in the non-English speaking OECD, or the ex-communist countries of Central Europe), or as little as *10 per cent* (as in Latin America).



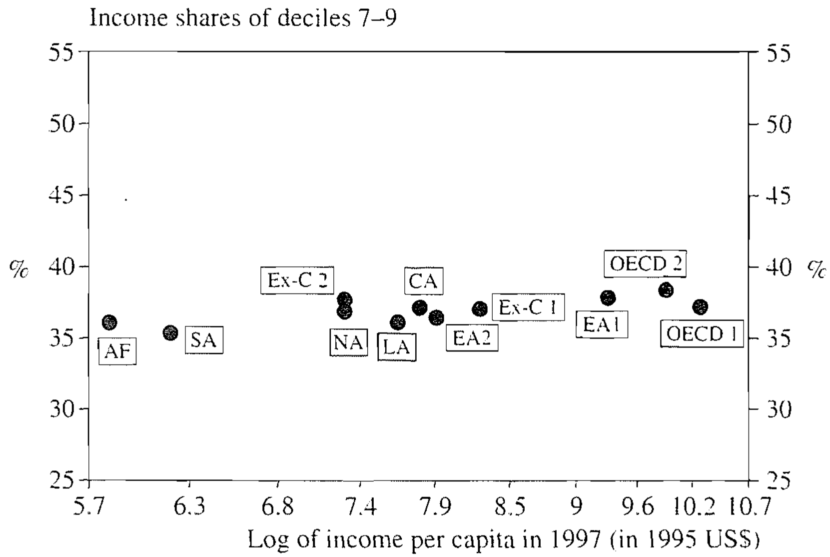
Notes:
Regional figures are median values.
Regions as in Appendix 1.

Figure 6.9 Regional income shares of deciles 5 to 9 and log of income per capita

As far as the top income decile is concerned, well, the sky is (almost) the limit – particularly if the individuals constituting that decile happen to possess the 'discreet charm' of the Latin American bourgeoisie.

In other words, the regional distributional structure shown by the Gini index only reflects the income disparities of *half* the world population (those at the very top and at the bottom of the distribution), but bears little resemblance to the distributional homogeneity of the other half. This is a rather peculiar phenomenon, not just from a statistical point of view (how useful is the Gini index as an indicator of overall income inequality?), but also from an analytical one: recent political and economic developments (including of course globalisation) seem to have been associated with two very different distributional movements across regions in the world: a (better known) 'centrifugal' one in terms of the income-shares of the top and bottom deciles (decile 10 and deciles 1 to 4), and a (less known) 'centripetal' movement in terms of the income-share of deciles 5 to 9.[23]

Among the many fascinating issues that arise from the regional distributional homogeneity in the middle and upper-middle of the distribution, one



Notes:
Regional figures are median values.
Regions as in Appendix 1.

Figure 6.10 Regional income shares of deciles 7 to 9 and log of income per capita

Table 6.2 Measures of centrality and spread for income groups (whole sample)

	Range	Median	Mean	Variance	St dev	C of var
d 10	32.6	29.4	31.4	64.8	8.1	**26**
d1 – d4	19.8	18.0	17.4	21.9	4.7	**27**
d5 – d9	15.4	51.7	52.4	11.4	3.9	**7**
d7 – d9	9.7	36.8	36.6	2.7	1.7	**4**

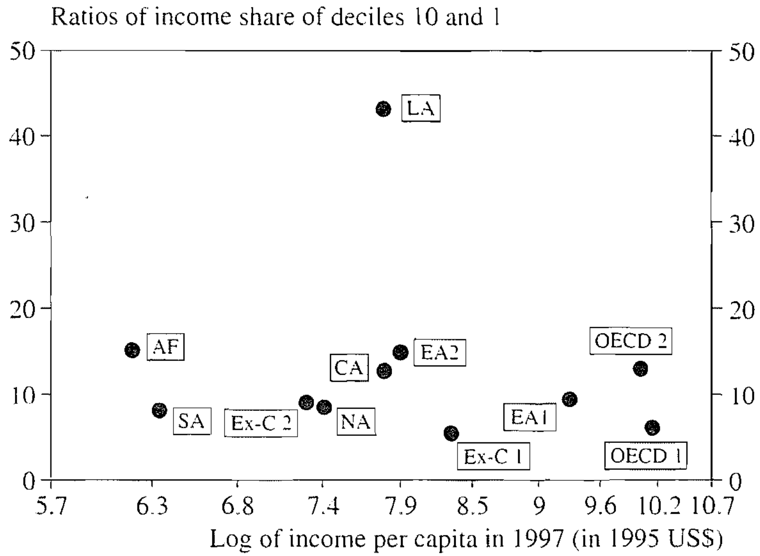
Note: st dev = standard deviation; c of var = coefficient of variation (figures shown are multiplied by 100). d 10 = decile 10; d1 – d4 = deciles 1 to 4; d5 – d9 = deciles 5 to 9; and d7 – d9 = deciles 7 to 9.

that stands out is its obvious implications for the well-known theory of the role of 'human capital' on income distribution. According to this theory, the level of education is a crucial variable (if not *the* most crucial variable) in the determination of income inequality.[24] However, in all regions of the world (developed and developing, Latin American and non-Latin American) one finds that the top income decile is made up from individuals with relatively high levels of education, while the bottom four deciles are made up from individuals who have undergone relatively low levels of formal education – either relatively little schooling, or (in the more advanced countries) usually education of a rather doubtful quality. If this is so, how is it that it is precisely in these two (relatively homogeneously-educated) groups that one finds the greatest relative distributional diversity? In turn, if it is in the population contained in deciles 5 to 9 that the real world-educational diversity takes place – in particular in terms of the proportion of the population which has secondary and tertiary education – how is it that it is precisely in this (educationally highly *heterogeneous*) group that one finds an extraordinary *similarity* in terms of shares of national income?

Obviously, more research needs to be done on the origins of the forces moving the shares of national income of different decile groups along such different paths (particularly in such opposite 'centrifugal' and 'centripetal' directions). However, it seems rather remarkable that this simple point does not seem to have been emphasised before. Also, it seems odd that most of the recent wide-ranging literature on income 'polarisation' has again tended to produce indices that place most of the emphasis of distributional changes towards the *middle* of the distribution, precisely where there is greater homogeneity.[25] In fact, the large degree of heterogeneity at the very top and bottom of the income distribution makes income ratios, such as that of deciles 10 and 1, statistically-sensitive indicators of distributional disparities across the world, in particular highlighting Latin America's huge income polarisation (see Figure 6.11). In fact, from this perspective, Latin America seems to be living in a distributional world of its own – acting as if it were on quite a different planet!

4. Income inequality and income per capita: testing for regional effects in a cross-section framework

As is well known, the Kuznets 'inverted U' framework is the most common form in which to test for the relationship between income inequality and income per capita both in a time series and in a cross-section framework. However, in doing so, one has to distinguish crucially between two factors: one is the study of whether there is a relationship between these two variables, the other is the issue of how to interpret this relationship analytically; that is, if the test shows a significant relationship of this kind, the Kuznets 'structural change' hypothesis is just one of several possible interpretations of the nature of this relationship. In this chapter, I am going to use the traditional econometric specification test for regional effects between these variables, but any evidence



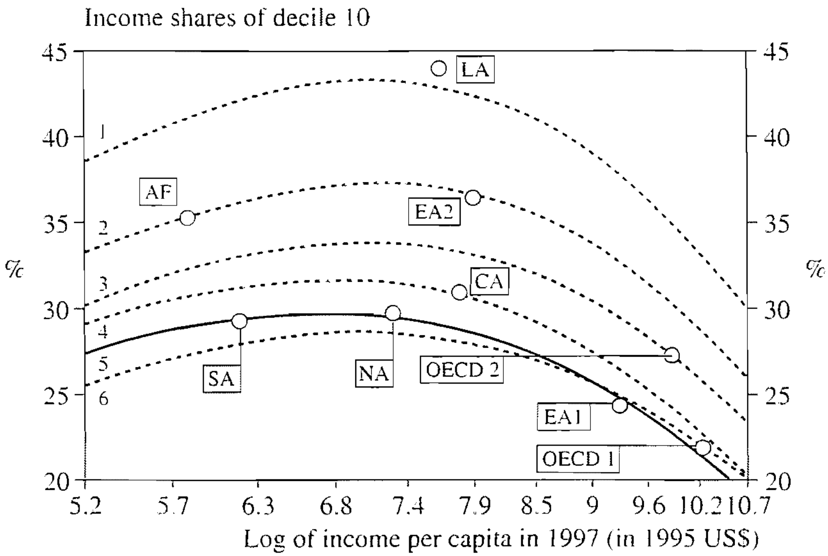
Note: Regional figures are harmonic means for the ratios of the income share of deciles 10 to 1, and arithmetic means for the log of income per capita. Regions as in Appendix 1.

Figure 6.11 *Regional ratios of deciles 10 and 1 and log of income per capita*

of a statistically significant relationship between them will not necessarily be taken as evidence of a Kuznets type of relationship. There are two main reasons for this. The first is that there is already a large (and convincing) literature against the existence of an actual Kuznets type of relationship between these two variables;[26] and the other is that the findings of sections 1 to 3 above, themselves make this type of relationship fairly irrelevant.

Also, as discussed in detail elsewhere,[27] for statistical and analytical reasons, I have decided not to include the 19 ex-communist countries (from Central Europe and the former Soviet Union) in the sample to be used to test for regional effects. As a result, the actual sample used will only contain 90 countries – however, this sample size is still large enough to provide sufficient degrees of freedom for a reasonably robust testing procedure.

Finally, also following the discussion of sections 1 to 3, in this testing I will not use the Gini index as a dependent inequality variable, as these statistics hide two very different distributional worlds. So the regional distributional effects will be tested using as dependent variables the income share of the different income groups, with the right-hand side variables being an intercept, the log of income per capita, and the square of the same variable.

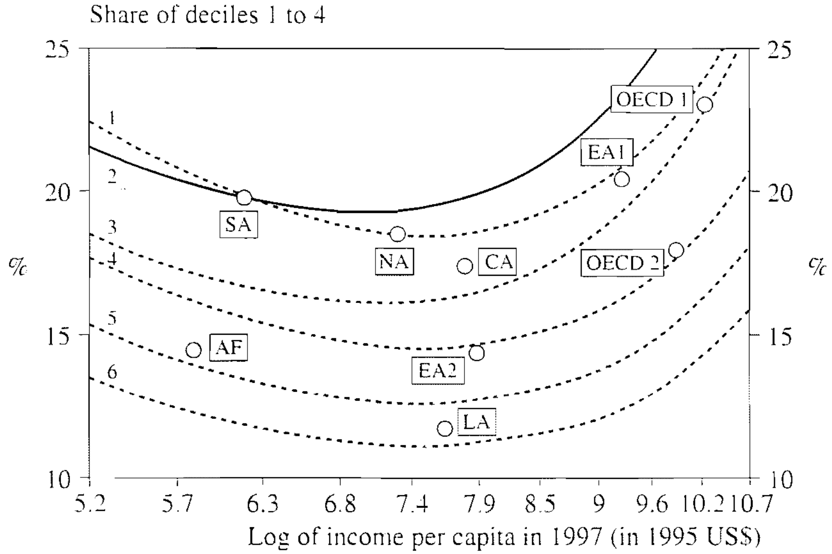


Notes:
1 = the regression with an intercept-dummy for Latin America; 2 = with an intercept-dummy for sub-Saharan Africa; 3 = base regression; 4 = with a dummy in the square of income per capita variable for the non-English-speaking OECD; 5 = with a dummy on the income per capita variable for South Asia and low-income South East Asia; and 6 = with an intercept-dummy for North Africa.[29]
For the summary statistics of the regressions, see Appendix 2.
Regional figures are median values. Regions as in Appendix 1.

Figure 6.12 Income shares of decile 10 and log of income per capita

Figure 6.12 shows the result of such testing for the income share of the top decile.[28] This figure shows how widespread the regional effects are. In fact, there are no less than five statistically-significant regional dummies – one of the dummies (Latin America) is significant at the 1 per cent level and the other four at the 5 per cent level; all other parameters and the F test are significant at the 1 per cent level. The adjusted R^2 is 74 per cent. In fact, the only regions where dummies were not significant at the 5 per cent level were East Asia, the Caribbean and the English-speaking OECD (just 14 countries in all); therefore, these countries are included in the base regression (together with the nine countries which are not classified within any of these regions; see Appendix 1).

Figure 6.13 shows again the mirror relationship between the behaviour of the top decile and that of the bottom four deciles. This regression is again highly significant, with all eight parameters (including all five dummies) and the F test significant at the 1 per cent level. The R^2 is 64 per cent.

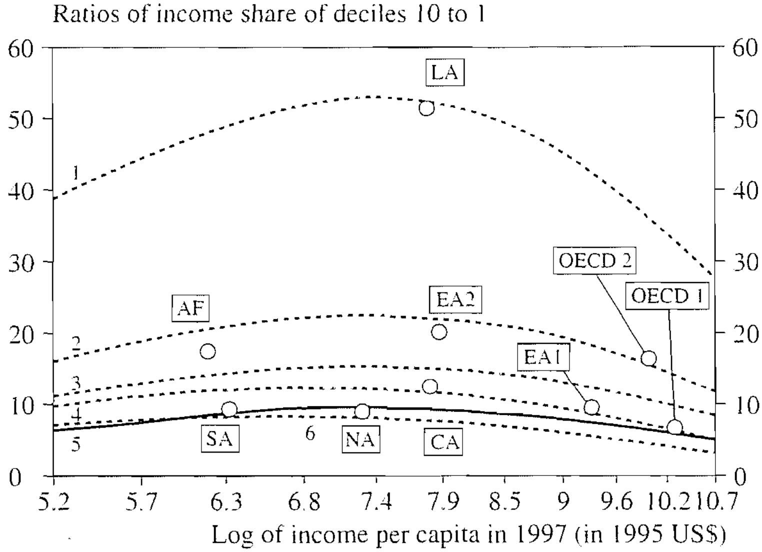


Notes:
1 = the regression with a dummy for North Africa; 2 = with a dummy for South Asia and low-income South East Asia; 3 = with a dummy for the non-English-speaking OECD; 4 = base regression; 5 = with a dummy for sub-Saharan Africa; and 6 = with a dummy for Latin America.
For the summary statistics of the regressions, see Appendix 2. In this regression it was necessary to correct for heteroscedasticity.
Regional figures are median values. Regions as in Appendix 1.

Figure 6.13 Income shares of deciles 1 to 4 and log of income per capita

However, not surprisingly, in terms of deciles 5 to 9 the regional homogeneity of their income-share means that there are no regional effects worth considering in this half of the population.

Finally, strong regional effects are again found when this 'inverted U' specification is tested with the ratio of deciles 10 and 1 as dependent variable (see Figure 6.14). Again, this regression is highly significant; four of the dummies are significant at a 1 per cent level, and all other parameters (except for the intercept) are significant at 5 per cent. The R^2 is 71 per cent. This is the specification of the distributional regional effects in which the Latin American 'excess' degree of inequality is shown in a more extreme form. In general, the Latin American intercept-dummies are significant at a 1 per cent level in all three specifications of the dependent variable (decile 10, deciles 1 to 4, and ratio of deciles 10 and 1). This seems to indicate that there is particularly strong statistical evidence that, towards the end of the 1990s.

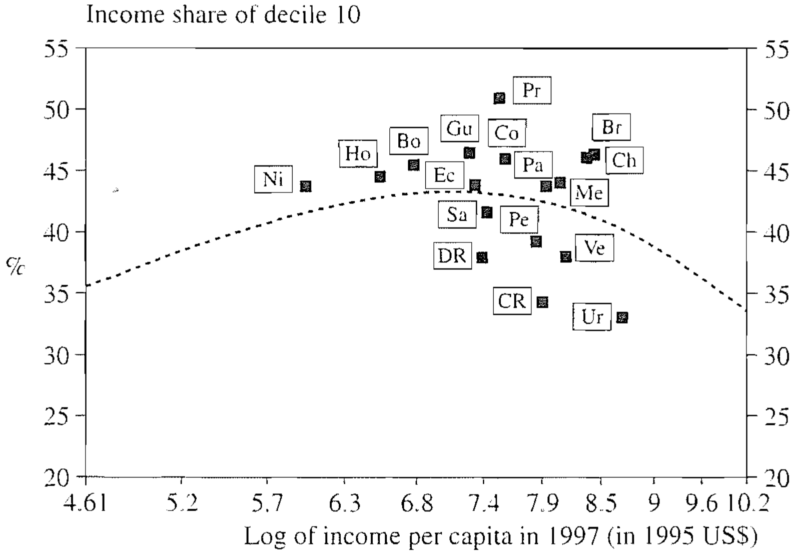


Notes:
1 = the regression with a dummy for Latin America; 2 = with a dummy for sub-Saharan Africa; 3 = base regression; 4 = with a dummy for the non-English-speaking OECD; 5 = with a dummy for South Asia and low-income South East Asia; and 6 = with a dummy for North Africa.
For the summary statistics of the regressions, see Appendix 2. In this regression it was necessary to correct for heteroscedasticity.
Regional figures are geometric means for the ratios of the income share of deciles 10 to 1, and arithmetic means for the log of income per capita. Regions as in Appendix 1.

Figure 6.14 Income ratios of deciles 10 to 1 and log of income per capita

Latin American countries developed a clear 'excess' degree of inequality *vis-à-vis* their middle income level, and that this 'excess' inequality is clearly greater than that of any other region of the world.[30]

However, as there is no Latin American country with a high income per capita, this sample has no information regarding what would be likely to happen to this 'excess' inequality as such countries move towards higher income levels.[31] Furthermore, as Figure 6.15 shows, towards the end of the 1990s as income per capita increases in Latin America, the distributional dispersion among countries of this region increases rapidly. The five countries with the highest income per capita in the region (Uruguay, Chile, Brazil, Venezuela and Mexico) are spread over a large range of income shares for decile 10 – in fact, the two countries with the largest income per capita, Uruguay and Brazil, have the lowest and the (second) highest income shares for this decile (33.1 per cent and 46.5 per cent, respectively). In turn, Brazil,



Notes:
Ni = Nicaragua; Ho = Honduras; Bo = Bolivia; Gu = Guatemala; Pr = Paraguay; Ec = Ecuador; S = El Salvador; C = Colombia; Pa = Panama; Br = Brazil; Ch = Chile; DR = Dominican Republic; Pe = Peru; Me = Mexico; Ve = Venezuela; CR = Costa Rica; and Ur = Uruguay.
The regression for Latin America as in Figure 6.12. For the summary statistics of this regression, see Appendix 2.

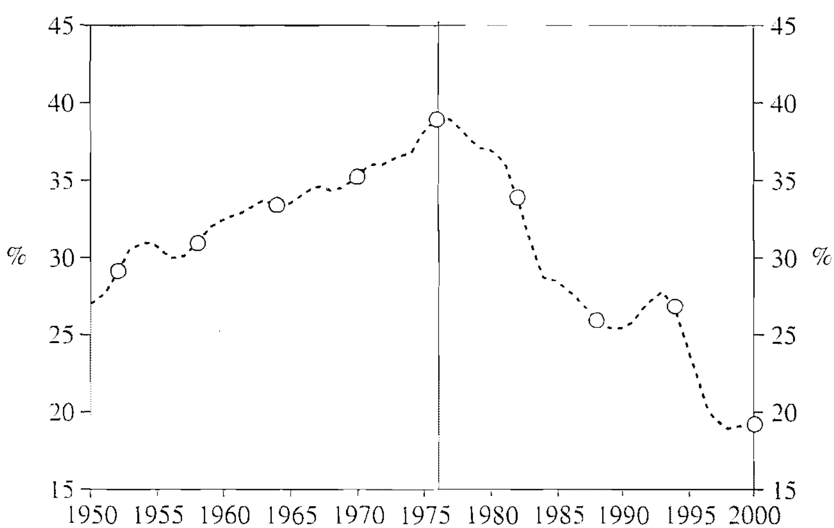
Figure 6.15 Latin America: income share of decile 10 and log of income per capita

Chile and Mexico are the three most 'stubborn' countries in terms of their reluctance to improve their income distribution as their income per capita increases – in fact, at the end of the 1990s they were actually moving in the opposite direction.

A brief analysis of Mexico could help us to understand why increased integration into the world economy, after economic reform in general and trade liberalisation in particular, have produced an increased inequalising effect. Although political reform began in Mexico during the presidential period of Lopez Portillo (1976–82), trade liberalisation began with President De la Madrid, who took office in the midst of the 1982 debt crisis; and in terms of growth of manufacturing exports, Mexico has never looked back – in constant US dollar terms, manufactured exports (including those of so-called 'maquiladora' activities) grew from US$ 8 billion in 1981 to US$ 145 billion in 2000 (both figures in US$ of 2000 values) – a figure similar to that of Korea's. This 19-fold increase (equivalent to an annual average growth rate of 17 per cent) brought the share of these exports in the country's total goods exports to 80 per cent (from less than 10 per cent in 1981).[32]

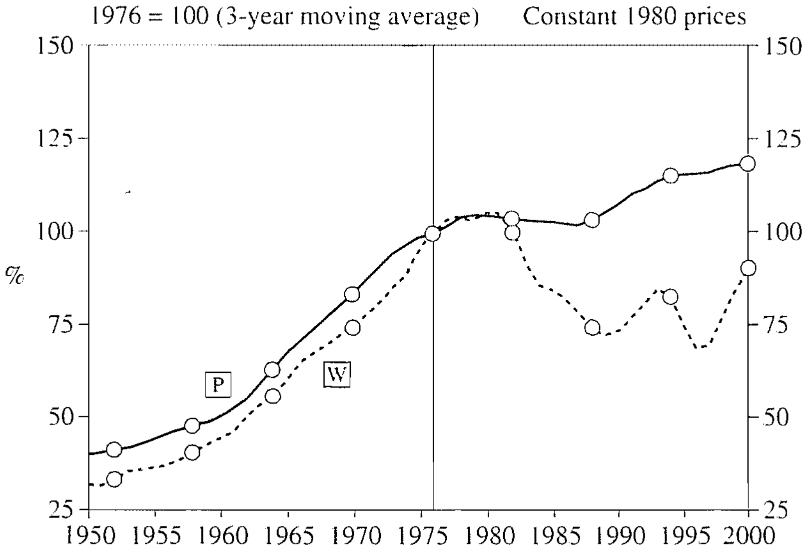
Even bearing in mind that there are few Developing Countries in such a convenient geographical position (at least as far as manufactured exports are concerned!), with such a preferential access to the US market (via NAFTA), and having received such a flood of FDI, the performance of Mexican manufactured exports in this period is truly exceptional. However, extraordinary as it is, this export expansion has had a far more complex – and certainly weaker – impact than expected on the Mexican economy as a whole, especially on growth, investment, productivity and wages. In particular, it has been associated with both a collapse of the export multiplier and the de-linkaging of the export sector from the rest of the economy; this has produced a situation in which increasing export competitiveness has had little effect on growth and living standards.[33]

Figure 6.16 shows the trademark of the 'liberalisation-package' in Mexico (as in the rest of Latin America): the fall in the share of wages in GDP. In Mexico, in just two presidential terms (1976–82 and 1982–88), and one economic crisis, the share of wages in GDP fell by no less than 14 percentage points. Again, in the last presidential period of the 1990s (which includes yet



Note: Intervals between circles correspond to presidential periods. Figure for 2000 is provisional.

Figure 6.16 *Mexico: wages as a share of GDP, 1950–2000*



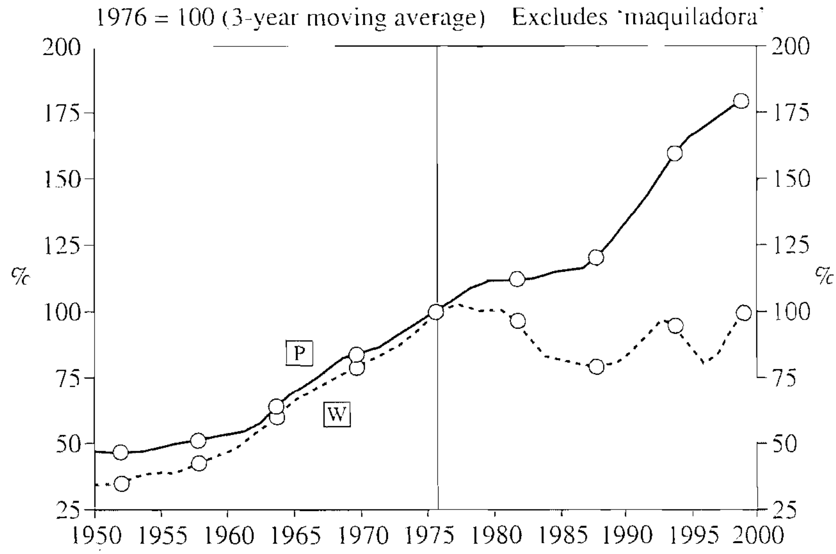
Note: [P] = average productivity; and [W] = average real wage. The wage figure for 2000 is provisional.

Figure 6.17 Mexico: average real wages and productivity, 1950–2000

another economic crisis), the overall share of wages in GDP fell by a further 8 percentage points. In all, the share of wages fell from 40 per cent of GDP in 1976 to just 18.9 per cent in 1999.

Figure 6.17, shows the root cause of this fall in the share of wages in GDP: the emergence of a new 'scissors' effect between wages and productivity after political and economic reforms. One can identify three distinct periods over these five decades. First, up to the Echeverria government (1970–76), and into Lopez Portillo's term of office (1976–82), one can witness the essential characteristic of the traditional PRI distributive policy: wages were able to grow at a similar pace to productivity growth; that is, mainly through increased bargaining power, labour had gained the property right to share in the benefits of growth.

In the second period, and marking the beginning of politico-ideological change in Mexico (and in most of Latin America) during the second half of the 1970s, economic policy led to a progressive stagnation of wages, despite the massive new oil-riches of the country.[34] Then, when economic crisis struck Mexico with the 1982 recession, and with the ascendance to power of President De la Madrid and his economic reform team, a rapidly growing gap emerged between productivity and wages. By 2000, and two presidents and



Note: [P] = average productivity; and [W] = average real wage.

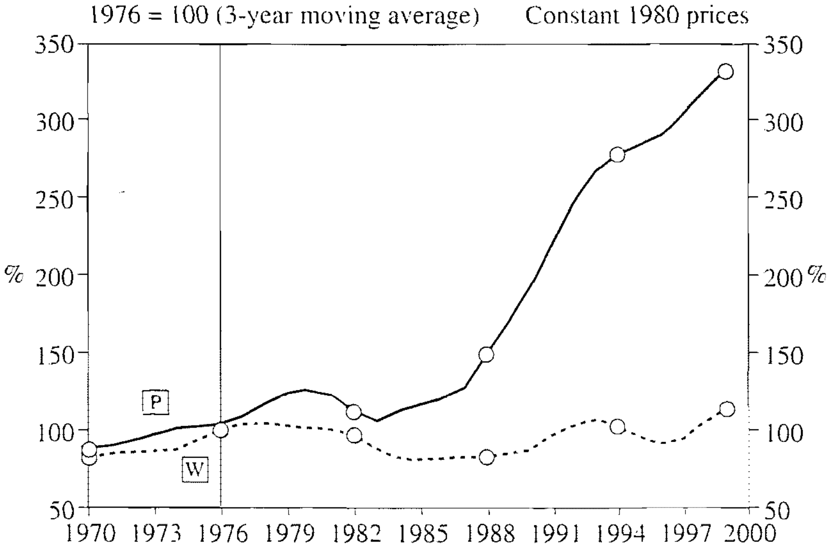
Figure 6.18 Mexico: wages and productivity in the manufacturing sector, 1970–99

another economic crisis later, this gap had reached approximately 30 percentage points.

Figures 6.18 to 6.20 show that the gap between productivity and wages took a different form in manufacturing than in non-tradables.

In manufacturing, prior to 1976 there was a relatively stable relationship between productivity growth and wage growth; afterwards, this pattern changes due to a sharp break in the trend of wage growth. In fact, as mentioned above, by the end of the 1990s the average wage was only recovering its 1976 level. In the meantime, productivity had increased by about 80 per cent. A clear case of a new 'winner (capital) takes all' pattern of distribution.

As Kalecki would have predicted, the two recessions (1982 and 1994) played a role in delivering this new distributional world, by drastically affecting the bargaining power of labour. But as Prebisch and Singer would have predicted too, as soon as manufacturing became export-oriented – particularly in a world in which capital is increasingly mobile and labour immobile – it began to behave as if it were a traditional primary commodity sector: wages immediately stagnated and all productivity growth was either captured by capital or transferred to consumers in the North (in this case in the US) via lower prices. Figure 6.19 shows how the most successful activity within



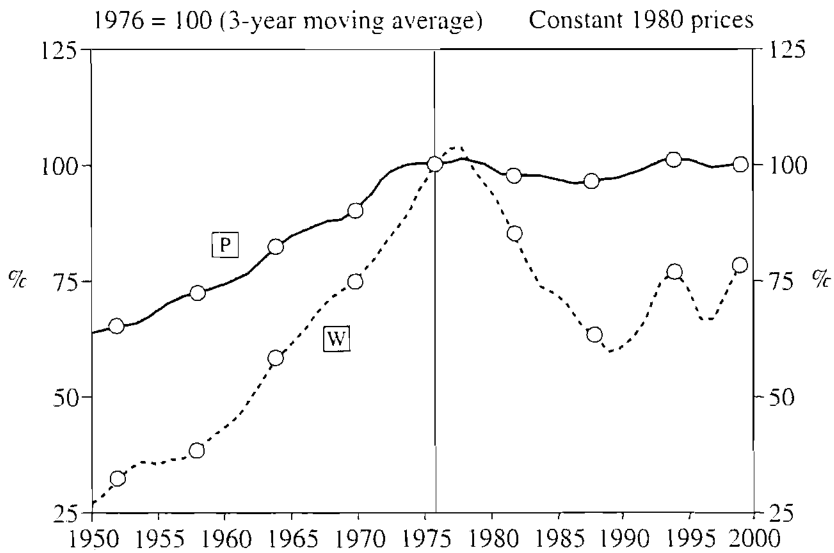
Note: [P] = average productivity; and [W] = average real wage

Figure 6.19 Mexico: wages and productivity in the car industry, 1970–99

manufacturing developed an extreme form of this new 'export-oriented' distributional pattern. Not even in an industry that had a 330 per cent productivity growth during this 'liberalised' period of deeper integration into the world economy, were wages able to grow in any significant way. The experience of Mexico in this respect is certainly closer to the predictions of Prebisch and Singer than to those of Samuelson's theorem of trade-related wage-equalisation across the world!

Moreover, what about the relationship between wages and productivity in the sectors that have been unable to deliver productivity growth? In non-tradables one also finds a new gap between productivity-growth and wage-growth, but this takes place in a different direction – that is, the same 'scissors' pattern (from well before 1981), but having a different 'angle' (see Figure 6.20). Here, given the stagnation of productivity, for the gap to emerge wages have to fall substantially.

This decline in wages in non-tradables (mainly services and construction) contrasts sharply with the situation before 1976, when there was another gap (then in favour of labour), with wages growing *faster* than productivity. This was one of the characteristics of the previous structure of property rights in the labour market (not only in Mexico but also in many other Latin American countries), with wages in *manufacturing* (which grew at a rate roughly simi-



Note: [P] = average productivity; and [W] = average real wage.

Figure 6.20 Mexico: wages and productivity in the non-tradable sector, 1950–99

lar to productivity growth) setting the pace for wage-growth in the non-manufacturing sector of the economy, even in those sectors in which productivity-growth was slower than in manufacturing.

In this way, a new pattern of accumulation has emerged with the economic reform in Mexico (as in the rest of Latin America). Now 'winner takes all', where there is productivity growth (*à la* Prebisch–Singer), and where there is none, capital benefits anyway via the contraction of wages (*à la* Lewis, because here the institutional changes in the labour market allow capital to shrink wages back towards their subsistence level). In this way, even if productivity growth is disappointing (mainly as a result of poor investment effort), the stagnation of wages in some activities, and their decline in others, have proved to be an effective compensatory mechanism for capital in the era of globalisation.

5. Conclusions

Although the Gini-picture of the income distribution of the different regions of the world shows a clear 'four-layer' distributional heterogeneity across the world, this phenomenon really only reflects what happens in half of the world's population – those at the very top and those at the bottom of the distribution.

The other half – those in the middle and upper-middle of the distribution – present a rather different picture, one of extraordinary homogeneity. This is a truly remarkable fact, which so far has not been properly emphasised in the literature. Obviously, more research needs to be done into what forces lie behind these opposite 'centrifugal' and 'centripetal' movements.

The homogeneity in the middle and upper-middle of the distribution raises some doubts regarding the distributional theories that give pride of place either to education or to 'augmented' wage differentials as the main determinants of income distribution. The groups with the highest degree of heterogeneity in distributional terms are more likely to have the higher degree of homogeneity in educational terms, and vice versa. In terms of wage differentials, relative to the extreme ends of the distribution, there does not seem to be much 'statistical life' in that part of the distribution where 'skilled' and 'unskilled' labour are most likely to be found.

In general, politico-institutional factors seem to have a far greater influence in the determination of income distribution than purely economic ones.[35]

This sample also shows that there is a significant distributional difference between the English- and non-English-speaking OECD; the same phenomenon is found in the ex-communist countries, between those that used to belong to the Soviet Union and those in Central Europe.

Finally, in terms of the 'U' and 'inverted U' relationship between income distribution and income per capita in the era of globalisation – and taking into account all the necessary (and extremely important) econometric caveats on cross-section regressions of this nature, the problems with the quality of the data, and the fact that in many countries (especially in sub-Saharan Africa) the data relate to expenditure and not income – the relevant regressions seem to support several hypotheses. First, that statistically the cross-section relationship still applies for the distributional diversity at the very top and at the bottom of the income distribution; secondly (and analytically far more importantly), that within these relationships (much more homogeneous) regional effects clearly dominate; and thirdly, that Latin America has so far grown with the largest 'excess' inequality of all regions in the world. In fact, from this perspective, Latin America seems to be living in a distributional world of its own, acting as though it were on a completely different planet.[36] As the likelihood is that all over the Third World political oligarchies would like to appropriate such a high share of the national income, the key question that still needs to be answered is, why is it that it is only in Latin America that they manage to get away with it?

Appendix 1

- LA (Latin America) = Bolivia, Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay and Venezuela.
- AF (Sub-Saharan Africa) = Burkina Faso, Burundi, Cote d'Ivoire, The Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Lesotho, Madagascar, Mali, Mauritania, Mozambique, Niger, Nigeria, Rwanda and Senegal, South Africa, Swaziland, Tanzania, Uganda, Zambia and Zimbabwe.
- EA1 (= 'first-tier' NICs) = Korea.
- EA 2 (= 'second-tier' NICs) = Malaysia, Philippines and Thailand.
- SA (large South Asia and low-income South-east Asia) = Bangladesh, China, India, Indonesia, Lao PDR, Pakistan, Sri Lanka and Vietnam.
- NA (North Africa) = Algeria, Egypt, Jordan, Morocco and Tunisia.
- CA (Caribbean countries) = Guyana, Jamaica, St. Lucia and Trinidad and Tobago.
- OECD 1 (non-English-speaking OECD) = Austria, Belgium, Denmark, Finland, France, Germany, Greece, Italy, Japan, Luxembourg, Netherlands, Norway, Portugal, Spain and Sweden.
- OECD 2 (English-speaking OECD) = Australia, Canada, Ireland, New Zealand, United Kingdom and United States.
- Ex-C 1 (ex-communist countries of Central Europe) = Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovak Republic and Slovenia.
- Ex-C 2 (ex-communist countries of the former Soviet Union) = Belarus, Estonia, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Moldova, Russian Federation, Turkmenistan, Ukraine and Uzbekistan.
- Not classified = Cambodia, Ethiopia, Israel, Mongolia, Nepal, Papua New Guinea, Turkey, Switzerland and Yemen.

Appendix 2

Parameters' point estimation

	Reg. d10	Reg. d1–d4	Reg. d10/d1
Intersect	2.0484	4.8866	–0.6353
Ln Y pc	0.4222	–0.5541	0.9062
Ln Y pc sq	–0.0288	0.0354	–0.0610
LA dummy	0.2462	–0.3118	1.2329
AF dummy	0.1016	–0.2317	0.3822
SA dummy	–0.0196	0.0286	–0.0846
NA dummy	–0.1717	0.1963	–0.4801
OECD1 du	–0.0013	0.0019	–0.0041

Notes:
Reg. 1 corresponds to Figure 6.12; Reg. 2 corresponds to Figure 6.13; and Reg. 3 corresponds to Figure 6.14. Ln Y pc = log of income per capita; Ln Y pc sq = square of the log of income per capita; for dummy-specifications see Figure 6.12.

't' values

	Reg. d10	Reg. d1–d4	Reg. d10/d1
Intersect	5.05	7.95	–0.46
Ln Y p c	3.74	–3.50	2.48
Ln Y pc sq	–3.99	3.61	–2.63
LA dummy	5.17	–4.87	7.45
AF dummy	2.07	–2.89	2.22
SA dummy	–2.02	3.37	–4.73
NA dummy	–2.45	2.97	–2.98
OECD1 d.	–2.32	3.92	–3.22

Notes:
In regressions 4 and 5 the heteroscedasticity test fails at the 5 per cent level of significance. so the 't' statistics (and the 'p' values below) are based on 'White's heteroscedasticity adjusted standard errors'.

'p' values

	Reg. d10	Reg. d1–d4	Reg. d10/d1
Intersect	0.000	0.000	0.650
Ln Y p c	0.000	0.001	0.015
Ln Y pc sq	0.000	0.001	0.010
LA dummy	0.000	0.000	0.000
AF dummy	0.042	0.005	0.029
SA dummy	0.047	0.001	0.000
NA dummy	0.016	0.004	0.004
OECD1 d.	0.022	0.000	0.002

Regression statistics

	Reg. D10	Reg. d1–d4	Reg. d10/d1
R-bar-sq	0.74	0.64	0.71
se y	0.13	0.19	0.47
F	32.7	20.5	28.2
'p' of F	0.000	0.000	0.000

Note: R-bar-sq is the adjusted coefficient of determination; se y is the standard error for the 'y' estimate; F is the F statistic; and 'p' of F is the 'p' value of F.

Notes

1. Tony Atkinson, Jayati Gosh, Daniel Hahn, Richard Kozul-Wright, Hugo Pagano, Guillermo Paraje, Hashem Pesaran and Guy Standing made very useful suggestions. The usual caveats apply.
2. For a comprehensive analysis of this literature, see Kanbur (2000). See also Atkinson (1997), Aghion *et al.* (1999), IADB (1999), and UNCTAD (1996 and 2002).
3. At the time of the creation of NAFTA, there were already well over ten million Mexicans living in the US.
4. For the Luxembourg Income Study (LIS), see http://www.lis.ceps.lu. The WB basic information is now published regularly in its World Development Indicators (WDI). See also WIDER (2000).
5. See World Bank (2001).
6. The Sierra Leone survey, for example, which was undertaken in the midst of a rather brutal civil war, claims to have 'national' coverage! In the case of Latin America, a critical survey of the quality of household surveys can be found in Székely and Hilgert (1999a).
7. See Deininger and Squire (1996).
8. See, for example, Székely and Hilgert (1999b).
9. Following advice from WB staff, data from Sierra Leone and the Central African Republic are excluded from the sample due to inconsistencies.
10. In terms of developing countries, the Latin American median for the top quintile is 55.2 per cent, while that for the 'developing-non-Latin-American' group of countries is 46.6 per cent.

11. This is just one of the many instances that show the loss of information resulting from reporting data only in terms of quintiles
12. In fact, as discussed elsewhere, decile 10 also tends to have a significant internal dispersion; and in Latin America, the real concentration of income is found within the first five percentiles of income recipients (see Palma, 2002a); this point is also clear in some country-studies, see for example Ferreira and Litchfield (2000) for Brazil, Panuco (1988) for Mexico, and Paraje (2002) for Argentina. Consequently, what one would really like to know is the effects of globalisation on the income share of the top 5 per cent of the population; however, this is not possible with the available data.
13. See Palma (2002a)
14. Chile is only one of a few countries in the Third World for which there is systematic income distribution data for any length of time. See this publication for a detailed discussion of the quality of these data (relating to 'Greater Santiago', all of which have the same source and methodology), and of the work done by this author to improve their degree of homogeneity.
15. Moreover, later on, when the second democratic government in Chile (1994–99) abandoned the progressive distributive policies of the first, and the income share of decile 10 recovered all the ground lost since 1989 (6 percentage points of national income), the share of decile 9 actually dropped by 3 percentage points. Perhaps it was the intuition of this situation, and the fact that a return to a right-wing government would only accentuate this distributional asymmetry between deciles 9 and 10 that, during the last presidential election, led a satirical magazine in Chile to characterise the economic programme of the right-wing (Chicago-boy) candidate with a sort of 'post-modernist' Robin Hood metaphor: for them, his economic programme was equivalent to a group of bandits who would rob the rich ... to give to the very rich!
16. The wide range of the income share of decile 1 across countries is almost as remarkable as that found in decile 10 – from 5.1 per cent in the Slovak Republic and Belarus (and 4.8 per cent in Japan), to just 0.5 per cent in Guinea-Bissau (and 0.6 per cent in Guatemala, and 0.7 per cent in Paraguay). Again, Latin American countries are found at the unequal end of the ranking; while the median value for the income shares for decile 1 for all countries is 2.6 per cent, that for Latin America is just 0.8 per cent (a figure that is only about one-third that of the non-Latin American countries).
17. The range for the ratio of deciles 10 and 1 extends from 3.6 in the Slovak Republic (and 3.9 in Belarus, 4.4 in Austria, 4.5 in Japan, and 5.1 in Finland), to no less than 114 in Bolivia (and 112 in Honduras and 104 in El Salvador).
18. See, for example, World Bank (1987) and Krueger (1983).
19. See, for example, Lall (1983).
20. See, for example, Juhn and Pierce (1993); Revenga (1995); Cline (1997; this book has a very useful survey of the literature); Haskel (1999); and Melendez (2001). For critiques of this literature, see Krugman and Lawrence (1993), Robinson (1996), and Atkinson (1997).
21. In this section of the chapter, data from Hong Kong and Taiwan are added to that of Korea to form an enlarged EA 1. The data for these countries, which are not available in the WDI database, were obtained from Deininger and Squire (1996). However, these two countries are not included in the regressions below (Section 4), as their data have a different source.
22. Given both the extraordinarily large size *and* variance in the shares of decile 10 across countries, these shares end up dominating an international comparison based on the Gini indices, as this index is calculated as the area between each Lorenz curve and a hypothetical line of absolute equality (expressed as a percentage of the maximum area under the line).
23. See also UNCTAD (1996).
24. See, for example, Neal and Rosen (2000).
25. Wolfson, for example, started this latest 'polarisation' literature by developing an index that cuts the Lorenz curve right in the middle! For a discussion of this point, see Palma (2002b).
26. See especially Kanbur (2000).
27. See Palma (2002d)

28. For a detailed discussion of the econometrics issues raised by cross-section regressions like these, see Palma (2002d). In particular, one has to understand that these regressions are simply a cross-sectional *description* of cross-country inequality differences, categorised by income per capita: that is, they should not be interpreted in a 'predicting' way, because there are a number of difficulties with a curve estimated from a single cross-section – in particular, strong homogeneity restrictions are required to hold (see, for example, Pesaran *et al.*, 2000). This is one of the reasons why the use of regional dummies is so important – they bring us closer to the required homogeneity restrictions for prediction; nevertheless, there is no obvious way of knowing whether we are close enough to them to be able to predict with a reasonable degree of confidence. The jury is therefore still out regarding the predictive capacity of regressions like these. Moreover, in any classification of this type there is a 'pre-testing' danger, as there are many ways that regions could be defined.
29. Dummies for each region were selected according to the Akaike Information Criterion. The same dummies were used in the regressions below.
30. This statement can be confirmed, for example, by testing the Latin American dummy *vis-à-vis* the sub-Saharan African one: in all four specifications the null hypothesis that both are not significantly different is easily rejected at the 1 per cent level.
31. In any case, as discussed above, even if there was such information, in order to be able to use regressions like these for prediction purposes, one would require strong 'homogeneity restrictions' to hold.
32. In 2000, Mexico's manufacturing exports were 3.5 times greater than those of Brazil and Argentina taken together. In terms of overall merchandise exports, Mexico's share in the Latin American total doubled from just under one-quarter to about one-half.
33. For a detailed analysis of the Mexican economy after trade liberalisation, see Palma (2002d).
34. One has to remember that wages stagnated at a time of economic euphoria in Mexico, with the new oil industry coming on stream at a time of particularly high oil prices. This mania reached such heights that the President once declared that from then on in Mexico 'economic policy was no longer an issue of allocation of scarce resources among multiple needs, but one of the distribution of abundance'. Well, this 'abundance' clearly did not reach wages!
35. This issue is discussed in more detail in the Latin American context in another paper (Palma, 2002a). See also Krugman and Lawrence (1993).
36. A possible characterisation of, say, Brazil and Chile would be that these are middle-income countries, where the top 10 per cent are able to live the equivalent of a modern European lifestyle mainly thanks to the fact that the bottom 40 per cent are still living the equivalent of a medieval European lifestyle.

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PART III

TRANSNATIONAL CORPORATIONS

7 The role of transnational corporations in the globalisation process

Grazia Ietto-Gillies[1]

1. Introduction

Globalisation is a complex phenomenon which is more in the nature of a process than a state of affairs. There have been several attempts at definition (McGrew, 1992; Oman, 1996; Castells, 1996; Giddens, 1999; Held *et al.* 1999).[2] Most definitions boil down to the fact that globalisation is both a process of geographical/spatial outreach and of an increased degree of interconnectedness and interdependence between people, groups and institutions based in different countries of the world.

As a process of spatial outreach it is not new and has long historical antecedents (Held *et al.*, 1999). Nonetheless it is argued in this chapter that the current process is considerably different from any previous process of outreach. One of the major differences is seen in the role that transnational corporations (TNCs) play in the globalization process.

The chapter proceeds in section 2 with an analysis of the salient characteristics of the globalisation process. The third section considers the role of TNCs in cross-border transactions. Section 4 develops the argument that the TNCs are a dominant cause of the globalisation process. Section 5 considers the wider policy implications of this perspective and the last section concludes.

2. Salient characteristics of globalisation

The current globalisation process is characterised by both qualitative and quantitative aspects and it differs from previous outreach processes in many of these aspects. The process is cumulative and thus the various aspects and mechanisms reinforce each other.

Among the *qualitative* aspects of globalisation the following play an important part:

- *Breadth of change.* The changes now involve a variety of fields or 'domains' (Held *et al.*, 1999) ranging from the economy and society in general, to population movements, to the business sector, to politics, to the military, the environment and culture.
- *Political basis.* The process has been reinforced by the economic and

social policies of deregulation and liberalisation now involving most countries in both the developed and developing regions.

- *Financial domination of the economy*. The dominance of finance capital is not new in capitalism. However, the last 20 years have seen such dominance reaching unprecedented levels both in terms of intensity of financial activities in relation to the size of economies, and in terms of number of countries involved in financial transactions.
- *Social and organisational changes*. The organisation of production and business in general has undergone considerable changes made possible and indeed necessary by the new technologies.
- *Transnational corporations*. The major changes are related to the organisation of production across countries due to the activities of TNCs, on which more in the rest of this chapter.
- *Technological basis of globalisation*. None of the above changes would have been possible on the scale in which we are witnessing them without the introduction and rapid spread of the information and communication technologies (ICTs). The ICTs affect every aspect of the globalisation process from the movement of people, products and resources, to the organisation of production. Considerable improvements have also occurred in the technology and costs of transportation.

As regards the *quantitative aspects* of the globalisation process, the following issues are relevant.

- There has been an increase in the *number of mechanisms* of interconnectedness across borders: from the traditional trade flows to foreign investment (direct and portfolio) and related incomes, to various types of collaborative business ventures.
- The *extensity* or geographical/spatial reach of interconnectedness has been increasing. Here, 'extensity' means the geographical scope and therefore the number of countries involved in cross-border operations within and between regions.
- The *intensity* of cross-border flows has also been increasing. By intensity I mean the ratio between cross-border transactions and the size of the domestic economy(ies). The latter can be represented by a variety of economic and social variables such as gross domestic product or domestic capital formation or population or labour force.

3. Cross-border transactions and the TNCs

The interconnectedness across countries manifests in a variety of transactions and flows; particularly in the following:

- International trade in goods and services
- Foreign direct investment
- Portfolio investment
- Profits, interests and dividends from the various types of foreign investment
- Inter-organisational collaborative partnerships
- Movements of people across borders for leisure or business activities or in search of jobs.

The institutions that participate and that are key to all the above activities are the TNCs, that is those companies with *direct business activities* in at least two countries. These direct business activities involve the ownership of productive assets abroad in a percentage large enough to give control over the conduct of the business.[3]

The cross-border transactions which are most specific to – and indeed defining of – the TNC are foreign direct investment (FDI). From the 1970s onward there has been a steady and large increase in FDI, most of which originates in developed countries and is indeed directed to the same group of countries. In 2001, 88 per cent of the world stock of FDI originated from developed countries. The same group of countries received 66 per cent of the world stock (UNCTAD, 2002: Annex, tables B4 p. 315 and B3 p. 310).

However, as well as being responsible for all or most FDI, the TNCs participate in all other cross-border business activities listed above. Over three-quarters of world trade originates with TNCs and indeed over a third of it is estimated to take place on an intra-firm basis (UNCTAD, 1996).[4]

Transnational corporations – including banks – are responsible for large amounts of portfolio investment and cross-border loans. The incomes deriving from foreign investment – whether direct or portfolio or loans – will accrue to the institutions involved in such investment and therefore, largely, to the TNCs (Ietto-Gillies, 2000).

Most collaborative agreements are between firms, though there are many instances of collaboration between public and private institutions (Hladik, 1985; Contractor and Lorange, 1988; Hergert and Morris, 1988; Hagedoorn, 1996).

The movement of people across frontiers may have the direct involvement of TNCs to a lesser extent than other cross-border movements. However, an increasing part of migration – that related to expatriate managers – is largely linked to activities of TNCs (Salt and Singleton, 1995; Salt, 1997).

There are currently 64 592 TNCs operating with a network of 851 167 foreign affiliates (UNCTAD, 2002: Annex, table A.I.3, pp. 270–2). Dunning (1981: ch.1, p. 3) reports nearly 11 000 TNCs and 82 600 foreign affiliates in 1976. The huge growth between the mid-1970s and 2002 is the result of the following: a larger number of companies from developed countries operating abroad; the increasing involvement in foreign operations by both large and smaller companies; the transnationalisation of many companies from developing countries. All this is part of what globalisation is about.

4. TNCs as a dominant cause of globalisation

The analysis of globalisation in terms of causes, effects and policy implications has led Held *et al.* (1999) to summarise the positions into three approaches or theses. The *hyperglobalist thesis* – which has Kenichi Ohmae (1991; 1995a and b) as main exponent – sees the TNCs as the key agents of globalisation and the sources of efficiency and growth. The globalisation process itself is to be encouraged and any constraints to it removed. Traditional nation states with over-regulation and uneven regional development are among the obstacles to globalisation. Ohmae therefore advocates the demise of the nation state and the rise of smaller, more developmentally homogeneous region states.

An opposite point of view – *the sceptic thesis* – is taken by Carnoy *et al.* (1993), Hirst and Thompson (1996) and Kozul-Wright and Rowthorn (1998). These authors claim that the globalisation process has been exaggerated and that, in reality, most international activities by TNCs have a very strong home-country base. The nation state and its policies are seen as relevant as ever.

Held *et al.* (1999) see globalisation as a process of *global transformations* similar to other historical processes of global reach but far more advanced in geographical extensity and intensity.

Chesnais (1997) sees *finance* as the main basis of the globalisation process. In his view the deregulation and liberalisation policies of the 1980s have set in motion forces leading to a new regime of capitalist accumulation dominated by finance. He advocates the halting and reversing of this process by curbing the power of finance capital and its hold on industrial capital.

Ietto-Gillies (2001: ch. 9) puts forward a different view on the causes of globalisation and this leads to specific policy implications. The analysis starts from the premise that the current economic and social developments are characterised by two specific types of innovation: (a) technological innovation in the field of communication and information; and (b) organisational innovation which allows a specific actor in the economic system – the transnational company – to use the ICTs to further the productive forces. Globalisation is indeed a new phase in capitalist development characterised by a tremendous increase in the potential – and, to a lesser extent, the actual – development of the productive forces.

Both the organisational and technological types of innovations have, so far, been exploited mainly by the transnational corporation. Though not all organisational innovations contribute to the development of the productive forces, many do. Indeed the scope for further development and exploitation of innovation by the TNCs themselves and indeed by other actors in the economic system is huge.

Starting from the above premises, let us now turn to the causal analysis of globalisation. In this context it is useful to distinguish between the driving forces of globalisation and its dominant causes. The driving forces in the globalisation process are all those elements that contribute to the process and shape its pattern. In particular: the activities of TNCs and of financial institutions; the diffusion of the ICTs; the policies of governments, particularly those related to liberalisation and de-regulation; the policies of international institutions such as the IMF.

Not all these forces operate on an equal basis. Two in particular I consider to be the dominant causes, that is those at the root of the globalisation and those which are largely irreversible.

In the search for dominant causes I follow the concept of *causa causans*[5] developed by Keynes (1937). He uses this concept in order to establish a basic, dominant cause of the level of output and employment in a complex system where many forces operate at once. This is indeed the situation as regards the globalisation process. In the identification of the dominant causes a litmus test will be used consisting of the following two conditions: (a) the dominant causes are a subset of the driving forces and they are identified as those that specifically contribute to the development of the productive forces at the basis of the globalisation process; (b) such a development of the productive forces and the dominant causes behind it are largely irreversible.

On the basis of these conditions the two dominant causes or *causae causantes* of globalisation can be identified in the following two areas of innovation, both of which contribute to the development of the productive forces.

- Technological innovation in the field of communication and information together with advances in the field of transportation.
- Organisational innovation and in particular the organisation of production across countries.

These two elements are strongly interlinked. The diffusion of ICTs makes possible the organisational innovation and the vast development of TNCs' activities we are witnessing. Conversely, the needs of TNCs are behind the rapid diffusion of ICTs.

These two driving forces are largely irreversible and contribute to the development of the productive forces. Other driving forces in the globalisation process – such as financial forces, or policies of national governments and international institutions – do not contribute to the development of the productive forces; moreover, they are indeed reversible. This is why they are here seen as different from the two dominant causes in the role they play in the globalization process.

Therefore though I consider the impact of financial forces and deregulation/ liberalisation as very important in the shaping of the current globalisation process, I do not see them as irreversible forces.

The main characteristic of the TNCs is their ability to plan, organise and control business activities across countries. It is a characteristic currently specific to them and one that, therefore, differentiates them from other actors in the economic system who cannot – or not yet – organise themselves internationally. Such actors include labour, the consumers, uninational companies and indeed local, regional and national governments.

The TNCs play a key role in the globalisation process because: (a) they are key to organisational and technological innovations and therefore to the development of the productive forces; (b) they contribute to most flows of international transactions as listed in section 3 above; (c) they are, so far, the only actor that can truly plan, organise and control activities across borders; (d) they are in a position to take full advantage of the ICTs and indeed contribute to their diffusion and development; (e) they participate in the globalisation process as active rather than passive participants, unlike many other actors.[6]

5. Policy implications

There are specific long-term policy implications emerging from this analysis. First, the fact that those driving forces of the globalisation process which are not dominant causes, can be reversed. Thus, for example, this approach considers the growth of financial transactions to be a driving force, though not a dominant cause. Much financial activity, far from contributing to the development of the productive forces is a hindrance to it and has a purely distributive purpose. Moreover, the financial dominance of domestic and international economies is reversible if the political will is there.

The TNCs play the key role in the development of organisational innovation within and across borders; indeed they are, at present, the only actor that can truly plan, coordinate and control activities across borders. This puts them in a position of considerable power *vis-à-vis* other actors and in particular labour, national governments, consumers and uninational companies.

We need more *coordination* power within and across frontiers, *by other actors*. There is therefore a need to implement policies designed to develop *countervailing transnational power* in the other actors, be they labour, uninational companies, consumers or governments themselves. This will enable these actors to participate fully and actively in the globalisation process and will make the process more *inclusive*.

In a world in which much activity takes place across borders, there is an increased need for *transnational governance* as well as for the strengthening of national and regional governance. This can be achieved via the establishment of appropriate supranational institutions among whose aims should be the monitoring of transnational activities.

National and regional governments must develop strategic perspectives on their industrial development otherwise the strategies of the TNCs may become predominant by default (Cowling, 1990; Cowling and Sugden, 1994 and Chesnais and Ietto-Gillies, 2000).

The development of the ICTs and indeed of other technologies, particularly in the life sciences, are giving a tremendous boost to the productive forces. We are, in many ways, still at the beginning of the exploitation of productive potential of all the new technologies. There are some key questions arising from these developments and in particular: (1) can knowledge and the results of research be kept private when its public character is so clear in terms of the scope for (and low marginal costs of) utilisation and diffusion? (2) Can the social relations of production remain the same in the face of such sweeping changes in the productive forces?

The 1960s and 1970s were seen as decades of *confrontation* between TNCs and national governments, particularly but not exclusively those in developing countries. There were large numbers of nationalisations of foreign affiliates particularly in developing countries.

The wind changed in the political environment from the 1980s onward. These were seen as decades of *cooperation* between national governments and TNCs (Dunning, 1993: ch. 13). Far from threatening nationalisations many governments in developing countries followed in the footsteps of some developed countries in engaging in large-scale privatisations. The privatised assets were often bought by foreign companies. UNCTAD (1993: fig. 1, p. 17) shows that the number of nationalisations peaked in the mid-1970s and became non-existent after the mid-1980s. Privatisations started in the mid-1970s and increased very rapidly in the 1980s and 1990s.

The cooperative stance went hand-in-hand with the establishment and diffusions of a liberal agenda in which deregulation created the conditions for TNCs to pursue their own strategies within and across borders without any obstacles.

Throughout the 1990s we have been bombarded with a rhetoric based on the equation, globalisation equals liberalisation and deregulation. This equation seems to have been accepted by many on both the right and the left: the former sees it as desirable, the latter as inevitable. It is neither, and we must reject the equation. We can have many positive aspects of globalisation without the deregulation binge of the 1980s and 1990s, with all the related problems they generated.

In this ideological framework, the cooperative stance has increasingly led to a stronger and stronger position for TNCs to follow their own strategies in an unfettered way. In effect we have seen cooperation turning into the TNCs' *domination* of other economic players including governments themselves.

Various groups in society saw their power waning while the distribution of income and wealth moved away from the poorest people, groups, communities, classes, countries, to the rich ones. This has led to a social and political environment characterised among other elements by the following: (a) increasing discontent which has taken the route of grass-roots opposition to the visible face of global capitalism (such as high-profile TNCs and well-known brands); (b) disillusion with the democratic process. *Confrontation* has come back on the world agenda but not as confrontation between governments and TNCs but rather between people – organised in various pressure groups – and TNCs as well as international institutions (such as the World Trade Organisation) seen as the agents of TNCs and the midwives to the globalisation ills. Thus the confrontation takes on the form of street protests.[7]

As governments followed strategies for the few, often in opposition to democratic principles, people have come to believe less and less in the democratic process as a way of changing the social and economic situation. The gradual fall in electoral participation in many developed countries – and most notably in the US and UK – is a sad sign of this disillusionment with the democratic process.

The way out seems to be to channel this new style confrontation from street protests to politics. The democratic process must be made to work and this can only be achieved if we move *from confrontation to regulation*. National governments must regain the lead in developing appropriate policies to deal with the TNCs' powerful position. We need regulation to channel the many opportunities and cope with the many problems raised by the new technologies and by the TNCs' activities (in relation to the environment, safety, competition and labour standards) and because many problems cannot be tackled without appropriate international institutions. Self-regulation is unlikely to work even for issues of environmental and labour standards; in the end these standards will always be in the way of profits. Moreover, self-regulation cannot secure the coordination within and between industries necessary for the long-term prosperity of companies and countries.

Transnational companies have a positive role to play in the current phase of capitalist development. Many are involved in much-needed development and diffusion of innovation; many produce products that people genuinely want and need; many generate employment and develop skills. However, their activities must be regulated by a system of coherent governance within and between borders. The current pattern of social exclusion to the benefits of globalisation and of technological advances, must be replaced by a more inclusive and participatory framework. Inclusiveness must also embrace present and future societies via a serious commitment to (and implementation of) a responsible strategy for the environment.

6. Conclusions

This chapter starts with an analysis of the globalisation process in terms of its qualitative and quantitative characteristics. It then considers the main flows of international transactions and the role played by transnational corporations in them.

A brief summary of various theoretical approaches to globalisation is followed by a specific approach that sees the TNCs and the ICTs as the dominant causes of globalisation. This conclusion is reached using Keynes's methodological use of the concept of *causa causans* and distinguishing between driving forces and dominant causes of globalisation.

Thus the TNCs are here placed at the very centre of the globalisation process and in direct causal relationship with it. Their participation in it is seen as active and, indeed, causal. This contrasts with the passive role played by other actors such as labour, consumers and uninational companies.

There are specific policy implications arising from this approach and they are highlighted in section 5.

Notes

1. The views in this chapter are further developed in Ietto-Gillies (2001), particularly chapters 1, 2, 9 and 10
2. Details on definitions and on the theoretical positions of various authors are in Ietto-Gillies (2001: ch 9)
3. The share of asset ownership that can secure control can be deemed to be as low as 10 per cent (IMF, 1977). Below it the equity investment is classified as portfolio
4. For the relationship between trade and international production cf. Cantwell (1994) and Ietto-Gillies (2001: ch. 2). These works discuss the theoretical underpinning of the relationship and give references to the relevant literature.
5. A fuller analysis of Keynes's position is in Gillies and Ietto-Gillies (2001) as well as in Ietto-Gillies (2001: ch. 9).
6. These points are developed at greater length in Ietto-Gillies (2001: ch. 6).
7. Pianta (2001) gives a vivid analysis of the 'bottom-up' globalisation process and its various manifestations.

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8 The role and control of multinational corporations in the world economy

Gerald Epstein[1]

1. Introduction

Multinational corporations (MNCs) have become an increasingly important force in the dynamics of the global economy. For example, according to the United Nations, during the last 20 years, the gross product of the foreign affiliates of multinational corporations increased faster than global GDP while foreign affiliate sales increased faster than global exports. Taking into account both their international and national production, the United Nations Conference on Trade and Development (UNCTAD) estimates that multinational corporations produced about 25 per cent of the world's GDP in 1999 (UNCTAD, *World Investment Report*, 2000, p. xv).[2]

As one might expect, the impact of MNCs on developing and developed countries is hotly debated. At one extreme are the MNC boosters who argue that MNCs provide stable capital inflows, jobs, technology transfer and investment to 'host countries', while increasing growth and employment in the 'home' countries (Moran, 1998; 2002). On the other hand, critics contend that international capital mobility in general and MNCs in particular are creating a 'race to the bottom' around the globe, enhancing profits and political power for multinational corporations and local elites who benefit from their presence, while eroding wages, tax bases, social protections and the environment.

Importantly, different views on the impacts of MNCs not only characterise a divide between pro-labour forces on the one hand, and business boosters on the other; they also divide critics of globalisation, often along lines of those from the 'North' vs. those from the 'South'. Northern labour's opposition to outward foreign direct investment (FDI) to the countries of the south is often seen by southern workers and NGOs as protectionist and harmful to workers in southern countries. At the same time, efforts by southern governments to attract foreign direct investment are sometimes seen by northern workers as an attempt to 'take good jobs' away from them.

Despite the fact that there has been a great deal of research during the last several decades on MNCs, there is no consensus on their effects. Still, the evidence that does exist suggests the following: though foreign direct investment can have positive impacts on home and host countries, the likelihood that these positive affects will materialise and be widely shared is greatly diminished by the 'neo-liberal' policy framework that is dominant in much of the world today. I conclude that what is needed instead of more de-regulation and 'free' capital mobility, is a more democratic framework of multinational investment regulation to help countries and their citizens reap the benefits that can be associated with international investment. If this was done properly, the tensions that arise between the interests of southern and northern workers might be significantly reduced.

2. Multinational corporations: some stylised facts[3]

Table 8.1 presents data on the rate of growth of several measures of MNC activity since the mid-1980s, as well as some measures of global economic activity as a basis for comparison. It indicates that these estimates of MNC activities have been growing at a significantly faster rate in recent years than has world GNP, national gross fixed capital formation, or exports of non-factor goods and services.[4]

Table 8.1 The expansion of multinational corporations' international activities, 1986–2001 (annual rates of growth, per cent)

	1986–1990	1991–1995	1996–2000	2001
FDI inflows	24.0	20.0	40.1	–50.7
FDI outflows	15.7	27.0	36.7	–55.0
Cross border M&As	26.4	23.3	49.8	–47.5
Sales of foreign affiliates	16.9	10.5	14.5	9.2
Gross product of foreign affiliates	18.8	6.7	12.9	8.3
Exports of foreign affiliates	14.9	7.4	9.7	0.3
Employment of foreign affiliates	6.8	5.1	11.7	7.1
Memorandum:				
GDP at factor cost	11.5	6.3	1.2	2.0
Gross fixed capital formation	13.9	5.0	1.3	0.0
Exports of goods and non-factor services	15.8	8.7	4.2	5.4

Source: UNCTAD, *World Investment Report* (WIR), 2002, Table 1.1, p. 4.

Taking a longer perspective, Table 8.2 presents data on the size of FDI stock and world exports relative to the size of the economy over the last century or so. The stock of foreign direct investment relative to GDP has quadrupled since 1950 and increased by two-thirds since 1913. The ratio of world exports to GDP has tripled since 1950, and increased almost three-fold since 1913. The table suggests that, along with trade, MNCs have been a premier agent of globalisation in the last half-century.

Table 8.2 World stock of FDI and exports relative to world GDP, 1913–2000 (per cent)

	1913	1950	2000
FDI relative to GDP	9.0	4.0	19.6
World exports relative to GDP	8.7	7.0	23.3

Sources: FDI: 1913, 1950: Burke & Epstein (2001); 2000: *World Investment Report* (2000), Tables I.1, b-2.
World exports: 1913 and 1950: Angus Maddison, *Monitoring the World Economy, 1820–1992*, OECD 1995. 2000: *World Investment Report*, 2002, table I.1.

Table 8.3 The regional distribution of FDI inward and outward stock, 1980–99 (percentage)

	Inward stock of FDI			Outward stock of FDI		
	1980	1990	1999	1980	1990	1999
World	100	100	100	100	100	100
Developed	75.5	78.4	67.7	96.9	95.2	89.9
Developing	24.5	21.4	32.1	3.1	4.8	9.8
All developing minus China	23.2	20.0	23.7	3.1	4.6	9.3

Source: UNCTAD, *World Investment Report*, 2000, authors' calculations from tables B2 and B3.

Table 8.3 presents data on the regional distribution of the inward and outward stock of foreign direct investment and how it has evolved since 1980. The key point to notice is that stocks of both inward and outward FDI are highly concentrated in the developed economies; the overwhelming share of FDI flows is between the developed countries. In particular, in 1999, 67.7 per cent of the inward stock was in the developed economies; and almost 90 per cent of the outward stock was from the developed countries. Still, recently there has been an increase in the share of FDI going to the developing world, so that by 1999, one-third of the stock of inward investment was in the developing countries, compared with around 25 per cent in 1980.

Within the developing countries themselves, however, these stocks are highly concentrated among a handful of countries. In the developing world, as is well known, China and other Asian countries, mostly Taiwan, Hong Kong, Thailand, Malaysia and Singapore, get a significant share of the developing world's FDI. As the fourth row of Table 8.3 shows, if China is excluded from the data, the share of inward stock held by the developing world has been more or less stagnant over the last 20 years, at a little less than a quarter. Among the developing countries, only ten developing countries received 80 per cent of total FDI flows to the developing world in this same period. More importantly, as the *World Investment Report* notes, there are no signs that the concentration of FDI across countries has been declining over time. Of course, if we had better data on other aspects of MNC activities, for example, sub-contracting, outsourcing and licensing, we might find evidence that MNC activities have become more dispersed in recent years, as the anecdotal evidence suggests.

Most authors agree on these basic stylised facts. What is in dispute, of course, is their implications. Has this tremendous increase in foreign direct investment and the role of MNCs been helpful or harmful to 'host' and 'home' countries? What policies and regulatory institutions are required to increase the size and widen the distribution of the benefits from foreign direct investment?

3. The impact of MNCs on 'host countries' in the developing world

Advocates for the contributions of MNCs to economic development cite several key channels through which FDI benefits developing host countries. In light of space limitations, I only briefly treat them below, and even then, can only consider the most important ones. I will suggest that, while there might be some truth to many of these claims, the evidence is far more mixed than advocates often claim. Moreover, because of space limitations, for the most part, I will not be able to discuss the impact on the developed countries (see Crotty *et al.*, 1998 and Burke and Epstein, 2001 for more discussion of these issues).

3.1. Possible positive effects

3.1.1. 'FDI is a stable source of finance' An increasingly common view in policy circles is that FDI is a better form of investment for developing countries because it is more 'stable' than portfolio investment (see for example, Lipsey, 1999; UNCTAD, 1999). This view has gained adherents partly as a result of the recent Asian financial crisis when portfolio flows where highly unstable. For example, a number of papers have shown the coefficient of variation for FDI is smaller for most countries than for portfolio and other non-FDI flows. This contrasts with results from a study in the 1980s which showed no significant difference in the stability of the flows (Claessen and Gooptu, 1995).[5]

The implications of the claim that FDI is less volatile than portfolio investment, however, are not at all clear. For one thing, it may be a statistical artefact, due to the fact that most countries' FDI data do not include data on the reinvestment of retained earnings (the US is an exception). For example, it is possible that reinvestment of retained earnings is just as volatile as are portfolio investments, but does not show up as part of FDI. Moreover, the recent findings on the stability of FDI may be the result of special features of the Asian financial crisis itself. In particular, South Korea and other countries were forced to open up their firms to inward FDI or liberalise flows substantially, and therefore drew in a large amount of FDI. These one-time, special factors therefore may not be operative the next time there is a major outflow of portfolio investment.

Most important, however, is that these arguments do not take into account the overall costs and benefits of attracting FDI. Having a flow which is more stable, but which on balance does not yield net benefits, is not in itself beneficial.

3.1.2. Employment One of the most important reasons why developing countries want to attract FDI is to create more employment opportunities at home, and one of the biggest reasons why northern workers are suspicious of outward FDI is because they fear a loss of jobs. Of course, when a foreign company opens up a factory and hires workers, employment is generated. But a much more complicated question to ask is what is the impact on employment in the economy as a whole after all the other indirect effects are taken into account? For example, Braunstein and Epstein (2002) found that FDI had small or no net impacts on employment in China, once the impacts on domestic investment and other Chinese policy measures are taken into account. Lipsey (2002), on the other hand, finds that FDI does generate more employment, on balance, in many countries. Perhaps of equal if not more concern, is the impact of FDI on wages and productivity associated with that employment.

3.1.3. Wages There are several arguments in the literature about the effects of FDI on wages: (1) that FDI leads to increases in the demand for labour, thereby raising wages; (2) with greater technological know-how, especially in developing countries, MNCs have higher productivity and can pay their workers more, an impact that could spill over into the rest of the economy and raise overall wages; and (3) because capital is internationally mobile and labour is not, FDI may enhance capital's bargaining power relative to labour, thereby lowering wages (Paus and Robinson, 1998). Some interesting but limited work has been done on these issues for developing countries. Using panel data that included both developing and developed countries, Paus and Robinson (1998) find that: FDI has a direct positive impact on real wages; that that impact is especially true in developing countries (but not in developed countries); and finally that this positive impact is true only for the period 1968–87, after which there is some evidence that the threat effect of relocating has had a negative effect on wage growth in industrialised countries. In a comparative study of Mexico, Venezuela and the United States, Aitken *et al.* (1995) find that higher levels of FDI are associated with higher wages in all three countries, but in Mexico and Venezuela, this association was limited to foreign-owned firms. This lack of evidence of wage spillovers to domestic firms is consistent with the large wage differentials between foreign and domestically-owned firms in these countries.

Some interesting work has also been done on the impact of FDI on relative wages among workers in developing countries, based on the premise that FDI raises the relative demand for skilled labour. Hanson and Harrison (1995) and Feenstra and Hanson (1997), in separate studies of relative wages in Mexico, find that exporting firms and joint ventures pay higher wages to skilled workers and demand more skilled labour than other firms. Feenstra and Hanson (1997) use more specific measures, with the result that FDI growth is positively correlated with the relative demand for skilled labour in Mexico. In regions where FDI is concentrated, it accounts for over 50 per cent of the increase in the skilled labour wage share that occurred in this area in the late 1980s.

3.1.4. Investment: crowding in – crowding out One important factor that affects the degree to which a host country benefits from FDI is the degree to which inflows of FDI 'crowd in', that is, create more domestic investment rather than 'crowd out' domestic investment. Advocates often point to the crowding in effects, but recent evidence concerning developing countries suggest that crowding in cannot be taken for granted. Agosin and Mayer (2000) study the relation between inflows of FDI and domestic investment for the period 1970–96 in three regions: Africa, Asia and Latin America. Their basic finding is that crowding in occurred in Asia but crowding out occurred in Latin America. In Africa, the results were less clear. Moreover, recent research by Braunstein and Epstein (2002) indicates that even in China, there is no evidence of crowding in by FDI.

3.1.5. Technological development and spillover effects One of the claims most often repeated about the impact of FDI on developing country host countries is that it will lead to technology transfers, technological upgrading and productivity improvements. A number of papers, using country level or industry level data, have indicated a positive correlation between FDI and economic growth and FDI and productivity growth (see Hanson, 2001 and Braunstein and Epstein, 2002 for surveys.) But, Gordon Hanson (2001), in an important UNCTAD study of the benefits of FDI for developing countries, is not very confident about the findings of these types of studies. He argues that although the early empirical literature was optimistic about the impact of MNCs on host-country productivity, its findings are open to several important problems. First, countries with higher growth attract more FDI so the direction of causality in the correlation between growth and FDI is unclear. Second, omitted variables, such as a good industrial policy, or better-educated workforce, for example, could explain both higher growth and more FDI. Hanson describes more recent and promising work done on the micro-level, where time series data of manufacturing plants provides solutions to these empirical problems by showing how the productivity of domestic plants changes over time in response to the presence of MNCs. Haddad and Harrison (1993), using data for Moroccan manufacturing plants in 1985–89, find a weak negative correlation between plant total factor productivity growth and the presence of MNCs in that sector. Aitken and Harrison (1999), using data on Venezuelan manufacturing plants for 1976–89, find that productivity growth in domestic plants is negatively correlated with foreign presence in that sector. Hanson concludes that micro-level data undermines empirical support for productivity spillovers from FDI, perhaps indicating that MNCs confine competing domestic firms to less profitable segments of industry.

3.2. Possible negative impacts

3.2.1 Asymmetries and threat effects As shown above, FDI is highly concentrated among countries. Nonetheless, FDI is still quantitatively quite important to many developing countries. Table 8.4 presents data of FDI inflows relative to gross domestic capital formation (GDCF) in all industries and in manufacturing, and private domestic capital formation (PDCF) in all industries, in the developed and developing world between 1980 and 1998 (with a separate section on Eastern Europe). Table 8.4 shows that FDI has become increasingly important in relation to capital formation between 1980 and 1998 especially in the developing world and especially in manufacturing. For the developing countries, the rates of growth of FDI as measured against GDCF have become quite high in all industries and for private investment. For example, by 1998, inward FDI flows into manufacturing comprised more than one-third of gross fixed capital formation in manufacturing for developing countries.

According to the *World Investment Report*, a large number of countries had FDI flows in excess of 20 per cent of Gross Domestic Capital Formation (UNCTAD *World Investment Report*, 2000, p. 5). Thirty-eight out of 162 developing countries listed in the *World Investment Report*, or almost 25 per cent of them, had FDI levels of 20 per cent of GDCF or greater. Twelve of

Table 8.4 Ratios of FDI flows to gross domestic capital formation (GDCF) and private domestic capital formation (PDCF), by region and sector, 1980, 1990, 1998

Region/Country	FDI inflows as a % of GDCF: All industries	FDI inflows as a % of GDCF: Manufacturing	FDI inflows as a % of PDCF: All industries
World			
1980	2.3	9.0	3.4
1990	4.1	14.0	5.4
1998	11.1	21.6	13.9
Developed countries			
1980	2.7	8.5	3.4
1990	4.9	11.9	5.2
1998	10.9	16.6	12.9
Developing countries			
1980	1.2	11.7	3.6
1990	4.0	22.3	6.7
1998	11.5	36.7	17.7
Central and Eastern Europe			
1980	0.1		
1990	1.5		0.7
1998	12.9		16.2

Source: *World Investment Report*, 2000, table 1.2, p. 5.

these countries had FDI levels of 40 per cent or more of GDCF. This compares with two out of 25 developed countries with FDI levels in excess of 20 per cent of GDCF (or just 8 per cent of them).[6]

Thus, many developing countries who get very little FDI from the point of view of the developed country investors nonetheless, may be highly dependent on FDI in the sense that FDI inflows are large relative to the size of their economies. At the same time, FDI is also highly concentrated in the hands of a relatively small number of companies. For example, despite the fact that there were 60 000 parent firms with more than 600 000 foreign affiliates in 1998, only 100 firms, mainly from developed countries, account for approximately 13 per cent of the total assets of all foreign affiliates, 19 per cent of all foreign sales and 18 per cent of foreign employment among all MNCs (UNCTAD *World Investment Report*, 2000, pp. 8–9; 71).[7]

These asymmetries lie at the heart of some of the most important dynamics between MNCs and developing countries. They are based on the fact that MNCs invest relatively little in most developing countries while, at the same time, even a little bit of investment for many developing countries constitutes a significant marginal contribution to those countries' investible resources. At the same time, there are a relatively large number of political jurisdictions in which MNCs can invest, and a relatively small number of MNCs who can make significant investments. The *World Investment Report* 1999 estimates that perhaps as many as 6000 national, regional and local public sector entities compete for the various investment projects undertaken each year by MNCs (UNCTAD *World Investment Report*, 1999, p. 154).

Together, these asymmetries mean that, even though foreign investment *as a whole* is of enormous importance to MNCs, it is generally the case that any particular investment in a developing country, with one or two possible exceptions, is relatively unimportant to them. As a result, the bargaining power of political jurisdictions and workers relative to MNCs is often very low.

Certain aspects of the emerging global framework make this asymmetry worse: among these are the relative lack of foreign aid for the poorest countries; the erratic nature of portfolio flows, which makes FDI seem more attractive by comparison, even though FDI is fairly erratic itself; and the rules of the WTO and other trade/investment agreements which make it difficult or impossible for countries to manage foreign investment in the interests of their citizens.[8]

These processes may generate negative impacts of MNCs on workers in many countries of the world, developed and developing alike. Here we only have space to discuss several characteristic problems: tax competition, policy competition and threat effects on wages.

3.2.2. Tax competition Economists and government officials have become increasingly concerned with the impact of international capital mobility on inter-jurisdictional tax competition.[9] Starting in the 1970s, Oates (1972) began the development of a canonical model of inter-jursidictional tax competition. As Oates put it:

> The result of tax competition may well be a tendency toward less than efficient levels of output of local services. In an attempt to keep taxes low to attract business investment, local officials may hold spending below those levels for which marginal benefits equal marginal costs, particularly for those programs that do not offer direct benefits to local business (Oates, 1972, p. 143, as quoted in Wilson, 1999).

While Oates focused on federalism, the same argument can be readily applied to issues of international taxation (Wilson, 1999).

There seems to be considerable evidence that international capital mobility is driving down taxes on a global basis. The OECD published a report in 1998 dealing with the increasingly common phenomenon of tax competition between states in order to attract MNCs (OECD, 1998). The study contends that the accelerating process of globalisation of trade and investment has fundamentally changed the relationship among domestic tax systems. In their words 'Globalisation and the increased mobility of capital has also promoted the development of capital and financial markets and has encouraged countries to reduce tax barriers to capital flows' (OECD, 1998, p. 14). The study reviews empirical data to conclude that

> harmful preferential tax regimes that drive the effective tax rate levied on income from the mobile activities significantly below rates in other countries have the potential to cause harm by: distorting financial and real investment flows, undermining the integrity and fairness of tax structures, discouraging compliance by all taxpayers, reshaping the desired level and mix of taxes and public spending, causing undesired shifts of part of the tax burden to less mobile tax bases such as labor, property and consumption and increasing the administrative costs and compliance burden on tax authorities and taxpayers. (OECD, 1998, p. 16)

3.2.3. Policy competition Countries and other jurisdictions have other means of trying to attract investment: subsidies, infrastructure investment, the creation of a cooperative workforce are all examples of ways to create an 'investment friendly' environment. While tax competition is beginning to be debated in developed countries, the other forms of competition being forced on developing countries attempting to integrate into the world market is less studied. It is clear from the few studies that have been done, however, that developing countries may be in a less advantageous position under the system of global competition for FDI. As Moran puts it:

> With the exception of some oil exporting states, the developing countries and economies in transition do not have the financial resources to offer grants along the lines of many OECD countries. Instead the most frequently used investment incentives are tax holidays ... but the complexities of deploying these incentives and the administrative weakness in these countries themselves prevent these tools from being used effectively. (Moran, 1998, p. 101)

Nonetheless, bidding for foreign investment has become a major activity by both developed and developing countries.

The *World Investment Report* shows that many countries throughout the world have changed their tax and regulatory laws governing foreign direct investment in the last decade. Over the period 1991–99, the overwhelming majority of national policy changes – 94 per cent of the 1035 changes – favoured foreign investors (UNCTAD *World Investment Report*, 2000, p. 6).

In 1999 for example, these policies included more general and sectoral investment incentives (20 per cent of the changes), more liberal entry and operational conditions (40 per cent of the changes) and more sectoral liberalisations (20 per cent).

These changes in national tax and regulatory policies are only part of the overall trend toward making the institutional environment more attractive for foreign investment in the past decade. Regional agreements have also been important, with NAFTA being the most famous but only one of several in recent years, including agreements between Chile and Mexico and between the members of the European Community and Mexico. More generally, investment liberalisation and protection has become an important issue in many international economic agreements, including many of the free trade and cooperation agreements signed between the European Community and third countries. Even the WTO Secretariat seems to agree that this may be a problem: 'as competition for FDI intensifies, potential host governments find it increasingly difficult to offer less favorable conditions for foreign investment than those offered by competing nations.' (WTO, 1996).

Arguments in favour of incentives rely heavily on the assumption that governments have detailed knowledge of the value/size of the positive externalities associated with each FDI project. In practice, it would be an almost impossible task to calculate these effects with any accuracy, even with the aid of well-trained specialists. In reality, getting drawn into competitive bidding for an FDI project is like sending government officials to an auction to bid on an item whose actual value to the country is largely a mystery. Though the empirical evidence seems quite murky, the lessons we can draw from this discussion seem quite clear: incentives work often enough at the margin that they lead many policy makers to believe that they must bid for investment; yet they work sufficiently infrequently that bidding is a high risk business. In the end, this suggests that dynamics of bidding is fraught with dangers for governments that engage in it, yet at the margin, under the current regime, there are strong pressures to continue playing the game.

3.3. Liberalisation vs. FDI control

The point above emphasises the question of whether liberalisation, even if it does bring in more FDI, allows a country to manage it sufficiently so that it benefits the domestic economy and its citizens. The most important conclusion of a good deal of literature is that for FDI to enhance economic development, it must fit within the overall development strategy (Dunning, 1994; UNCTAD *World Investment Report*, 1999; Nembhard, 1996; Chang, 2002; Amsden, 2001).

But liberalisation itself, and the investment treaties which are accompanying it, make it more difficult for economies to utilise FDI to its best advantage.

While the extent of this liberalisation varies considerably by country, several policy changes prevail including reduction or elimination of screening and prior authorisation procedures, joint ownership requirements, and restrictions on profit remittances. These changes along with the extension of national treatment to foreign firms which prohibits discriminatory practices favouring domestic firms are viewed by advocates of liberalisation as eliminating the principal pôlicy obstacles that impeded foreign direct investment in the past.

The experiences of the East Asian NICs – the most successful developing nations over the past two decades – suggest the flaws in this approach. Education, infrastructure and other public services played a central role in their development strategies and contributed to their success by fostering environments favourable to both domestic and foreign investment. Moreover, this region attracted FDI despite the presence of some of the most restrictive investment regimes in the world. For example, China rigorously screens foreign investment, limits it to specific sectors and ties incentives to various export, foreign exchange, local content and other performance requirements while many other nations have been eliminating screening procedures, reducing sectoral restrictions, and dismantling performance requirements. Similarly, Malaysia subjects projects (both foreign and domestic) to a demanding screening process which evaluates size, local involvement, labour and output market availability, and infrastructure and foreign exchange requirements or contributions (see Chang, 1998, for an important discussion of these issues).

In short, liberalisation, the rules in the WTO and other investment agreements may prohibit precisely those policies that in the past have contributed to the beneficial impacts of FDI, when and where they have been beneficial. As these tools for domestic management are taken away, it seems likely that many of the beneficial impacts may be reduced or eliminated as well (see Crotty *et al.*, 1998 for an elaboration of these arguments).

4. Alternatives to the neo-liberal framework for MNCs

MNC boosters argue that the best way for developing countries to get more from MNCs is to liberalise and open their economies even more, not less (for example Moran, 2002). According to them, misguided attempts to restrain or regulate MNCs will lead to less FDI, or to investment that is less integrated into MNCs' overall production networks and, so the argument goes, will be less beneficial to host countries.

Some important research has called into question the view that more regulation leads to less investment. Kucera (2001) for example, shows that higher levels of core labour standards are *not* associated with lower FDI, and might even be positively associated with them. He hypothesises that such labour standards might lead to greater political stability and therefore lead to more FDI. Similarly, studies have failed to find a consistent negative relation between higher environmental standards and foreign direct investment (see, for example, Oman, 2000).

Still, there is reason to be concerned that all is not well in the world of MNC regulation. There are strong theoretical reasons and anecdotal evidence to suspect that competition among jurisdictions for investment is fierce and that such competition makes it difficult for countries to implement and enforce socially desirable regulation; that empirical evidence is potentially flawed because FDI data reflect equity investments, not real capital investment data, and therefore have been skewed by high levels of mergers and acquisitions in recent years (Fitzgerald, 2002); and, in any case, the empirical evidence on the 'race to the bottom' or 'social dumping' is mixed, rather than overwhelming.

Given the great empirical uncertainties involved and the potentially high costs of unfettered investment competition, it is encouraging that there are many initiatives, from many levels of society, to develop a regulatory framework to coordinate or reign in the intense competition for FDI that currently characterises the global economy (for example Fitzgerald, 2002; Broad, 2002; Heintz, Chapter 12, this volume).

Surveying this large emerging literature is well beyond the scope of this chapter. But a few points are worth emphasising here. The first step forward is for governments to be sceptical about the benefits of FDI. As I have suggested, the evidence on the benefits is quite mixed and often may not be worth the intensive bidding associated with attempting to attract investment. Part of the problem here is surely the lack of transparency in the bidding process: government officials and associated business associates may well receive significant benefits, but these may not trickle down much. Second, there is no evidence that the push by international organisations such as the IMF, World Bank, OECD and WTO to promote more FDI liberalisation is well-founded theoretically or empirically. These organisations should desist in this promotion, unless and until there is stronger evidence that such investment is beneficial within the current regulatory environment. The implication of this *moratorium on investment* liberalisation would be a much greater tolerance by the international financial institutions of a variety of national regulatory regimes toward foreign investment, regimes that suit the particular circumstances of different countries. Finally, continued efforts by governments and international institutions should be undertaken to develop mechanisms to reduce 'prisoner's dilemma' outcomes which are so likely in this current environment. Among the measures that should be considered are floors on taxation, subsidies and environmental regulations, and the increased commitment to the enforcement of core labour standards.[10]

Notes

1. The author thanks without implicating his co-authors, Elissa Braunstein, James Burke, James Crotty and Patricia Kelly for their contributions to joint work on multinational corporations on which this chapter has liberally drawn.
2. UNCTAD uses the term transnational corporation (TNC) rather than multinational corporation (MNC), which we use here. To a large extent, which term one uses is a matter of habit and taste.
3. This chapter partly draws on previous work: Braunstein and Epstein (1999; 2002); Burke and Epstein (2001); Crotty *et al.* (1998).
4. Foreign direct investment (FDI) is a financial measure of MNC behaviour, which refers to equity investments by a company or individual in a company in a foreign country, providing the investor has at least a 10 per cent ownership share. Two other variables – sales of foreign affiliates and gross product (or value-added) of foreign affiliates – quantify the real activity of foreign affiliates of MNCs. The advantage of these latter measures is that they measure international production itself, rather than simply financial investment. A disadvantage is that these data are not nearly as widely available as are data on FDI. Even these multiple measures miss important aspects of MNC production, for example, increasingly important activities such as subcontracting.
5. Interestingly, the United States is an important exception to these findings; its FDI inflows in the last several decades have been very volatile (Lipsey, 1999).
6. Of course, these data do not imply that all FDI inflows finance gross fixed investment. For example, mergers and acquisitions generate inflows of FDI, but do not necessarily increase gross fixed capital formation (GFCF). Using the GFCF measure may therefore overstate the importance of FDI inflows for national investment and growth. They nonetheless do give a comparative sense of how large the flows are and suggest that these flows might be quite significant for many countries.
7. The *World Investment Report* (2000) warns us that these estimates are very rough and should be treated with caution (p. 93, fn. 2).
8. One could add to that the restrictive macroeconomic policy that, world-wide, has constrained economic growth for the last 20 years or so. See Crotty *et al.* (1998) for a similar argument which also emphasises the aggregate demand context.
9. For an excellent recent survey of this literature, see Wilson (1999).
10. See Heintz, Chapter 12, this volume, and Braunstein and Epstein, 1999 for more discussion of these issues.

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9 Gender and foreign direct investment

Elissa Braunstein

I. Introduction: gender and macroeconomics

Foreign direct investment (FDI) is commonly treated by economists and policy makers as a premier agent, not only of globalisation, but also of economic growth and development. In light of the Asian and Latin American financial crises, where portfolio flows proved to be flighty and unreliable, FDI is now more than ever courted as the capital flow of choice, becoming one of the most sought-after commodities in the global economy. The rising significance of FDI in policy circles is paralleled by its effect on women's integration in the global economy. In semi-industrialised countries at least, FDI has been linked with women's market employment and the gender wage gap (Braunstein, 2002; Seguino, 2000b), connections that suggest that using a gender lens to evaluate the dynamics of multinational corporations (MNCs) is more important than standard economic approaches to FDI presume.

Research on gender and FDI in developing countries has been confined for the most part to small-scale studies that take a case study approach to women's employment by MNCs. A common guiding question in these studies is whether multinational assembly employment is good for women. The answer often depends on the frame of reference used for comparison – usually women's actual local alternatives versus how these jobs measure up to a higher standard of human development. In an article that challenged the stereotype of low wages and poor working conditions, Linda Lim staked out the divide by arguing that women working in export factories are 'unambiguously better off than they would have been without these jobs' (Lim, 1990: 112). She criticised the literature's prevailing methodologies as ahistorical and lacking in a rigorous approach to causality.

That the debate on gender and FDI has centred so much on the microeconomics of work has meant that it is often treated exclusively as a 'gender issue' in economics – that is, with no special relevance to the larger machinations of growth and development. But the gender and macroeconomics literature is changing that. Drawing on heterodox macroeconomics and feminist analysis, gender and macroeconomics (G&M) analyses seek to demonstrate the relevance of gender as an analytical category in macroeconomics and international economics (Cagatay *et al.*, 1995). G&M got its start in the mid-1980s, when feminist economists first argued that gender relations interact with processes of structural adjustment programmes then being imposed by the International Monetary Fund and the World Bank as a condition of debt restructuring. Feminists argued that these interactions have implications both for the distribution of costs and benefits between different groups of women and men, and for the achievement of the economic objectives of the structural adjustment programmes themselves (Benería and Feldman, 1992; Benería and Roldan, 1987; Cagatay *et al.*, 1995; Elson, 1991; 1995; Bakker, 1994).

Processes of globalisation have shaped G&M analyses in significant ways, partly because openness to international trade and finance is so central to neo-liberal prescriptions for growth, and partly because international trade has been so closely associated with women's market work (Cagatay and Ozler, 1995; Joekes and Weston, 1994; Standing, 1989; Wood, 1991). Recent work in the G&M field is focused on growth, trade and finance, with particular emphasis on how engendering economic models improves our understanding of globalisation (Cagatay *et al.*, 2000). The resultant literature covers a wide span, from the incorporation of the non-market sector into a computable general equilibrium model (Fontana and Wood, 2000), to establishing the importance of the gender wage gap in export-oriented growth (Seguino, 2000c), to assessing the impact of wage differentials on North–South manufacturing terms of trade (Osterreich, 2002). Work on gender and FDI has focused on how women's roles outside the formal market sector impact the profitability of multinational investment, and has assessed the constraints imposed by physical capital mobility on the prospects for increased living standards and equality for women (Braunstein, 2000; 2002; Seguino, 2000b).

In this chapter I will review the literature dealing with gender and FDI, starting off with the stylised facts, then moving on to review the role of FDI in development and the importance of gender in understanding that role.

II. The stylised facts

While the case study literature on gender and FDI provides key insights into the specific contexts of their subjects, they do not offer stylised analyses that can be compared to the dynamics of FDI in other countries. Important exceptions include recent surveys on *maquiladora* employment in Mexico (Fussell, 2000) and Honduras (Ver Beek, 2001), both of which focus on evaluating whether *maquiladora* employment is better than local alternatives, an intentioned response to Lim's criticisms. Siegmann (2002) questions the presumed beneficial effects of FDI on women's employment and human capital attainment in Indonesia following the financial crisis.

What we do know is that where multinational investment has been a significant factor in economic development in the last several decades – primarily in East and South-east Asia and in parts of Latin America and the

Caribbean – there is strong evidence that the share of female employees in the labour-intensive export-oriented assembly and multinational manufacturing sector is high (Braunstein, 2002; Joekes and Weston, 1994; UNCTC/ILO, 1985). But this feminisation trend can be reversed as export sectors mature and begin to use more technologically or administratively-intensive production methods, as has happened in Ireland, Mexico and Singapore (Elson, 1996; Joekes, 1999).

One of the reasons that the employment effects of FDI are difficult to gauge is the increasing prevalence of subcontracting and informalisation, part of the new trend towards creating more flexible structures of international production. These jobs are often directly connected to specific MNCs via local intermediaries, weakening the distinction between foreign and local ownership (Benería, 2001; Ward and Pyle, 1995).

As in other areas of production, these labour markets are segmented by gender. Women tend to be concentrated in electronics, textiles and garments, where low labour costs are a crucial part of international competitiveness (Starnberg Institute, 1989; UNCTC/ILO, 1988). Why do MNCs prefer to hire women? As Diane Elson and Ruth Pearson (1981) pointed out in an important early article, one must consider how unit labour costs differ. First, women's wages are typically lower than men's, and employers perceive women as more 'productive' in the types of jobs available in the export sector. Reasons that employers cite for the latter include: women's putative 'nimble fingers'; their obedience and being less prone to worker unrest; their being suited to tedious work; and their reliability and trainability relative to men (Anker and Hein, 1985; Elson and Pearson, 1981; Fernández-Kelly, 1983; Lin, 1985). Similar reasoning can be applied to the 'pink collar' aspects of the international production of services, an increasingly significant component of FDI in developing countries.

Although the modal worker of an export-oriented multinational is widely thought of as a young unmarried woman, there are some differences by industry and region. Women working in the electronics industry, which requires greater dexterity and keen eyesight, tend to be younger, while women working in textiles and garments tend to be older and are more likely to be married (Fernández-Kelly, 1983; Lim, 1990; Safa, 1990; 1995; UNCTC/ILO, 1985). From a regional perspective, women in Asian export processing zones tend to be younger and are less likely to be mothers than in Latin American and Caribbean export processing zones (Lim, 1990).

In terms of wages paid by MNCs, there are good reasons to expect MNCs to pay wage premiums (and offer more job security) relative to locally-owned firms: the greater resilience of MNCs better insulates employees from economic cycles; workers in larger enterprises, which are more likely to be multinational, are better protected by labour legislation and more likely to be unionised and receive benefits; and MNCs are concentrated in the relatively high wage electronics sector (Joekes and Weston, 1994; Lim, 1990; UNCTC/ILO, 1985). Evidence drawn from work done in export-processing zones suggests a 'salary life cycle', where more recently established EPZ wages tend to be higher than local wages, but over time, these wage differentials decline (UNCTC/ILO, 1988).

In Fussell's study of *maquiladoras* in Mexico mentioned above, where the multinational export industry is 25 years old and provides some clues as to the future of this type of employment in developing countries, *maquiladora* employers do not usually offer better wages than other employers in the local market (they do only for women with little education). What Fussell does find is that *maquiladora* employment offers greater work stability, so it is considered desirable for women with greater household financial responsibilities (Fussell, 2000). Kurt Alan Ver Beek (2001), in a study of *maquiladoras* in Honduras, finds that *maquiladora* workers earn about 50 per cent more than at their previous jobs.

Another way to consider the relationship between FDI and wages is via its impact on the gender wage gap, or the difference in wages between women and men. Stephanie Seguino argues that gender inequality, measured as the gender wage gap, has been a stimulus to growth in Asia via its positive effects on exports and investment, as women have been crowded into export sectors, lowering their wages and increasing profit for investors (Seguino, 2000a). Seguino (2000b) also shows a positive correlation between total FDI (measured as FDI inflows plus outflows) and gender wage differentials in Korea and Taiwan, hypothesising that total FDI is a good proxy for capital mobility and the ability of workers to bargain for better wages. Kucera (2001) comes to a slightly different conclusion, finding evidence in a larger cross-country study that various measures of gender equality are positively associated with FDI, suggesting that what may be true about gender and FDI for semi-industrialised countries is not the case for all countries.

Although the work reviewed above provides a foundation for understanding the dynamics of gender and FDI, it also indicates that there is a lot of empirical and theoretical work yet to be done. The next section underscores the importance of this type of work by casting the topic of gender and FDI in the field of development economics.

III. FDI and development: the gender connection

Despite the increasing popularity of FDI in prescriptions for growth, the empirical evidence for a causal connection between FDI and development is weak. Economic analyses of FDI and development fall into three broad categories that evaluate FDI's impact on domestic investment, productivity and wages. Starting off with domestic investment, it is easy to assume that

FDI automatically adds to growth by expanding the pool of resources available for investment, but that need not be the case. FDI might encourage or crowd in domestic investment, as when there are strong backward or forward linkages with domestic firms created by new foreign firms. Or, FDI could crowd out domestic investment, as when foreign firms compete with domestic firms and drive them out of business. Empirical evidence suggests that policies and macroeconomic context matter for these effects: in an UNCTAD study of developing regions between 1970 and 1996, Agosin and Mayer (2000) find evidence of crowding in of domestic investment in Asia and crowding out in Latin America; Braunstein and Epstein (2002), in a similar study of mainland China between 1986 and 1999, find strong evidence for crowding out.

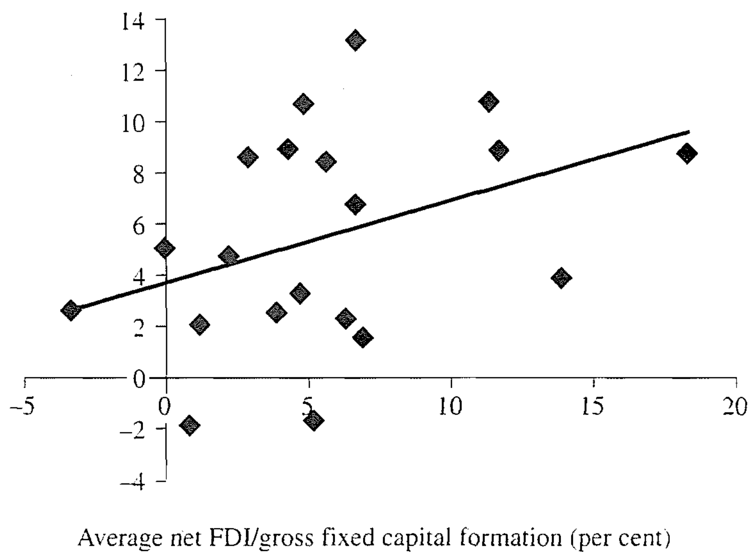
FDI may also contribute to development and growth via its impact on productivity. Foreign investment might bring with it advanced technology and ideas that enhance its direct effect on investment and growth if these factors 'spill over' into the rest of an industry and increase the efficiency of domestic producers. What is the empirical evidence? Macroeconomic studies find positive correlations between FDI and productivity growth, but there is a growing consensus that these studies do not accurately measure the impact of FDI on productivity. Recent work that looks at particular firms finds that MNCs have in fact had a negative effect on the productivity of domestic firms in the same industry, suggesting that MNCs may confine competing domestic firms to less profitable segments of industry (Hanson, 2001).

The evidence on wages and FDI in developing countries is also inconclusive. While wages are often used as an independent variable to explain FDI, it is rare to find the causality running the other way in the empirical literature on FDI in developing countries. But there is a clear causal link. First, FDI may affect labour demand (depending on whether it is greenfield investment or cross-border mergers and acquisitions, and on what competitive impact it has on domestic investment), thereby affecting wages. Secondly, spillover effects from potentially higher productivity (and paying) foreign enterprises could raise wages throughout the country. And lastly, because capital is internationally mobile and labour is not, FDI may enhance capital's bargaining power relative to labour, thereby lowering wages (Paus and Robinson, 1998). Empirical studies of developing countries have indicated a positive correlation between wages and various measures of FDI (Aitken *et al.*, 1996; Braunstein and Epstein, 2002; Paus and Robinson, 1998). But one study found that the correlation disappears in the late 1980s, suggesting that increasing global capital mobility has weakened this relationship (Paus and Robinson, 1998). Another study carried out in Mexico and Venezuela found that the positive wage effect holds only for MNCs themselves, and does not spill over into the rest of the economy as theory would predict (Aitken *et al.*, 1996).

These and other issues that surround the impact of FDI on development would be clarified by employing a gender-aware analysis. The following sections review four examples of using such an approach.

Feminisation

As mentioned above, FDI in developing countries tends to be of the manufacturing export-oriented variety, where labour costs are a key determinant of profitability, and women form the bulk of the multinationals' labour force (Braunstein, 2000), suggesting that higher levels of FDI may be associated with a feminisation of the labour force. Figure 9.1 presents a scatter plot of changes in the feminisation of the labour force versus average net FDI (inflows minus outflows) as a percentage of gross fixed capital formation for a collection of 20 semi-industrialised countries, during the period 1975–99. There is a clear positive correlation between the two data series, as indicated



Notes: Change in feminisation of the labour force equals female labour force/total labour force in 1999 minus the same figure in 1975. Average net FDI/gross fixed capital formation equals annual average FDI inflows minus outflows as a percentage of gross fixed capital formation. All values taken in 1995 $US. Countries used include: Brazil, Chile, China, Columbia, Costa Rica, El Salvador, Greece, Hong Kong, India, Indonesia, Korea, Malaysia, Mexico, Paraguay, the Philippines, Portugal, Singapore, Sri Lanka, Thailand and Turkey.

Sources: Figures based on author's calculations using data from World Development Indicators 2001.

Figure 9.1 FDI and feminisation, 1975–99 by the trendline (the correlation coefficient is 0.39), suggesting that high net FDI flows are associated with relative employment gains for women.

To really explain this simple correlation, more detailed analysis is necessary. It could be that the same factors driving feminisation also drive FDI. Perhaps this correlation changes over time, and as economies mature the association gets weaker as the work by Fussell and others discussed above suggests. Feminisation could also be the result of the crowding out of typically male-dominated industries by competing foreign firms, so it is important to assess the differential effects of FDI on male as well as female employment. In terms of its impact on economic development, if FDI does indeed have a feminisation effect, it may have an important role to play in incorporating women into the modernising industrial sector of a developing economy. If, however, feminisation comes at the expense of male-dominated industries, the net benefit of FDI to communities must be questioned, as women take on greater financial responsibility for their families in the face of male unemployment.

Gender wage equality and growth

If FDI does indeed raise the relative demand for female labour, it may also play an important role in lowering the gender wage gap. Such an effect is important not only in terms of its effect on gender equality. It could also have significant implications for long-term investment and growth because women's income has been associated with increased investments in children (Benería and Roldán, 1987; Blumberg, 1991; Chant, 1997), a finding underlying what has been termed the 'good mother hypothesis'. Income that is controlled by women is more likely to be spent on children's health and nutrition (Dwyer and Bruce, 1988; Hoddinott *et al.*, 1998). Accounting for the quality of future labour services in models of economic growth raises the importance of the role of FDI in gender wage equality. If FDI does indeed have beneficial effects on this measure, increasing international capital mobility may dampen them, suggesting that investment liberalisation may ultimately be bad for economic growth if persistent gender inequality constrains investments in children and the development of human capital.

Intra-household gender relations and the price of labour

Intra-household gender relations also affect a country's ability to attract FDI via their impact on investment profitability (Braunstein, 2000). To see why this is so, consider how female labour supply and the price of labour are partly determined by intra-household gender relations and decision-making. Women make decisions about whether or not to look for waged work, decisions that are taken in a household context. One's input into these decisions depends on one's power or voice in the family. One way to conceptualise this influence is by thinking in terms of 'gender regimes' that mark a continuum of decision-making processes within the household.

At one extreme is patriarchal dominance, where women have little or no influence over decision-making. It parallels what in the anthropological literature has been identified as systems of household organisation centred around the conjugal bond, and embedded in cultural rules that prescribe male authority over as well as responsibility for the protection of and providing for women and children. Its clearest instances are found in geographical areas that include North Africa, the Muslim Middle East, and South and East Asia (Kandiyoti, 1991: 107–108). These factors would lead one to expect a high reservation wage (the minimum wage at which someone is willing to sell their labour) for mothers whose traditional roles do not include financial provisioning for the family, but a correspondingly low wage for daughters, whose low economic value to the patriarchal household head provides a deep pool of low-cost labour to expanding export sectors, as happened in East Asia in the 1960s and 1970s. It is also important to note here how household organisation in East Asia has guarded against the negative impact of relying on a low-wage export strategy. Because export workers were not typically supporting entire families on their own, low export sector wages could co-exist with the relatively equal and rising household incomes that were an important part of the East Asian export-led development model.

At the other extreme are households maintained by women alone, where female headship confers decision-making power but also a potentially high degree of economic risk as women no longer share financial responsibility for providing for their families. Reservation wages will be low for a larger subset of women than in areas where most households are headed by (employed) men, expanding the pool of cheap female labour available to MNCs.[1] The weaker conjugal ties found in the Caribbean, parts of Latin America and sub-Saharan Africa fall into this category.

In between these extremes lie a diversity of intra-household bargaining structures, where a woman's input into decisions over resource allocation and distribution is largely determined by her fate ('fallback position') should her husband or parents dislike her actions enough to withdraw their cooperation. By determining female labour supply and the price of women's labour, these gender regimes affect the ability of countries to attract FDI that is sensitive to labour costs.

Informalisation

The increasing disintegration of international production, as reflected in the rise of outsourcing and subcontracting by multinational firms, may also be linked to and serve to perpetuate gendered norms of work. Women form a majority of the informal workforce in the developing world (Benería, 2001), partly because their gendered responsibilities in the home and persistent gender inequalities in education and the formal labour market confine women to the most flexible and poorly paid labour markets. Looked at from this perspective, it could be argued that the rise in outsourcing is partly due to the persistence of gender inequality and the sexual division of labour: outsourcing becomes a way to maximise profit because of the flexible work situations that women often seek. From the perspective of economic development, this means that the informal sector is no longer the traditional, shrinking sector that much of development theory assumes. Rather, it becomes a growth sector that is complementary to the 'modern' formal sector (Benería, 2001). The rise of this sector and the nature of its employment relations also have important implications for women and their families. Employment becomes a perpetual source of instability, and women workers are largely left out of the gains won by unionisation and the imposition of labour standards in the formal sector.

IV. Conclusion

As neo-liberal globalisation progresses, and global competition among developing countries for FDI proceeds, understanding under what circumstances FDI contributes to the goals of development is increasingly important. Merely attracting FDI is not enough, as its effects on the domestic economy depend on the social and policy framework it finds. Seeing FDI and development through a gender lens clarifies these relationships. For instance, looking more closely at FDI-induced feminisation reveals how accounting for the impact of FDI on domestic investment and employment affects growth as well as individual households and communities. Understanding the role of gender wage inequality, and the labour market institutions that perpetuate that inequality, in economic growth specifies the circumstances under which FDI can support a country's overall development strategy. Understanding how the traditional sexual division of labour makes informalisation more profitable for MNCs boosts arguments for a better social welfare system to lift some of the burden of women's non-market work, or for global living wages which raise the bar for all firms. As the nascent literature on gender and FDI makes clear, gender matters at a macroeconomic level.

Note

1 An exception is in parts of sub-Saharan Africa, where female household heads have traditional access to their own income-earning assets, such as land, outside the multinational sector.

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PART IV

LABOUR STANDARDS

10 The minimum wage in a global context

Peter Brosnan

Minimum wage laws are a direct attempt to combat low pay by making it illegal to pay workers less than the rate provided for in the minimum wage legislation. Their origins go back more than a century (Starr, 1981). When the ILO acted within its first decade to adopt a convention on minimum wages – Convention 26 (Concerning the Creation of Minimum Wage-fixing Machinery, 1928) – its concern was to ensure that global trade was not based on cheap labour. This is still a key reason for its being concerned with maintaining adequate minimum wage systems, but other concerns include the reduction of poverty, fostering social justice and economic development (McMahon, 1991). As the pressures of globalisation make poverty, justice and development look less and less likely for many disadvantaged communities, the need for an adequate minimum wage becomes stronger than ever.

The objective of minimum wage systems

If the primary aim of a minimum wage is to prevent poverty, the minimum wage must be set in relation to basic consumption needs. If it is to make the income distribution more equitable, it must be set in relation to average earnings. If it is to prevent social dumping – exporting on the basis of cheap labour – it must be set in relation to wages in other countries.

Alleviating poverty

Unless a country's minimum wage is set ludicrously low, any increase in its rate must reduce poverty. Higher minimum wages mean lower levels of poverty in developing countries (Saget, 2001). Despite this, some argue that a minimum wage does little to relieve poverty since many of the poor are not in regular employment (for example Johnston and Stark, 1991) or that some of the lower paid belong to well-off households. This latter observation, however, is not a reason to permit low pay. It is a consequence of low pay!

It is true of course that a decent minimum wage is not the only way to alleviate poverty. The effectiveness of a minimum wage in alleviating poverty will depend on the tax system and the availability of additional social security benefits. Even so, a decent minimum wage ensures that no individual worker is forced into poverty due to his or her pay rate. The need for a decent minimum wage is greater in developing countries where there are often no social security systems, and where the distribution of income is such that a greater proportion of workers are likely to benefit from an increase in the minimum wage.

Reducing injustice

Low paid workers are rarely lazy or incompetent. Rather they are the victims of social and economic structures that prevent them from competing on equal terms with others. Some jobs are socially defined as deserving relatively low pay. At the same time, some categories of workers are less preferred by employers, or are in circumstances which prevent them applying for the better jobs. Thus, the preferred categories of worker get the better-paid jobs while the others have to compete for the poorer-paid jobs that are left. Consequently 'workers with ... equal skills and abilities are available at widely different prices' (Wilkinson, 1984, p. 422).

The categories of worker who are less preferred tend to be women, racial or religious minorities, migrants, people with less education (even if education is irrelevant for the tasks to be performed) and other 'socially disadvantaged' groups. As we have suggested before (Brosnan and Wilkinson, 1989) improving minimum wages would assist in attaining equal pay for work of equal value. It would improve the lot of a substantial proportion of women each time the minimum wage was increased.

The fact that many workers have to accept low pay is clearly unjust. But it is also unjust that the better paid within the same labour market benefit from the cheap labour of the low paid. They benefit from cheaper services where they employ the low paid directly and when they buy products or services 'subsidised' by low pay. Workers and other consumers in the advanced countries benefit too from the low pay of workers in the developing countries whose wages are much lower than theirs, and whose products may be priced correspondingly lower. Thus minimum wages are essential to reducing inequities within and between countries.

Developing the economy

The positive effects on the economy of a minimum wage have been posited for at least a century (Webb and Webb, 1920). More recently, Wilkinson (1984) has argued that a realistic minimum wage alters the terms of trade between different productive systems, making it more difficult for disadvantaged firms to rely on disadvantaged labour. The higher minimum forces firms to become more efficient, by investing in better equipment, better methods and in the training of their workforces. At the international level, countries with higher minimum wages will have fewer inefficient firms and therefore be able to compete better (c.f. Cahuc and Michel, 1996).

The other benefit is that the higher minimum boosts consumption spending and therefore employment. Workers on the minimum wage are likely to spend their whole wage (Borooah and Sharpe, 1986), and spend more of it on domestically produced products (Borooah, 1988). Thus an increase in the minimum wage would add more to domestic demand than an increase in pay at other points in the income distribution.[1]

Globalisation and low pay

Of the many differences between developing and advanced countries, few are as spectacular as the differences in wages. The low wages in developing countries are cited as one of the reasons for MNEs moving production from the advanced to the developing countries.

Developing countries

The transfer of jobs from advanced to developing countries is mainly in manufacturing. This has followed the emergence of the NICs of East Asia where there are fewer labour standards and often no minimum wage. For example Japan has been shifting its manufacturing to other countries since the late 1990s. Large and small firms are moving elsewhere, 70 per cent of them to China. In 2001, 69 listed manufacturing companies closed 120 factories. Advances in communication technology have allowed services to be increasingly sourced from developing countries too. Many of the administrative functions of western corporations can be sourced from developing countries and even call centres can be located away from the markets they service.

The garment industry provides an example of the changes in manufacturing. Starting in the 1960s and 1970s European and US companies outsourced to countries like Hong Kong, Singapore and South Korea. As wage levels and labour conditions improved in these countries, they moved to Indonesia, the Philippines, Thailand and Mexico. More recently production has shifted to Bangladesh, Central America, Vietnam and China (Hale, 2002). The effects of competition and the complicated patterns of contracting and subcontracting mean that there is intense pressure on prices, and therefore on wages and hours, with the result that even in low-wage countries 'there is the constant threat of further relocation' (Hale, 2002, p. 194).

Globalisation has changed the direction of the production chain. Whereas previously the transition from raw materials to finished product transferred production from developing countries to the advanced countries, now the geographic flow is much more complicated. Thus formerly highly paid work is transferred to developing countries while some low paid work remains in the advanced countries. Hoogvelt (1997) argues that because capital is mobile but lower ranked labour is not, low paid workers are forced to compete with the low paid workers in other countries so that the lowest common denominator prevails. Some would argue that the world 'has become a huge labour bazaar where states offer "their" labour forces at even lower rates' (Munck, 2002, p. 66).

Rather than impose labour standards – seen by many regimes as 'impediments to "progress"' – employers in export industries are freed from 'limits on working time, wages or benefits' (Standing, 1999, p. 64). Even where a developing country has a minimum wage, it may be ineffective in its application to the activities sourced by the MNEs. Many of these countries have large informal sectors where the minimum wage may not be enforced. Furthermore, many low paid workers, particularly in developing countries, are homeworkers who may not be covered by minimum wage legislation, or even if they are, are unlikely to be able to enforce their rights.

The strength of this can be exaggerated. As Munck points out, only 15 per cent of the labour force in developing countries is engaged in the production of tradeable goods (Munck, 2002, p. 67). About '80 per cent of the fall in industrial employment in the advanced economies between 1964 and 1994 can be explained by internal factors and only 20 per cent by competition from low wage economies' (British TUC, 2002).

The behaviour of governments in developing countries is much more than a simple reaction to opportunity. The IMF and World Bank encourage governments to reduce labour costs with a view to increasing exports. Every country is asked to 'liberalise' their labour market. The result is that minimum wage laws become irrelevant. For example, when prices were 'liberalised' in the East European economies, the value of real wages fell and consequently the minimum wage regimes ceased to be effective (Ghellab, 1998, p. 34).

Advanced countries

While the experiences of workers in the advanced countries are vastly different from those of their counterparts in the developing countries, they too are subject to much comparable pressure to work for low pay. The relocation of manufacturing to developing countries clearly affects labour markets in the advanced countries but the interrelated issue of global trends in employment forms are equally important in generating low pay in the advanced countries. The reduction in manufacturing employment sees a greater share of the labour force employed in the services sector. This has three main effects: the nature of employment is altered; trade unions are weakened; and pay declines for many workers.

The manufacturing jobs that have disappeared were nearly all full-time. However, a higher proportion of jobs in the service sector are part-time or temporary and in smaller workplaces. An additional feature is that many employees are being replaced with outside contractors, or becoming contractors themselves.

The service sector is therefore less conducive to traditional trade unionism, and the contingent labour force is hardly ever unionised. Thus trade unions are undermined. These trends have helped ensure that union power has declined in virtually every country since the early 1980s – even in countries where membership has not fallen. A further related factor is that the decline of manufacturing reduces wages in manufacturing itself, and by extension the wages of comparable workers throughout the economy (Weisbrot, 2002). These factors all interact, and the low wage outcomes are one more factor making union membership unattractive for many workers.

The increasing globalisation of markets has promoted non-union competition and 'contributed to the elaboration of low-wage employment strategies' (Katz and Darbishire, 2000, p. 7). MNEs are able to use the threat of moving to developing countries to put pressure on trade unions and workers in developed countries to concede wage levels and conditions. As unions have become generally weaker, and retreated to pockets of relative strength, bargaining has become increasingly decentralised with an emphasis on bargaining at company level, and the weakening of sectoral and national agreements. Nonetheless, countries such as Norway and Ireland have resisted pressure to adopt lower level bargaining on the grounds that it would hurt the lower paid.

All these trends, combined with persistent levels of unemployment have severely reduced the bargaining power and the income of vulnerable workers. Since the 1980s the distribution of income has become more unequal in most advanced countries.

National governments in the advanced countries find themselves under similar pressure as the developing countries to constrain wages, or to implement policies that lower pay. Furthermore the pressures of globalisation promote the proposition that wages in advanced countries need to match those in developing countries more closely. To the extent that other advanced countries follow this logic, it puts more pressure on those that might hold out. Thus governments adopt similar policies and use international comparisons to justify change. Thus the prevailing ideology becomes the need for workers to 'tighten their belts' for the common good.

Deficiencies of existing minimum wage systems

Introducing a minimum wage does not, of itself, ensure a fairer wage structure. The minimum wage must cover all the labour force. It must be set at a level that ensures that no one is low paid, and it must be adjusted regularly to take account of changing price levels and movements in other wages.

Coverage

A total of 103 countries have ratified ILO Convention 26. The various ILO conventions concerned with minimum wages[2] allow for a wide variety of practices: some countries rely on collective bargaining but with extensions of collective agreements to other workers; in some a national minimum wage is negotiated through collective bargaining; in others the minimum wage is determined by government. Whatever the arrangements, few countries have a minimum wage system that applies to every worker.

Whatever the country, the majority of the labour force earns more than the minimum, but in general, the higher the level at which the minimum wage is set, the greater the proportion of the labour force that is affected. Thus in Luxembourg, which has the highest minimum in Europe, the proportion is relatively high at around 16 per cent, while in Spain, where the minimum is very low, the proportion is only about 2 per cent.

The arrangements vary substantially across nations. In some countries the minimum wage only applies to the private sector. Some have different rates for blue- and white-collar workers, for qualified and unqualified workers, or for different regions. Some countries have an experience requirement or different rates for trainees. Some countries exclude particular categories of worker or grant them a lower rate; for example, Portugal has a lower rate for domestics, while a number of countries, Kenya and Morocco being examples, have lower rates for agricultural workers. Many countries exclude part-time workers and young workers, or they provide lower rates for workers below certain ages.

In the developing countries, the group that is in most need of the protection of minimum wages comprises people employed in the informal sector. However, conditions in the informal sector are difficult to police. Furthermore, informal sector workers may work outside established legal frameworks and thus not be entitled to the minimum wage. While the informal sector in the advanced countries employs between 2 per cent and 15 per cent of the labour force (Standing, 1999), the ILO estimates the share in developing countries at between 30 per cent and 80 per cent of the labour force (ILO, 1997).

Level

The ILO conventions on minimum wages offer little guide as to what is a reasonable level. The associated 'recommendations' do make reference to living standards, prevailing wages and so on, but are vague. The intention is that minimum wages must meet the cost of living, but it is often the case that the minimum wage comes nowhere close to that objective. As an example, the minimum wage in Nicaragua meets only one-third of the cost of living (Tabb, 2002). The Council of Europe (1977) suggested the minimum wage be set at 68 per cent of average full-time earnings, however no European country has attained this level. Within the OECD, statutory minima range from '20–33% of the median earnings of full-time workers in the Czech Republic, Japan and Spain to around 60% in Belgium and France' (OECD, 1998).

Marlier and Ponthieux (2000) found that 77 per cent of the low paid in Europe were women.

The minimum wage is unstable in many countries, but particularly in the developing countries. Saget (2001) estimates that minimum wages in Latin American countries lost 30 per cent of their value between 1980 and 1990. There are only a few countries that adjust the minimum wage automatically with wage or price increases. Many do have regular review processes in place, but the effects on employment and on 'competitiveness' are often considerations. Consequently the value of the minimum wage can fall easily into the range where it fails to meet basic consumption needs.

Compliance and enforcement

Compliance is a serious problem in all countries. Possibly no country has a large enough inspectorate to enforce a minimum wage, and many countries have no inspectorate at all, merely relying on complaints from workers or trade unions. There are regimes that are unwilling, or incapable of enforcing workers' rights, whatever the law may say. Many countries are unable to provide information about the minimum wage – the proportion of workers covered, the degree of compliance or its impact on particular population sub-groups such as youth, women and so on. Saget (2001) quotes studies that indicate high levels of non-compliance in many developing countries: 54 per cent in Guatemala, 9 per cent in Chile, and 15 per cent in Indonesia.

Government timidity

An effective minimum wage strategy is only possible if government supports it. Given the number of ratifications of the ILO conventions on minimum wages, it could appear that governments in general agree with the concept. However, many governments whose countries have ratified the conventions have no minimum wage in place, have a defective minimum wage or have even abolished minimum wage systems that had been set up. As examples, Papua-New Guinea introduced minimum wage legislation in 1972 but scrapped it in 1992; while Zimbabwe increased its minimum wage during the 1980s but the economic reform of 1990 suppressed it except for gardeners and other domestic workers (Saget, 2001).

There are several reasons why governments are reluctant to establish and maintain effective minimum wage systems: fear of inflation, concerns about the fiscal impact, and unease over the possible employment effects.

Inflation

Policy makers fear that higher minimum wage rates will cause a general upward movement in prices. This concern is especially important if trade partners or trade rivals have relatively stable prices. This consideration partly accounts for Portugal having a very low minimum wage compared with other European countries (€406 when most of the other European countries have monthly minima over €1000); the Portuguese authorities aimed to set the minimum such that Portugal's inflation rates converged to the European average.

The probability of general inflation following a minimum wage increase is not high. Inflationary effects may be offset by increased productivity (Hughes, 1976) or a reduction in profits. An important factor will be the extent to which higher paid workers successfully restore differentials disturbed by the higher minimum wage. However, labour markets are segmented such that better paid workers are unlikely to be making comparisons with workers whose pay is so low to be on the minimum wage (Brosnan and Wilkinson, 1988). Perhaps most importantly, the globalisation processes described above have weakened the ability of trade unions to respond to changing differentials, should they wish to do so.

Fiscal effects

Governments are not unaware of the effects of the minimum wage on their fiscal position, particularly where government employees are on minimum wage rates, or where the government employs contractors who pay minimum wage rates. A further concern is where social security benefits or pensions are linked into minimum wages. This is one of the obstacles facing the PT government elected by Brazil in late 2002. A 20 per cent increase has been scheduled for April 2003. The effect on wages will be minimal because most workers earn more than the new rate. However, it has been estimated that the cost of increased pensions will be 3.1 billion reals (€868m) (Bloomberg, 2002). Concern with similar issues underlay the IMF's threat to Russia, that it would block a scheduled loan if the minimum wage were increased (Standing, 1999, p. 217).

Unemployment

A prevailing unease on the part of governments is the relation between the minimum wage and unemployment. The argument, derived from simplistic economic theories, is that with higher minimum wage rates, fewer workers will be hired. Some of the arguments are summarised in a recent paper (Brosnan, 2002). Although these propositions have been tested in various countries, the results are never conclusive. Econometric coefficients are frequently not significant or the predicted relationships are found not to exist. Where there does appear to be a relationship, other factors are usually responsible (Ghellab, 1998). Nonetheless, countries still hold down wages for fear of unemployment. This was a fundamental part of the Czech strategy for 'social peace' during the transition to a market economy (Orenstein and Hale, 2001).

Why are governments reluctant to increase minimum wages despite there being only weak or non-existent effects on employment? In the context of a more globalised economy, one answer is pressure from international agencies such as the IMF. Another answer is that there may be concern that the higher minimum will increase the price of exports and render them uncompetitive. Given that low labour costs are one of the features that governments use when they hawk their country as a location for MNEs, this argument has to be taken seriously.

A number of factors reduce the force of the argument. In the first place, input–output tables show that, in general, export sectors have higher wages. This is not surprising. If exporting is based on efficient production, wages and profits are likely to be higher.

Secondly, many low paid workers are in non-exporting sectors, such as personal services. While tourism draws on that sector, cheap services are rarely a key factor in determining preferred tourist destinations; the empirical evidence is that higher-wage countries are the most attractive destinations.

A third factor is that many developing countries export agricultural products that are sold at 'world prices' irrespective of the cost of production. They are produced usually in sectors with low wages or in the informal sector which escapes regulation. For example, most of Chile's minimum wage earners are in the agricultural export sector. A higher minimum wage would not affect the price received.

Fourthly, when we consider manufactures, we find that the developing and advanced countries do not compete strongly with each other. There is greater competition within these groupings (and sub-groupings). Even so, as noted above, a lot of manufacturing is for the local market, and in all cases wage levels do not affect price by much, for wage costs are usually a small proportion of value-added (Brosnan and Wilkinson, 1988). As Roy has noted, a higher wage in the Indian carpet sector would not affect sales and employment because the mark-ups that determine the ultimate sale price occur elsewhere (quoted by Hensman, 2002, p. 360).

Fifthly, we need to separate the rhetoric from the reality. While MNEs may say they want cheaper labour it is only one of many factors in choosing a location. Stability, infrastructure, legal issues, supplies of raw material and access to markets may be more important. However, governments are keen to attract and retain new plants and will avoid increasing the minimum wage if they are told it is a deterrent. Once an MNE has located in a country, to move is expensive. Newer plants are usually high-tech and will not be moved because of a small increase in the minimum wage.

Thus the argument that a higher minimum wage will damage exports does not have a strong basis. Nonetheless, it is a persuasive argument in policy circles and, if poverty is to be reduced and a more just economic system established, ways must be found to take minimum wages out of competition.

Conclusion

As the world economy becomes more globalised, stronger minimum wage laws are needed. On the positive side, more and more countries have ratified the ILO conventions on minimum wages. On the negative side, there are many deficiencies in the various systems. They often do not cover all workers in the relevant country. They are invariably set at unrealistically low levels. Even countries with the better minimum wage systems fail to enforce them adequately.

The nation state is the only organisation currently capable of regulating wages where collective bargaining is poorly developed. However, as we noted above, pressures of globalisation make governments cautious about, or even hostile to, increases in minimum wages. Unfortunately some national trade union movements, Germany's being one, are reluctant to push for better minimum wage systems because they believe they would undermine collective bargaining. Nonetheless, governments and trade unions have an interest in there being adequate minimum wage systems in the countries with whom they trade or compete in trade.

The interrelationship of workers' rights and trade has been raised with the debate over a social clause for the WTO. However, this remains controversial with some, such as the Indian trade union movement believing it would do more harm than good. The social rights clause, even if it were implemented, does not provide guarantees of employment, meaningful work or a decent income. It would seem to be a very long step indeed to the equally important issue of an economic clause (see Harvey *et al.*, 2002).

The responsibility would thus fall back on the ILO which has adopted three conventions on minimum wages. The ILO could go further to adopt a convention that requires that all workers be entitled to the minimum wage and also that requires some level of enforcement. It could be more adventurous in terms of level. It has adopted conventions on hours and other matters where it does prescribe specific levels. It could, for example, adopt a convention that requires countries to have a minimum wage set at a specific level, which increases over time to allow the governments and employers in low-income countries to make the necessary adjustments. A suitable starting point might be a rate of US$1.00 an hour. This would be well below the existing minimum in most countries but would raise the minimum wage to meet basic consumption levels in a number of others. Over time, the minimum could grow to where it began to equalise minimum wages across a range of countries. The question is whether the government, trade union and employment representatives could agree on such a modest arrangement.

Stronger minimum wage systems are not a full solution to the problems of poverty, inequality or uneven economic development, nonetheless they are an essential component of any policy package for achieving these objectives, particularly if these problems are to be tackled in a global context.

Notes

1. These arguments are spelt out more fully in Brosnan (2002).
2. Also Convention 99 Concerning the Creation of Minimum Wage-fixing Machinery in Agriculture (1951), and Convention 135 Concerning Minimum Wage-fixing with Special Reference to Developing Countries (1970).

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11 Globalisation, labour standards and economic development[1]

Ajit Singh and Ann Zammit

I. Introduction

For some time now, the governments of a few advanced countries, as well as their trade unions and some parts of the business sector, have been pressing proposals to establish multilateral rules permitting punitive trade measures to be taken against countries deemed to be failing to uphold core labour standards. The countries most likely to be arraigned would be developing countries. The latter have, however, firmly rebutted these initiatives, which they argue are protectionist both in intent and in effect.

This chapter seeks to move the debate beyond the present stalemate onto a more constructive plane. Whilst examining the economic arguments in this controversy, it is also concerned with the broader political and moral dimension. We suggest that developing countries are committed to improving core and other labour standards; the reason why, in general, they are unable to implement many of these forthwith and much more widely is not because of the wickedness or perversity of their governments but essentially their economic circumstances and the structure of their economies. It is emphasised that developing countries should continue to adhere fully to these commitments both for intrinsic developmental reasons and also, importantly, so as not to lose the moral argument.

II. The North's case for a social clause

The pressure for adopting measures to compel developing countries to adhere to labour standards comes in part from workers in the North, particularly those in the US, whose perceptions and fears have inspired a powerful union campaign spearheaded internationally by various international trade union federations. They complain that competition from 'cheap labour', resulting from low labour standards in the South, is unfair. They also complain that, unless labour standards are observed in all nations, there will be a 'race to the bottom' with respect to the terms and conditions of work (ICFTU, 1999). Their perception is that the generally lower labour standards in the South pose three direct threats to their own employment, wage levels and bargaining position.[2]

A more specific complaint is that

> Unfair competition does not lie simply in the fact that labour costs (pay, health and safety requirements, social spending, etc.), are extremely low compared with those prevailing in most of Europe; it is also that the state is often acting to keep wages low, by denying workers the rights necessary to improve their conditions and by failing to enforce even such legislation as may be on their statute books (Morris, 1994).[3]

Particular targets for criticism are those 'countries with development models based on Export Processing Zones – where cheap labour, use of young female workers and, often, lack of union rights are among the main selling points' (ICFTU, 1996).

It is indeed true that during the last two decades labour markets in advanced economies have displayed unfavourable tendencies, especially compared with the previous two decades of the Golden Age. These deficits have been manifest in three important areas: de-industrialisation; increased inequality of wages and incomes; and mass unemployment. The following examples will be sufficient to indicate the nature of these deficits in the US and in the European Union countries:

- During the 100 years before 1973, real average hourly earnings of American workers rose by nearly 2 per cent a year. At that rate real earnings doubled every 36 years. In other words the standard of living of each generation of workers was double that of the previous one. This long-standing rise in the standard of living came to an abrupt end in 1973.[4] Over the two decades between 1979 and 1998, instead of increasing, the average real wage fell.
- At the same time, there was a reversal of the long-term trend towards reduced wage and income inequality which had been experienced in the couple of decades following World War II, and some say goes back as far as the 1920s. To illustrate, in 1979 male workers who had received a college education earned on average 30 per cent more than those who only had high school education. By 1995, the college educated were earning 70 per cent more than those receiving only high school education. Considering only those with high school education, the top 10 per cent of workers, in terms of wages, earned 60 per cent more than the average worker in 1979. By 1995, this wage gap had increased to 83 per cent (Slaughter, 1998).
- Rising inequality is manifest not just in terms of education, but also in terms of experience, skills, and indeed in the wage structure as a whole. As mentioned above, the real average hourly wage of the average US worker declined continuously between 1979 and 1998; that of those at the bottom of the wage distribution, that is the lowest 10 per cent, declined over an even longer period, namely between 1973 and

1998. Real hourly wages stagnated for all other groups except those in the top 10 per cent of the distribution. Even for this top decile, real wages have risen by a mere 6.6 per cent over the 25 years between 1973 and 1998 (McCall, 2000).

- Further, the erosion of trade union power represents another important deterioration of labour standards in the US in recent years. While the US claims that its Constitutional guarantees of worker rights and freedoms absolves it from signing ILO Conventions, there is widespread failure to comply with some of the ILO's core labour standards.[5] Indeed, a number of independent studies and government reports indicate that American labour law no longer protects workers' fundamental right to join a union. Instead 'unions are involved in a battle in which workers risk losing their jobs to realize their rights' (Kochan, 2000). A number of states have passed anti-union legislation asserting the 'right to work' which makes it more difficult to organise unions to go on strike. In addition to this encouragement given to non-union plants, the right to organise is still denied in the agricultural sector, which is among the lowest paid. By the early 1990s, only 15 per cent of American workers were organised in unions, whose role in protecting and improving the terms and conditions of work through collective bargaining has been much diminished.[6] Although, with the tightening of the labour market in the last two or three years union membership has at least stopped declining, the United States is still considered to have a relatively unregulated regime with regard to labour market issues and what is referred to as a 'union-avoidance culture' (Brown, 2000).

European workers have similar but different concerns compared with US labour. The European welfare state system, despite serious attempts by governments and employers to erode the scope of the benefits, still provides a floor for the lowest paid workers. However, unlike the US, Europe has been afflicted by mass unemployment and, in the popular perception, this is attributed to outsourcing by multinationals and, among other important factors, to unfair competition from developing countries.

- Since the early 1970s, European countries have experienced a high rate of increase in unemployment, such that the average level of unemployment rose from an average of 2.7 per cent in the period 1964–1973 to 10.3 per cent between 1990–99.[7] In 1995, in France, Italy and the UK the rate was 10 per cent of the labour force, and in Spain and Finland over 15 per cent. Even in Sweden, which previously had maintained a high level of employment, the rate rose rapidly from 1.5 per cent in 1990 to over 10 per cent in 1995 (Singh and Zammit, 1995).

- While the freedom to associate largely remains intact in Europe, the actual strength of trade unions in terms of membership has diminished significantly and their role in collective bargaining has been considerably eroded in the last 20 years. These changes were an integral part of the post-1980 economic order which is rooted in different social norms and which has involved the unravelling of the social pact between government, employers and labour and a weakening of the welfare state (Singh, 1990).
- During the period 1980 to 1988, trade union membership declined in all countries except Sweden and Finland. In France, trade union membership dropped from 19 to 12 per cent, in Italy from 50 to 39 per cent and in the Netherlands from 40 to 26 per cent. In the UK, trade union membership fell from over 50 per cent to about 33 per cent, covering only one in three employees (Milbank, 1993).

The above data regarding trends in the wages and employment of workers in the North provide clear evidence that their concerns are genuine. The key question is whether these detrimental developments are due to competition from developing countries. As the analysis below suggests, this is not the case.

III. Competition from developing countries and labour market outcomes in developed countries: an assessment

These labour market difficulties in the advanced countries are extremely important and deserve full consideration. If it were true that trade in manufactures with low-wage developing countries was the main cause of increasing inequality in the US or of mass unemployment in Europe, this would not bode at all well for constructive international cooperation. In fact, however, the results of research, especially the most recent contributions, indicate that this popular perception has very little basis.[8] The important insights of this research may be summarised as follows.[9]

- An elementary but extremely important point is that most manufacturing trade of the advanced countries takes place between these countries themselves. Only a small part is with developing countries. It is indeed true that, starting from a very low level, the volume of manufactured exports from developing countries to advanced countries expanded at a very fast rate of 12 per cent a year between 1970 and 1990. Similarly, their share of world exports of manufactures has increased from just 12 per cent in 1980 to 25 per cent in 1996. Nevertheless, despite this impressive increase in manufactured exports of developing countries, the total imports by advanced countries of manufactured goods from developing countries (excluding China) amounted to only about 1.5 per cent of the combined GDP of OECD countries. It will therefore be difficult to argue that the huge shifts in income inequality and phenomena such as mass unemployment in the North are being caused largely by this rather marginal amount of trade with the South.[10]

- Another simple but significant fact is that advanced countries, despite their increased manufactured imports from developing countries, have generally maintained a surplus in manufacturing trade with developing countries as a whole. UNCTAD (1995) carried out a comprehensive analysis of North–South trade over two decades – from the early 1970s to the early 1990s. This indicated that in 1993 the total OECD manufacturing imports from developing countries amounted to approximately US$ 150 billion (in 1985 prices). However, the corresponding exports from the OECD to developing countries totalled nearly US$ 250 billion, yielding a net OECD surplus of nearly US$ 100 billion. As a proportion of GDP, the OECD surplus was about 1 per cent, approximately the same as two decades earlier in 1974. Disaggregation of the OECD figures suggests important inter-country and inter-regional differences. The European Union's manufacturing trade balance with developing countries followed much the same pattern as that for the OECD as a whole. The situation, however, has been rather different with respect to the US and Japan: Japan's trade balance with developing countries increased appreciably between 1974 and 1993, while that for the US fell over this period, becoming negative by the mid-1980s.

  The industrial countries' surplus in manufacturing trade with developing countries has fluctuated in response to world economic events: it rose in the 1970s as developing countries borrowed petro-dollars and greatly increased their imports of capital goods from advanced countries. With the debt crisis engulfing many developing countries in the 1980s, the surplus fell. Importantly, this was due to reduced exports to the developing countries rather than to increasing imports from them. In the first half of the 1990s, as economic growth in developing countries revived, the surplus again rose as a result of increased Southern imports from the North.
- Research indicates that neither mass unemployment nor the extent of deindustrialisation, that is, the fall in employment in manufacturing, in G7 advanced countries are associated with fluctuations in this surplus but rather with cyclical and conjunctural movements in economic activity in these countries themselves.[11] Thus, for example, the US was among those of the G7 industrial countries losing the least number of manufacturing jobs during this period, whilst experiencing a trade deficit with developing countries.

- The experience of the 1950s and 1960s on these issues is illuminating. Just as in the recent period 1974 to 1993, when there has been a sharp increase in the import penetration of leading advanced country markets by manufactured imports from the South, there was a similar fast increase in imports in the 1950s and 1960s into the US and the original six EEC member states from Japan and Italy (which could be regarded as developing countries in that period, much like the newly industrialising countries today).[12] However, this earlier acceleration in the North's imports did not lead to mass unemployment, reduced real wages, or to increased income inequality. Rather, European countries had full employment, in the US real wages grew at a rate of nearly 2 per cent a year and inequality decreased. The main difference between then and the more recent period under discussion is the fact that in the earlier period advanced economies were growing at about 5 per cent a year compared with half that long-term rate since 1973.
- Most economists recognise that the unfavourable labour market characteristics in advanced countries detailed in the last section (deindustrialisation, mass unemployment and increased wage dispersion) are far-reaching economic and social phenomena which do not arise from a single cause. Although trade with developing countries may be one of the factors, there are additional interrelated factors which may be equally plausible and more important. These include trade imbalances between developed countries themselves, cyclical movements in economic activity and its slow long-term growth in advanced countries, technical change, and changes in economic and social policy in these countries. In practice it is difficult for economists to isolate and measure the influence of each of these possible causal factors and it is therefore not surprising to find that there is considerable controversy over this matter.[13]
- There is, however, agreement among mainstream economists that the proximate cause for these developments is the diminished demand for unskilled labour. This is deemed to cause increased wage inequality in the US because the labour markets there are flexible, whilst in Europe, because of the welfare state and more rigid labour markets, the effect is in terms of increased unemployment. Linking the decline in the demand for unskilled labour to mass unemployment in Europe and increased wage dispersion in the US in a unified explanatory framework is referred to as the 'transatlantic consensus' (Atkinson, 1999).
- The extent of the consensus is limited, however, to agreeing on the supposed fall in the demand for unskilled labour. What causes this fall in demand is subject to much debate. A large majority of mainstream specialists in this area attribute it mostly to technological progress

which is biased in favour of those with more skills, rather than to trade with developing countries.

- Some recent important research, however, criticises the simple theoretical framework (the two factor, two sector, two country Hecksher–Ohlin model) normally used in mainstream approaches as being too limited or unreal. This two-by-two-by-two model for North–South trade, with the North specialising in skill-intensive industries according to its comparative advantage and the South producing and exporting low-skill products, does predict that there will be a fall in the demand for unskilled labour leading to increased wage dispersion in the US and unemployment in Europe. However, a somewhat more realistic formal model involving trade between three groups of countries (the US, Europe and the NICs) does not yield such predictions at all.[14] Furthermore, other economists put greater emphasis on the lack of reality of the assumptions of the traditional trade models which assume constant returns to scale, perfect competition and full employment, giving no consideration to demand-side factors or to the accumulation of capital and therefore to growth.
- Significantly, new research also questions the underlying empirical generalisation on which the 'transatlantic consensus' is based, namely that there has been a fall in the demand for unskilled labour in advanced economies in the last two decades. The latter is inferred in the US, for example, from the fact that the wages of the unskilled workers fell relative to those of skilled workers. The evidence for 1977 to 1987 is broadly compatible with this proposition: the earnings of the bottom decile (assuming these to be unskilled workers), fell with respect to the median. However, very importantly, the corresponding data for the US economy for the period 1987 to 1997 suggests an opposite trend, that is, the bottom decile to the median ratio rose. Similarly, wage differentials in the UK fell in the 1990s, in contrast to the 1980s when these rose substantially.

In short, recent research suggests that traditional trade models are not applicable and that the basic premise regarding a decline in the demand for unskilled labour cannot empirically be sustained for the 1990s. It also suggests that the principal explanations put forward for this ostensible fall in demand, that is, technological change and trade, are not sufficient to account for the broader observed facts regarding increased inequality in incomes in general. Indeed, Atkinson (1999) sees the need to look to wider explanations. For example, he points out that what is observed in many countries in the 1990s is not a decline in wages at the bottom end of the scale but rather a rise at the very top. This, it is suggested, is in part a reflection of changing public perceptions of what is socially acceptable and the associated changes in policies, rather than being entirely a result of economic factors, such as technological change or trade. Economists nowadays tend to overlook the fact that labour markets are unlike product markets. In the real world, even the most flexible labour markets require social agreement on the fairness of wage and income differentials. How these norms are arrived at is a complex social and political process.

Limitations of the theoretical framework of mainstream models on the subject are further highlighted by considering the effects of the Asian economic crisis on unemployment in advanced countries. Two years ago it was widely thought that the considerable fall in the price of manufactured exports from the Asian crisis countries following devaluation would lead to a further net loss in US jobs. This, however, has not materialised, as indicated by rising levels of employment, particularly among the unskilled. In fact one could argue that these exports from crisis-affected Asian countries have helped increase rather than decrease employment to the extent that they exerted downward pressure on wages and prices and hence lessened inflationary pressure. This enabled the Federal Reserve to allow the US economy to operate at a higher level of economic activity and employment than would otherwise have been possible. Thus, although in the crisis-affected Asian countries the direct effect of reduced wages on US employment may have been expected to be negative, once the indirect effects are taken into account, the result is very different.

To sum up, analysis and evidence indicate that trade with developing countries does not necessarily lead either to unemployment or low real wages for workers in advanced countries. Between 1950 and 1970, despite the rapid increase in imports from the then NICs, European countries enjoyed full employment and rising real wages. In the US, real wages grew rather than remaining stagnant as they were later. Income inequality and wage dispersion diminished both in Europe and the US, unlike in the following period. Although there are many factors which could explain the differences, a very important cause was the much faster economic growth in Northern economies in the earlier period. Even those economists who believe that there is a tendency for the trade between rich and poor countries to be detrimental to unskilled workers will recognise that this tendency can be overwhelmed by the 'lift all boats' effects of faster economic growth (Bhagwati, 1994).

Considered in these terms, even if there were some significant adverse labour market outcomes of trade with the South in the 1980s and 1990s, these could have been overridden by faster economic growth. However, the slower economic growth observed in advanced economies in these decades was the result of their own policy decisions and social and political dynamics. (Glyn *et al.*, 1990; Crafts and Toniolo, 1996.) It did not result from manufacturing trade with developing countries.

Finally, it is important to reiterate that the empirical evidence for the 1990s contradicts the key theoretical expectation of those mainstream economists who believe that trade with the South necessarily leads to a fall in the demand for unskilled labour.

IV. Labour standards and economic development

The previous section considered Northern apprehensions that unemployment and increasing inequality in the advanced countries were due to competition from developing country imports. The discussion concluded that this was neither a necessary outcome nor did the analysis of recent developments prove these apprehensions to be well founded.

This section considers the implications of imposing compulsory labour standards on developing countries. This is a complex question, with many layers of argument, which requires a careful and extensive analysis. However, the analysis of these issues here will be necessarily brief.

In their advocacy of such standards for developing countries, advanced countries make a distinction between the seven core labour standards and other standards. The former relate to the core conventions concerning freedom of association and collective bargaining, freedom from forced labour, non-discrimination and the abolition of child labour.

There is, of course, a whole host of 'other' labour standards, but in the current context of developing countries the most likely ones at issue would include minimum wages, employment guarantees and health and safety measures. In advocating a social clause or other mechanisms to force compliance with the core conventions, the advanced countries suggest that they are only asking developing countries to adopt core labour standards, and not measures such as minimum wages. The enforcement of core labour standards is justified on the grounds that they are basic human rights and hence no other considerations enter the picture. It is argued, further, that the enforcement of core labour standards will not, in any case, alter developing countries' comparative advantage in production and trade.[15]

This perspective raises two issues, which need to be addressed here in view of their importance for developing countries. The first concerns the suggestion that the implementation of core standards has no impact on wage levels and other labour costs. The second concerns the primacy of core labour standards, and whether their classification as human rights completely rules out any discussion of the best way to proceed to implement them.

IV.1 Economic costs and benefits of core labour standards

Even though the implementation of core labour standards in developing countries will not necessarily affect the costs and pattern of production directly, a little reflection will show that the indirect effects may be quite important, and these could involve not just economic costs but also economic benefits. Further, the costs and benefits of implementing core labour standards are likely to be different for each of the various labour standards. It is also important to appreciate that the costs and benefits would be different if some or all of these core standards were to be implemented simultaneously. For example, the costs to producers of introducing equality of remuneration or non-discrimination in employment are likely to be higher if workers also have the right to organise and bargain collectively. To illustrate and clarify the main issues involved, the focus in the following discussion will first be on the freedom of association and on free collective bargaining. Subsequently other labour standards, particularly that of the elimination of child labour, will be briefly considered.

The contention that the implementation of the two core standards under discussion here (freedom of association and the right to collective bargaining – Conventions No. 87 and 98), will have no economic consequences for producers or to the economy as a whole is not generally valid. At an elementary level, the mainstream textbook model of perfect competition would posit that the introduction of these standards would be distortionary as this will lead to monopsony in the labour market and thus to a misallocation of resources. This is, of course, a static analysis based on a rather restricted set of assumptions and one can envisage a dynamic model of the economy in which labour standards reduce conflict by providing an institutionalised way of minimising disruption, improving cooperation between the employees and employers and thereby encouraging the latter to invest more. This would generate greater growth in the national economy.[16]

While theoretically possible, such a model with positive effects on economic development does not correspond to the economic conditions of most developing countries. In the longer term, however, when a higher level of development and a more advanced economic and institutional structure has been attained, the economic impact of employers' and workers' associations is more likely to be favourable.

There are a number of reasons for expecting negative effects in the short to medium term for developing countries resulting from the compulsory introduction of freedom of association and collective bargaining, according to the terms of ILO Conventions Nos. 87 and 98. The most important of these are outlined below.

IV.1a The structure of the economy Most developing countries are not only poor but have a sharply dualistic economic structure, extreme segmentation of the labour market and surplus labour. In the mid-1990s, on average, only a small proportion of developing countries' labour force (15 per cent) had employment in industry and services in which they had a formal wage contract. For this segment of the labour force it is feasible to consider applying core ILO labour standards. In contrast, however, 61 per cent of the labour force works in agriculture and another 22 per cent in rural non-farm and urban informal employment (World Bank, 1995). Even for the urban sector alone, UNDP (2000) reports that, in the 1990s, informal work accounted for 57 per cent of urban employment in Bolivia, 56 per cent in Tanzania and 48 per cent in Thailand.

It is difficult to introduce and almost impossible to enforce ILO Conventions on this large part of the labour force. The vast majority of labour in these sectors gains a living in micro-enterprises including subsistence agriculture, which creates obvious problems of organizing labour and monitoring standards. Further, in the more populous developing countries, there invariably exists a large reserve army of unskilled low-productivity labour that has to make ends meet by any means. In effect there is a large reserve of labour in search of work at any price. The possibilities for unionisation and collective bargaining of the sort traditionally associated with the advanced industrial economies are much more limited. With deindustrialisation and the rise of the service economy, even the advanced industrial countries are now confronted with this problem once again.[17]

In general, improvements in labour standards, core or otherwise, of this often very considerable portion of the labour force in agriculture and the informal sector in developing countries depend on significant changes in economic structure. Labour standards improve as the proportion of the labour force in these two sectors declines while that in organised industry and the formal service sector rises. Fast economic growth speeds up these phenomena, leading to greater employment in the formal economy and there is usually much improvement in both core and other labour standards.[18] Indeed, as an enterprise moves from the informal to the formal sector, there is an improvement in labour standards because, almost by definition, government rules and regulations concerning safety, health standards, and so on for employees do not generally apply in the informal sector, even if they are on the statute books. (For a further discussion, see Section V below.)

IV.1b Autocratic employers and immature trade unions As explained in the following section, freedom of association and collective bargaining in advanced countries has developed through an evolutionary process over a period of well over a century. In the course of this evolution the unions and employers developed responsible institutional mechanisms for conflict resolution. The employers came to appreciate the advantages of trade unions and collective representation for the workers. On the union side wasteful and damaging inter-union rivalry and other dysfunctional features of early trade unions were curbed, and in many industrial countries centralised wage bargaining or other similar pay coordinating structures were put in place.

However, if in accordance with the advanced countries' proposals, the two labour conventions under discussion are imposed in a 'big bang' manner in a developing economy (through, for example, international trade sanctions), it is more than likely that this would lead not to conflict resolution, but rather to strikes and consequent economic disruption. Many developing country employers, including the largest ones, often have a feudal or paternalistic outlook and do not see any need for trade unions. It is not unusual for them to use violent methods to stop the formation of unions and their activities, much like the historical experience of advanced countries such as the US. On the side of the employees, in the early stages of unionisation, there is also likely to be considerable inter-union competition for members, leading to populist positions being taken by union leaders. Further, attempts at violent suppression of trade union activity by employers invariably leads to counter violence by unions. The consequent economic and social disruption discourages investment, both foreign and domestic, and therefore does not help the cause of economic development.

Moreover, free collective bargaining between employers and unions, if it takes place at all, will only be concerned with the wages and employment of those who are already working in the formal sector. The interests of the vast majority of workers in agriculture and in the informal sector who are not unionised would be ignored. Furthermore, to the extent that formal sector unions succeed in getting higher wages and employment guarantees for their members, this is likely to reduce, other things being equal, the demand for labour in that sector, forcing the unemployed to seek work in the informal sector. So the paradoxical result of efforts to impose compulsory labour standards is that they would harm economic development, reduce structural change, and thereby increase the numbers in the informal sector where labour standards hardly apply.

Thus, the compulsory introduction of free collective bargaining, if successfully implemented, is likely to widen the already considerable wage and income gap between workers in different parts of the economy. Instead of promoting equality and solidarity, the unintended result of unionisation of formal sector employees may well be the development of an aristocracy of labour based on extraction of rents by union members, particularly in more productive firms. In these circumstances a concern for broad social justice, especially with respect to the informal sector and small rural producers, may require government intervention and regulation of bargaining between unions and employers in the formal sector (see, for example, Stiglitz, 2000). Such intervention may also be necessary to cope with the adverse economic and social consequences of bargaining between autocratic management and immature unions as outlined above. However, many developing country governments lack the institutional and administrative capacity for adequate remedial intervention with unfavourable consequences for economic development.[19]

The paradoxical results of the enforcement of compulsory labour standards go further. Such enforcement would not only be counter-productive for developing countries, it is also unlikely to help the interests of those seeking protection in the advanced countries. To see this, assume that the imposition of labour standards leads, via trade union action, to higher wages and costs in the developing country's export sector – the most favourable assumption from the protectionist perspective in the advanced countries. Under this assumption, the competitiveness of developing country exports is likely to diminish, but this may provide only a brief respite for the advanced country producers.

In analysing this issue, it is useful to remember that most developing country exports to advanced countries are produced by a small number of NICs, whilst the vast majority of developing countries export only a very small fraction of the total. Although, in the short run, all countries are likely to be disadvantaged to a greater or lesser extent in terms of their competitiveness if core labour standards are made compulsory, the NICs are unlikely to be handicapped for long. As they have higher rates of investment, technological change and superior production and export dynamics, they will, in the medium term, be able to re-establish their competitiveness. The outstanding examples of this phenomenon are countries like Korea and indeed before then the example of Japan which started with Asian wage levels and has continued to be competitive in spite of continuing increases in real wages, as well as more and more stringent environmental standards imposed on their exports by importing countries. Higher labour costs in firms already competing in world markets are likely to stimulate investment in more productive techniques in order to maintain their competitive edge.

However, turning from the NICs to the great majority of developing countries, although accounting for only a small proportion of total developing country manufactured exports to advanced countries, these exports are, nevertheless, crucial to their well-being. A rise in their export costs as a result of the compulsory introduction of labour standards would, under plausible assumptions, lead to a lower rate of economic growth of exports in both the short and medium term, worsening their balance of payments, such that the growth rate has to be lower to be compatible with current account equilibrium. This will reduce the pace of structural change and the improvement of labour standards.

It will be appreciated, however, that both for the NICs and other developing countries the costs of adjustment, whether in the short or long term will be lower, the faster the rate of economic growth of production and exports in the domestic and in the world economy.[20]

V. Labour standards: the experience of developing countries

It is interesting in this respect to reflect on the actual experience of East Asian and Latin American countries during the course of economic development. Taking East Asia first, notwithstanding the recent Asian crisis, these 'miracle' countries experienced very fast long-term growth (near double-digit rates for two decades or more). The result has been fast absorption of surplus labour resulting in labour shortages; very high rates of growth of real wages by comparative international standards; speedy structural change, resulting in the displacement of the informal sector activities by the formal sector. Real wages in the fast-growing East Asian and South-East Asian economies rose at a rate of over 5 per cent a year between the mid-1980s and the mid-1990s.[21] In Taiwan, employment in the agricultural sector fell from 56.1 per cent in 1953 to 36.7 per cent in 1970 and was only 12.1 per cent in 1993. Industrial employment reached more than 40 per cent in 1990. In Korea in 1992, only about 15 per cent of the labour force were still in the agricultural sector and more than 25 per cent in the industrial sector (Lee and Park, 1995).

It is a matter of historical record that many of these countries repressed *trade unions during the early phases of their developmental spurt*. This was the case for example in Korea during the 1960s and 1970s. However, with the fast expansion of the formal economy and particularly the shrinking of the informal sector, not only labour standards in terms of employment and wages greatly improved, there was also a very considerable expansion of unionisation. By the end of the 1980s, unionisation constituted 40 per cent of the labour force in Taiwan and 17.2 per cent in Korea, compared to only 15 per cent in the US (Lee and Park, 1995). These huge improvements in core as well as other labour standards took place in these countries through the process of economic development itself, without any international coercion.

A comparison of East Asian countries with those elsewhere (for example, in South Asia or Latin America) suggests that fast economic growth may not be a sufficient, but is certainly a necessary, condition for the speedy establishment and improvement of labour standards. To illustrate, a democratic country like India in the 1950s had much better core labour standards in the formal sector than say, Korea; but the situation is now quite the opposite because of the much slower growth of the Indian economy relative to that of Korea. The proportion of the workforce in unions is much smaller than in Korea, and workers' wages in India have grown much more slowly. Similarly, in Latin America, despite its long history of trade unionism compared with East Asia, its much slower long-term rate of economic growth in the 1980s and 1990s has contributed to further 'informalisation' of the economy.[22] Tokman (1997) reports that eight out of every 10 new jobs in Latin America in the 1990s have been created in the informal sector with consequent unfavourable prospects for the workers involved to be able to exercise the rights given to them by the ILO conventions. A small proportion of the increase in informal sector work could be due to labour-saving technical progress in the formal sector, rather than to slower growth. However, it is too early to tell whether the long-term relationship between economic growth and formal job relations has become worse over time.

There are a number of reasons why improved core and other labour standards are associated with structural change and particularly with industrialisation. In the first instance, in contrast with the small-scale agricultural sector and the informal sector, work in industry is usually organised in a way that facilitates trade union organisation and activities. The relatively higher rate of growth of productivity in industry also provides scope for improvements in substantive labour standards. Employers in the industrial sector who have invested substantial capital in the enterprise are also interested in promoting core and other labour standards such as health and safety standards, since these tend to increase the level of commitment of the workforce and to increase the productivity of workers (see Piore, 1990).

V.1 Core labour standards and human rights

The above considered some of the most important costs and benefits of implementing the core labour standards relating to freedom of association and collective bargaining, and the appropriateness of such standards in the circumstances in which most developing countries find themselves. This subsection addresses the other central issue introduced at the beginning of the section, namely that concerning the primacy given to core labour standards, which have been accorded the status of human rights.

The unanimous adoption by ILO members in 1998 of the Declaration on Fundamental Principles and Rights at Work, embodying the seven core labour standards, is regarded as evidence of the widespread acceptance of the notion that certain labour standards have precedence. The rationale given for the primacy of the seven core standards is that they are universal human rights. Of these the freedom of association and trade union rights are given particular emphasis in that they give workers the freedom to press for improvements in other aspects of labour standards. Having the status of human rights purportedly pre-empts any economic cost–benefit analysis. These contentions are contested below.

V.1a Historical evolution of labour standards in advanced countries Historically, labour standards evolved in a rather different manner. In Europe, early efforts to improve labour standards focused on gaining legislation to eliminate the worst forms of child and female labour, and with initiatives to improve health and safety at work. It took many decades before the workers' efforts to associate and bargain with their employers gained legal recognition. In many countries, it was only after many decades of struggle and political debate, that trade unions were recognised and constituted a regulated institutional framework facilitating conflict resolution between employers and workers. Thus, broadly speaking, core and substantive labour standards evolved during the course of economic development, and legislation legitimising labour standards was introduced as a result of struggle by working people, and not through some *deus ex machina*. Labour standards have been both the cause and effect of democratisation in the advanced countries.[23] In the light of this evolution, the unions became increasingly responsible, and both economic growth and labour standards improved.

V.1b A hierarchy of labour rights? Although these two core standards concerning the freedom of association and collective bargaining are indeed extremely important and should be given high status, the primacy of those over non-core standards needs to be questioned. For example, should health and safety at work be accorded lower priority than the right to free association and collective bargaining? It is indeed true that 'deficits' in the latter have often resulted in the imprisonment and even murder of trade unionists. On the other hand, the disregard for the health and lives of workers manifested by the widespread lack of health and safety regulations has resulted in appalling tragedies such as those in the Bangkok factory and the Bhopal chemicals plant in which fires and fumes cost the lives of thousands of workers. Less dramatically but more insidiously, tens of thousands of unprotected agricultural workers worldwide suffer slow poisoning by the chemicals used to produce agricultural exports.

Equally importantly, there is international recognition of the fact that absolute poverty blights the lives of 1.3 billion people in developing countries. In 1995, 117 Heads of State or Government attending the Copenhagen Social Summit endorsed the Copenhagen Declaration, which put primary emphasis on the promotion of full employment and poverty reduction. Should not the right to a decent living also be regarded as a basic labour right?

V.2 Terms of Conventions 87 and 98 and the role of the government

There are also serious difficulties from the point of view of developing countries with the precise formulations of Conventions 87 and 98 concerning freedom of association, the right to organise and to engage in free collective bargaining. The texts of these conventions reflect the needs and institutions of advanced countries at a particular moment in time. The conventions do not take into account the fact that untrammelled collective bargaining may not only lead to social disruption as noted above, but also to serious macroeconomic disequilibria, all of which require government intervention in the bargaining process. Governments also need to intervene to ensure that the interests of the unemployed, low productivity sector workers or those in the informal sector or small-scale agriculture are taken into account. These concerns were recognised in European countries themselves during the so-called 'Golden Age' (1950–73) when many governments entered into social pacts with unions and employers to institutionalise the social market economy, which tried to achieve a broadly acceptable distribution of income and wealth (Glynn *et al.*, 1990; Eichengreen, 1996; Flanagan, 1999).[24]

Moreover, the orthodox approach to trade unions implied in the terms of the two Conventions is hardly relevant to peasant and small-scale farming in developing countries. These require different policies and institutions in which the government often plays a role, as for example, through price support programmes, technical assistance and promoting cooperatives. Some of these measures may be achieved through individual and collective initiatives and organisations, but in practice the government has to play a leading role. In developing-country agriculture, one of the main issues is land reform, since the size of land holding is a crucial factor in determining the capacity to earn a decent living and escape from poverty.

It would appear that human rights defined and interpreted in terms of these two core conventions are destined only for a small part of the working population, benefiting mainly those who are already relatively privileged. Furthermore, the untrammelled exercise of these rights by the minority may well prejudice the chance for others to have a decent living or to be able to exercise their rights to freedom of association and to collective bargaining.

VI. Should core conventions be made compulsory?

To sum up, from the perspective of developing countries, there are three significant policy conclusions with respect to the core conventions:

1. The number of core conventions should be expanded to make them inclusive and relevant to the needs of the whole working population worldwide.
2. Conventions 87 and 98 require fundamental revision to make them relevant to the developing world.
3. There are trade-offs between certain core conventions and therefore economic and social costs and benefits must be part of the moral equation.

These conclusions also have important implications for the question concerning whether core labour standards should be made mandatory by means of international trade sanctions or other punitive measures; these implications are examined below.

In the case of Conventions 87 and 98, the answer suggested by the above analysis is unambiguous. These conventions are deeply flawed, particularly from a developing country perspective, and it would be a mistake for developing countries to implement them in the fashion envisaged in the conventions. The argument here is not against workers' organisations as such, but the process of raising labour standards should ensure the inclusion of the mass of the working population. If these conventions were revised to make them more inclusive, developing countries would find them easier and more useful to implement. However, their mandatory application in developing countries under international coercion would still be unwise. This is because, although the acceptance of the role of the government in the collective bargaining process may help ameliorate some of the difficulties outlined earlier, there are still likely to be significant costs for the non-NIC majority of developing countries. Consequently, such compulsory standards will be resisted by these countries. However, encouragement to these countries through non-coercive means and technical aid by agencies such as the ILO to implement the standards are more likely to lead to positive results (Bhagwati, 1994).

The arguments for compulsory implementation of labour standards in developing countries are sometimes based on advanced country allegations of the formers' unfair advantages in trade which give rise to social dumping and a race to the bottom. These issues will be examined in the next section where it will also be seen that these considerations do not in any way justify compulsion.

Although we argue here against compulsory imposition of Conventions 87 and 98, we do not take the same view for all other core conventions. For example, granting slave and bonded labour their freedom in recognition of their human rights should be implemented forthwith. In view of the limited numbers of people involved, compulsion cannot be rejected on grounds of costs to developing countries. However, in the case of the conventions on child labour, which we discuss briefly below, again compulsion will not be appropriate.

VI.1 Child labour

Child labour (covered by a core ILO Convention (No. 138 on Minimum Age) and the Convention on the Elimination of the Worst Forms of Child Labour, which amplifies the former) raises other kinds of problems, which merit careful consideration.[25] The latter convention commits countries to working with the ILO to fix time-bound policies to eliminate the worst forms of child labour. As is increasingly recognised, the phenomenon of child labour is rooted in a number of fundamental factors, not least domestic and global policies that lead to income concentration, poverty, exclusion, under-employment and unemployment. The World Confederation of Labour (WCL) notes that, to abolish child labour, to prevent such situations arising, and to reintegrate children into society 'requires a broad-based strategy. ... Free compulsory and high-quality education is a pre-requisite for concrete results of such a strategy ... and has to include curricula for vocational training, which is now lacking in many countries' (WCL, 1997).

The essential point is that parents and governments in developing countries would like their children to be in school rather than at work, but in many poor countries they are unable to afford it. Detailed empirical studies from several countries confirm this view (see for example Grootaert, 1998 and Addison *et al.*, 1997; for a review of these and other studies see Basu, 1999).

Empirical evidence further suggests that, where parents have been compensated for the loss of child earnings and schools are available, children do not work but go to school. However, without such compensation for the parents, the imposition of the standard of child labour will simply lead to the children resorting to other often illegal or unsavoury activities, where they will be worse off than if they were working and earning some income for the family.[26] Thus, without supporting measures, the enforcement of the child labour conventions in developing countries will hinder rather than help the realisation of the objective of promoting the welfare of children.[27]

VII. Conclusion

An extremely important point which emerges from the discussion of core and other labour standards in this section is that substantial improvements in these standards, as well as significant growth of real wages and other substantive standards, can be rapidly achieved voluntarily through the process of economic development itself. As indicated, the fast-growing East Asian countries were able to accomplish these objectives without any international enforcement measures.

Efforts to enforce core labour standards will not help to raise standards in much of the informal sector and could well lead to further informalisation. If punitive trade measures were used to enforce such standards, a reduction in trade through the application of trade sanctions could result in cuts in employment precisely in the industries where labour standards have generally been seen to grow fastest. This is likely to throw more workers into the informal sector, worsening the already low levels of remuneration and conditions of work. The net result will be the opposite of what is allegedly intended.

This is not to say that leaving it to the market or to the natural forces of economic development will always be adequate to improve labour standards at a fast enough rate. The promotion of labour standards on a voluntary basis, backed up with technical and financial assistance for both the monitoring and implementing of the standards by the countries themselves, will be helpful in hastening the process. As explained before, developing countries have continually demonstrated their commitment to raising their labour standards, as manifested by various national and multilateral actions, including their recent acceptance of the ILO Declaration on Fundamental Principles and Rights at Work and Their Follow-Up (for the text, see ILO, 2000a, and for the Follow-Up, see ILO 2000b). In addition to the economic and practical arguments outlined above, they strongly object, however, on political grounds, to labour standards being made compulsory, whether the compulsion is enforced through the WTO or through joint ILO/WTO initiatives. Such measures would introduce yet a further layer of conditionalities to those imposed on them by the international financial institutions and through WTO trade and trade-related agreements, all of which circumscribe developing countries' policy options (South Centre, 1998a and 1998b).

The approach of the ILO Director-General to labour standards seems to be more promising for the purpose of establishing a universal social floor for the globalising economy. In referring to the notion of 'decent work' as a means of capturing and realising the aspirations of people throughout the world and seeking radically new solutions to the global problems of poverty and the working poor, Mr Somavia stated, at the opening session of the 88th ILO Conference in June 2000, that decent work

> is not a straitjacket, a one-size-fits-all solution. On the contrary, it is a way of treating in a coherent and dynamic way the aspirations and goals of different individuals, different cultures, different societies. The question is how to make it real. We all understand that the possibilities for decent work evolve with social and economic progress, and goals can and should rise over time (Somavia, 2000).

An important conclusion that can be drawn from the foregoing analysis is that the economic interests of informal sector low-productivity labour and those of the small-scale farming families must be promoted by other methods, including the development of popular organisations. The above analysis would also suggest that there is a clear need to redraft conventions 87 and 98 so that they lead to more democratic outcomes in the sense of taking into account the conditions and economic structures of developing countries. The core standards could also be extended to include one focusing on the right to a decent living.

Notes

1. This chapter has been abridged from a longer policy monograph, *The Global Labour Standards Controversy: Critical Issues for Developing Countries*, which was published by the South Centre, Geneva in 2000. The paper was presented at a Panel Discussion, at the American Economic Association meetings in Atlanta in January 2002, and at the Conference on Living Wage at the University of Massachusetts in Amherst in April 2002. Helpful

discussions with Robert Pollin are gratefully acknowledged. Ajit Singh acknowledges the assistance given by the Centre for Business Research, University of Cambridge.

2. A particular complaint is that the employment of forced labour and child labour facilitates the payment of extremely low wages, if any, thereby putting pressure on other segments of the labour market to accept low wages.
3. The necessary rights are those specified in ILO Conventions 87 and 98, granting workers the right to organise and to engage in free collective bargaining.
4. The basic source for the data in the following paragraphs is the US Council of Economic Advisers (1998) and Economic Policy Institute (EPI) (1999).
5. On the issue of forced labour, the requirement that prisoners and youths in detention work for derisory pay is standard practice in the US and in Europe. In the US, the prison population numbers over 1 million with half a million in local county jails. There is a disproportionate number of black and latino persons, often detained for minor offences and arguably as a form of social control (see, for example, Freeman, 1995). Prisoners are forced to work in factories, including clothing factories, that have located their operations close to prison sites, where they have a captive pool of cheap labour. It is estimated that in 1998 prison labour produced over 280 products worth over US$ 9 billion and replaced 400 000 jobs otherwise done by the normal workforce. Prison labour is paid the minimum wage but, after deductions for taxes, room and board, victim's compensation and so on the pay may be only US$ 60 a month for nine-hour days. A number of harsh disciplinary measures and other penalties are imposed if prisoners refuse to work. Federal law prohibits the domestic sale of prison-made goods unless prisoners are paid the going wage, so prison industries export the output, often to Asian countries (WINDS).
6. Unionisation becomes particularly difficult when a considerable part of the workforce consists of illegal migrant labour, as is the case in parts of the USA. Employers are, of course, keen to employ such workers, since these are willing to work on almost any terms and in the worst of all possible jobs. However, the fear of being arraigned and deported as illegal migrants constrains them from joining efforts to unionise and improve their terms and conditions of work. Inflows of migrant labour, legal or otherwise, are unlikely to dry up, until growth and development has improved the standard of living in the South.
7. The lower rate of unemployment in the US is partly explained by the fact that welfare provision for the unemployed is not as extensive as that in Europe, so that many people are obliged to seek work, however unremunerative the wage. The higher level of unemployment in the EU compared with that in the US is the source of a vigorous academic and policy debate on labour market flexibility.
8. For research suggesting that trade with the South has a detrimental impact on employment and wages in the North, see in particular Wood (1994; 1995). However, Wood's estimates of the extent of the impact far exceed those of other economists.
9. The analysis in this section is based on Singh and Dhumale (2000). For detailed empirical evidence underlying the arguments in the following four paragraphs see UNCTAD (1995)
10. Strictly speaking, under the rarified assumptions of general equilibrium trade models, it can be shown that small changes in quantities can cause large shifts in prices. For the intense academic controversy on this subject, see Krugman (2000), Leamer (2000) For earlier contributions, see Bhagwati (1994). It is also important to bear in mind a related point with respect to the effects of trade on jobs. Once a country starts trading there will normally be a gross loss of jobs, but not necessarily a net loss. Other things being equal, employment will contract in importing and expand in exporting industries. The magnitude of the net change in jobs will be determined by the relative growth rates of imports and exports, as well as by the capital intensity of production in the importing and exporting industries. For the individuals concerned, the gross loss of jobs is extremely important as many of them may not have the skills or the capacity to move to jobs created elsewhere in the economy. Thus governments often need to provide special assistance to displaced workers. The US government, for example, provides trade adjustment grants to workers proven to have been displaced because of imports.
11. For a fuller discussion of deindustrialisation, see Rowthorn and Ramaswamy (1997), Singh (1989 and 1994) and Howes and Singh (2000).

12. Between 1958 and 1997, import penetration by Italy and Japan of the market for manufactures for the original six EEC countries, excluding Italy, rose from 0.5 per cent to 3.7 per cent of apparent consumption (gross output minus net exports); the corresponding figures for the US were 0.3 to 1.8. This acceleration in the North's imports is coincidentally similar to that experienced by these countries between 1975 and 1992. Over the latter period, the European Union's manufactured imports from developing countries rose from 0.9 to 2.8 per cent of apparent consumption. The analogous figures for the US for this later period were 0.8 and 4.3.
13. For recent reviews of this literature, see Burtless (1995), Gottschalk and Smeeding (1997), Slaughter and Swagel (1997). See also Singh and Dhumale (2000), Atkinson (1999), Krugman and Lawrence (1994) and Richardson (1995).
14. See Atkinson (1999; 2000) and Davis (1998a; 1998b).
15. See, for example, the statement of US Secretary of Trade Barshefsky's statement on this matter at the Singapore WTO Ministerial meeting.
16. The central question here is whether labour standards would help or hinder economic development, through their impact on the rate of growth of output, employment and labour costs. The general answer, as suggested by the analysis in the text, is that this depends on a number of complex factors and interrelationships, in particular the assumptions which are made with respect to (a) the range of labour standards being introduced and the speed with which they are implemented; (b) the level of development of the country and degree of export orientation; (c) the dynamics of the production structure and production and export capabilities, including the ability to absorb modern technology; (d) the rate of savings and investment among others. It may also be useful to note that this analysis of the relationship between labour standards and economic development is somewhat different from the examination of the effects of labour standards on economic welfare in terms of the conventional theories of welfare economics and international trade. For an example of the latter perspective see Brown *et al.*, 1996.
17. The acquisition of labour rights and standards is not necessarily a permanent achievement. For example, the number of people employed in Indian restaurants in the UK now totals more than those in coal mining, steel making and shipbuilding put together. These once dominant industries were noted for their strong unions with substantial collective bargaining capacity, which brought continual improvements in substantive labour standards. In contrast, work in the restaurant business, which has low productivity, is typified by its informal, part-time nature, and the level of union organisation is low, as are labour standards. This needs to be distinguished from the growing phenomenon of 'informalisation' of the work contract, whereby the nature of the 'contract' is such as to turn the 'employee' into a virtually self-employed person, with few if any labour rights.
18. Employment in the formal sector increases until a very high level of per capita income is reached. At that point, the share of employment in industry declines and that of services, particularly informal services (informal in the sense that many labour laws become difficult to apply due to the small size of the enterprise) begins to rise.
19. Contrary to popular prejudice in advanced countries, most developing country governments are neither perverse nor wicked or worse. Some in East and South-east Asia have been recognised to be 'developmental states' with an outstandingly successful record of close government involvement in the economy (see for example Amsden, 1989; Singh, 1995a; Wade, 1990). Others, such as India, have been equally interventionist but have not been as successful. The large majority of Third World governments are less effective with considerably lower levels of institutional and administrative capacity. These governments may not always be multiparty democracies but it is important to recognise that they tend to be relatively 'inclusive', that is they cannot simply be regarded as representing the interest of employers. There are, of course, a small number of southern countries, which are totally corrupt, ineffective and non-inclusive, as was the case with Mobutu's Congo, for example. For such countries, neither compulsory nor voluntary labour standards would help.
20. For a fuller discussion of these issues see Singh (1990).
21. For further details, see Singh (2000).

22. The trend rate of growth of Latin American economies during the last 20 years has been only 3 per cent a year, compared with almost 6 per cent a year in the period 1950–1980 (Singh, 2000).
23. In the words of E.P. Thompson, studying the making of the English working class, 'The working class did not rise like the sun at an appointed time. It was present at its own making.' See Thompson (1963) and Hobsbawm (1964).
24. The European Agricultural Policy (CAP) was originally intended to improve the livelihoods of small-scale farmers and agricultural workers.
25. According to the ILO (www.ilo.org/public/english/ipec) there are 250 million child labourers in the world including child domestic workers. Of these, '60–80 million at least ... work in conditions which cripple their bodies, minds and souls, stunt their growth and shorten their lives.' Less than 5 per cent of these child labourers work in export industries. It is estimated that during the 1990s, 300 000 were soldiers.
26. Schemes are being implemented in Brazil and elsewhere which, with external financial support, provide a small income to parents on condition that their children go to school. In the Bolsa-Escola programme in about 200 Brazilian cities, families below the poverty line are paid the Brazilian minimum wage on condition that all of the household's children between 7 and 14 years of age are registered in school and that their attendance is regular – they must not miss more than two days of school each month (Buarque, 2000).
27. Recent theoretical research suggests that, under certain special circumstances, particularly where children constitute a significant proportion of the workforce, the banning of child labour could lead to a rise in adult wages, enabling poor households to do without the income from child labour. The author of this theoretical result himself observes that 'This is unlikely to be true for very poor economies but may be valid for better-off countries. Even so, one would need to do detailed empirical work to decide whether such a total ban is worthwhile. The interesting insight the theory gives us here is to tell us that it may be so and to give hints as to the type of economy where this is likely' (Basu, 1999).

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12 Global labour standards: their impact and implementation

James Heintz

Over the past four decades, a fundamental restructuring of international production has taken place – a transformation which is frequently referred to as the 'new international division of labour'. Developing countries have been shifting from exporting primary goods and raw materials to also exporting manufactured goods and intermediate inputs. The expansion of manufactured exports from the developing world has unleashed new competitive pressures. Not only are the newly industrialising economies competing with more established industrial powers, they also compete with each other. In this environment of heightened competition, international concern over fundamental human rights at work, the payment of poverty wages, and the existence of dangerous working conditions has intensified.

Recent evidence shows that, in the developing world, approximately 25 per cent of people engaged in paid labour live in households that survive on less than the equivalent of US$1 per person, per day (Majid, 2001). Moreover, setting a more accurate poverty line for these countries would raise this estimate significantly (Reddy and Pogge, 2002). The widespread incidence of poverty among working people around the world today is indicative of the general prevalence of indecent working conditions. In recent years, calls for a coordinated system of global labour standards have gained strength in order to address the problem. This chapter takes a close look at the debates surrounding global labour standards. In particular, it summarises the key arguments in support of global labour standards, evaluates the threat of negative consequences that could spring from such regulations, and discusses current developments in implementation strategies.

The labour standards debate: a summary of the key issues

One of the most prevalent arguments as to why global labour standards are necessary is that they prevent a 'race to the bottom'. That is, upward harmonisation of standards stops competitive pressures from reducing labour protections to their lowest common denominator. According to this logic, global integration creates a situation in which the deterioration of basic standards is rewarded by increased competitiveness and profitability. In the absence of international cooperation, individual countries cannot raise labour standards without jeopardising their competitive advantage. The scenario represents the typical prisoner's dilemma problem – countries will adopt the same low standards, even if social welfare falls below its potential maximum. Because of this, competitive advantages derived from weak labour standards are frequently seen as 'unfair' competition, since international cooperation in the form of global standards could produce a better outcome (Sengenberger, 1994).

Others have extended this analysis, arguing that individuals and their labour are not commodities to be exchanged on unregulated markets.[1] The notion that labour should not be subjected to the unfettered machinations of a liberal market economy was given theoretical life by the Austrian economic thinker, Karl Polanyi. Polanyi (1944) argued that subjecting labour to unregulated market forces would generate external social costs – including health problems, a deterioration of family and community structures, an erosion of craft standards, and a general degradation of many aspects of public and private life. According to Polanyi (1944, 1957), labour markets should be embedded in the larger society and must be governed by rules, norms, and ethical standards that make allowance for the hidden costs of marketisation.

In addition to arguing that labour standards protect valuable non-market aspects of society, some proponents have justified them in terms of economic efficiency (Palley *et al.*, 1999; Buchele and Christensen, 1995). According to this line of reasoning, labour standards support better labour relations, cooperation on the job, and sharing of information, factors which would enhance productivity. In addition, better standards, including higher wages, could pay for themselves through efficiency wage effects that increase effort on the job (Goldstein *et al.*, 2000; Huang *et al.*, 1998; Levine, 1992; Shapiro and Stiglitz, 1984). However, more empirical research is needed to document whether and under what conditions higher standards will exhibit these benefits.

Moreover, there is a theoretical problem with this argument: if higher standards are profitable, then why do employers fail to adopt them? One answer is that multiple equilibria exist and employers fall into low-wage, low-productivity traps. A policy intervention is necessary to move the labour market onto the high-road of greater efficiency. Alternatively, substandard employment might arise from a focus on short-term gains while ignoring long-term dynamic efficiencies. For example, the use of child labour could maximise short-term profits despite the low productivity of the very young. However, keeping children out of school could be inefficient in the long run since it means forgoing the future benefits of a larger accumulation of human capital and higher productivity (Basu, 1999).

Labour standards could also produce faster growth due to their macroeconomic, not microeconomic, impact. Standards that increase labour's bargaining power will redistribute income towards workers. Higher labour incomes could raise global demand and yield faster growth (Marshall, 1994). Others have reversed the logic and argued that more expansionary macroeconomic policies will produce an environment conducive to improving international labour standards (Singh and Zammit, Chapter 11, this volume; Amsden, 1994). In this case, faster growth raises labour standards, not *vice versa*.

The arguments in favour of a system of global standards must be evaluated against warnings as to the potential dangers. In general, most arguments against global labour standards claim they will trigger unintended consequences that will end up hurting the very people the policies aim to help. For example, eliminating child labour could encourage child prostitution. Raising wages could cost jobs. Stricter enforcement could cause firms to relocate. In short, global labour standards create market distortions that reduce economic well-being due to an inefficient allocation of resources.

The most common variant of this theme is the argument that global standards compromise the competitive position of those developing countries with an abundance of low-skill, low-wage labour (Bhagwati, 1995; Corden and Vousden, 2001). This loss of competitive advantage means fewer jobs and scarcer economic opportunities for poor workers with few skills. On the flip side, such protections shield workers in more affluent economies from global competition. In effect, there is a redistribution of wage income from developing to developed economies. Because of this, organisations advocating better labour standards on a global scale have been accused of pushing an agenda of disguised protectionism (Bhagwati, 2002: 47–90). Others have emphasised the relative importance of job opportunities over job quality for poor families in developing countries (Krugman, 1998; Kristof, 2002). They argue that, in the stark reality of the global economy, poverty-level wages and sub-standard employment represent an improvement over the next-best options in labour-surplus economies.

Others advance the position that, with complete markets, no externalities, and costlessly enforceable contracts, global labour standards will create a dead-weight welfare loss (Brown *et al.*, 1996). However, this efficiency argument depends on perfect markets being able to seamlessly map shifts in relative factor prices onto the output prices of tradable goods and services in order to achieve Pareto optimal outcomes. The introduction of market imperfections, externalities, or multiple equilibria dramatically changes this picture.

The idea that higher labour incomes support growth at the macroeconomic level has also been questioned. In the case of a small open economy, it is not always clear that a redistribution of income towards labour creates higher levels of aggregate demand (Bowles and Boyer, 1995). Wage income can be leaky in an economy with a strong propensity to import. Furthermore, insofar as investment responds positively to profitability, then standards that raise labour costs could have a dampening effect on investment, aggregate demand

and ultimately growth. Of course, if standards were enforced internationally, then *global* aggregate demand would rise as standards improve. However, small, open economies that compete for external sources of aggregate demand might still be characterised as profit-led, since higher unit labour costs undermine their ability to sell on global markets (Amsden, 1995).

Finally, there are non-economic considerations that should be taken into account – in particular, the political process by which the standards are developed. If the movement for global standards is primarily an outcome of concerns raised only by advanced industrialised economies, then the justification for these standards to be foisted upon developing nations becomes questionable, particularly if such standards are not considered to be part of the body of commonly accepted international law. Under these conditions, charges of 'aggressive unilateralism' and 'disguised protectionism' carry additional weight (Alston, 1996). Similar concerns surface in proposals that delegate responsibility for labour standards to global governance institutions (for example the World Bank or the World Trade Organization) in which the balance of power tilts in favour of the world's rich countries.

Gender dynamics and informalisation

With the new international division of labour, women frequently account for the majority of the labour in low-income sectors producing manufactured exports. Lower wages for women have supported demand for their labour in highly mobile, labour-intensive industries. These developments represent a more general trend towards increasing labour-force participation by women and declining average job quality which has been termed 'global feminization' (Standing, 1989). In addition, since labour markets around the globe remain segregated by gender, the growth in women's share of low-wage employment results from an expansion of jobs typically dominated by women, not simply an erosion of the quality of existing jobs as women enter the labour force (Elson, 1996). At first blush, the existence of a high proportion of women working in global manufacturing industries might imply that women would be the primary beneficiaries of improvements in labour standards. Such a cursory analysis, however, ignores the position women frequently occupy in both the household and in the paid labour market.

While the employment of women keeps labour costs low and enhances a firm's profitability, low-wage jobs also provide economic opportunities for women outside of the household and, in turn, can grant them a greater degree of choice in their lives (Kabeer, 2000). This enhanced freedom gives women the latitude to delay marriage and childbearing, gain labour market experience, protect their economic options outside of the household, and increase their long-run earnings potential (Lim, 1983). Furthermore, access to money income improves women's bargaining position at home, thereby affecting gender dynamics and strengthening women's influence over the distribution of household resources (Braunstein, Chapter 9, this volume; Sen, 1990; Roldan, 1988; Joekes, 1987). Therefore, insofar as better standards reduce employment, these job losses disproportionately affect women, directly through a loss of wage income, but also indirectly by exacerbating other gender-specific inequalities. Even if the number of jobs remains unchanged, better employment conditions can impact women's access to jobs. For example, there is evidence that as job quality improves, women's access to these opportunities declines relative to men's (Elson, 1996).

However, others have questioned the optimistic claim that low-wage employment provides an impetus for improvements in gender equality. Since women are often employed in globally mobile industries, an expansion of employment in these sectors may not raise women's bargaining power relative to men working in less footloose sectors, especially during periods of economic liberalisation (Seguino, 2000). Along similar lines, a recent survey of women working in the *maquiladoras* of Tijuana found that the expansion of jobs had little impact on their ability to demand higher wages. The workers' income was not significantly higher than what they could earn elsewhere, although *maquila* earnings were more stable (Fussell, 2000). Survey work in Pakistan suggests that the availability of subcontracted work does not improve the autonomy of women workers when such work reinforces their marginal position in the economy. Furthermore, participation in the subcontracted labour market in Pakistan is often the result of the 'push' of poverty, rather than the 'pull' of securing an independent income (Khattak, 2002).

The question of global labour standards, worker welfare and gender dynamics becomes more complex when we consider the growing informalisation of the low-wage labour market. Informalisation refers to the process by which economic activities increasingly move into unregulated spheres. Informalisation manifests itself in numerous ways: a growth of the informal economy relative to the formal sector; an expansion of temporary, contingent and marginal jobs; an increase in the incidence of outwork (for example home-based production); and a lack of adequate enforcement for existing regulations. In this respect, informalisation reflects the erosion of job quality and the expansion of flexible employment practices which has become a defining feature of the current patterns of global integration (Standing, 1999).

Recent research has documented a world-wide resurgence of informalisation beginning in the 1970s and continuing into the 1980s and 1990s (ILO, 2002; Benería, 2001; Charmes, 2000; Portes *et al.*, 1989). The fact that many countries have seen informal employment expand during periods of relatively stable growth supports the argument that structural changes in the global economy are responsible for growing informalisation. This stands in contrast to earlier counter-cyclical explanations which saw a rise in informal employment as being linked to poor economic performance in the formal sector.

Informalisation impacts labour standards through two channels. By definition, informalisation increases the share of workers who are not covered by existing regulations. More indirectly, an expansion of the informal sector can place downward pressure on standards in formal employment by weakening the bargaining power of formal sector workers. A general erosion of labour standards will be most pronounced when workers face a compromised fallback position. Since the supply price of labour for formal sector occupations depends, in part, on the income that could be earned elsewhere, patterns of informalisation which reduce the average quality of economic alternatives will increase the vulnerability of employment conditions in many entry-level, formal sector jobs.

In most countries, women account for the majority of informal sector workers (Benería, 2001). Therefore, the process of informalisation parallels the general expansion of low-wage employment for women. In addition, many informal sector workers face constraints that bar their participation in the formal labour market. For example, women engaged in childcare and other forms of unpaid household labour might be unable to participate in formal sector labour markets if the available jobs conflicted with patriarchal norms, the ability to perform unpaid work, or the quality of caring labour at home.[2] In such cases, informal employment offers greater flexibility. Furthermore, there is some evidence that more austere macroeconomic policies, such as those associated with structural adjustment programmes, have squeezed household resources and reduced the number of formal sector jobs. These conditions create an incentive for greater participation in informal productive activities in order to maintain household incomes (ILO, 2002; Benería, 1991; Vandemoortele, 1991).

Informal employment poses important challenges for enforcing global labour standards. The unregulated nature of informal production reduces labour costs and gives the informal economy a competitive edge over formal employment arrangements. Raising standards in the formal sector, therefore, could displace economic activity into the informal sector. Indeed, the recent growth of the informal sector calls into question the effectiveness of a purely legislative approach towards improving employment conditions since existing labour protections are not enforced in the informal sector. A more effective strategy would improve employment conditions in the formal and informal sectors simultaneously. This would require a partial 'formalisation' of informal sector activity. However, reversing the process of informalisation has the potential of negatively impacting women's access to an independent source of income. This would occur if formal sector jobs are disproportionately held by men, due either to labour supply constraints or patterns of labour market segmentation.

Damned if you do: evaluating the risk of unintended consequences

Perhaps the strongest caution against global labour standards is the danger of job loss, particularly in developing countries with an abundance of low-wage labour and few alternative opportunities. This concern about jobs is not trivial. The International Labor Organization estimates that at the end of 2000, approximately 160 million people will be unemployed around the world (ILO, 2001: 15–23). Furthermore, the argument that global labour standards will exacerbate gender inequalities is largely based on concerns that disemployment effects will hit women the hardest.

Labour standards reduce employment when they raise the cost of labour. Obviously, new standards will have no impact on employment if current practices already fulfil all the regulatory stipulations. Nevertheless, improvements in standards are justified precisely because existing conditions generally fall below a perceived threshold of decency. Therefore, if global labour standards are designed to have a broad social impact, they will likely raise labour costs. Indeed, empirical studies have shown a correlation between better labour standards and higher labour costs (Rodrik, 1996). However, even when standards raise the cost of labour, these higher costs do not automatically translate into a substantial loss of jobs. The question of the connection between labour costs and jobs remains an empirical one.

In evaluating the possibility that better standards mean fewer jobs, we begin with a more focused question: have low-wage countries experienced faster rates of employment growth in labour-intensive manufacturing than high-wage countries? In answering this question, it is simplest to restrict attention to one sector: the manufacture of clothing and wearing apparel. Why clothing? First, clothing is a highly globalised, labour-intensive industry. Labour costs make up a large fraction of production costs, and competitive pressures are fierce. Second, debates over global labour practices often centre on clothing firms. For these reasons, clothing is a particularly relevant industry for this discussion.

Figure 12.1 plots the initial level of apparel wages, expressed in US dollars, against subsequent employment growth, expressed as the average annual growth rate, for 59 countries for which comparable data are available.[3] The initial wage level is measured as a three-year average, centred on 1982, in order to smooth the distortions that could be introduced by exchange rate fluctuations in any given year. Employment growth reflects the 15-year period, 1982 to 1996. The figure shows a clear negative relationship between initial wage levels and subsequent employment growth. The estimated regression line running through the observations has a statistically significant negative

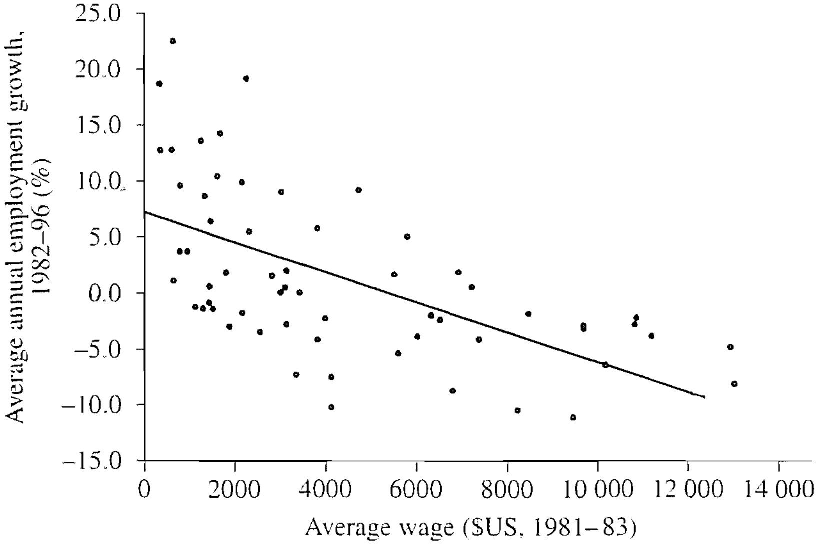

Figure 12.1 *Initial wage levels against subsequent employment growth for clothing manufacture*

slope (p-value < 0.0001) – every additional $1000 in initial wages is associated with an estimated 1.25 per cent decline in the average annual growth rate of employment.

The pattern of global clothing production appears to match the predictions of international trade theorists: countries with an abundance of low-wage labour have seen employment in their clothing sectors expand as markets have become more integrated. However, the relationships between initial wage rates and subsequent employment growth show a great deal of variation – countries with nearly identical initial wages demonstrate very different patterns of employment growth. More importantly, the relationships in Figure 12.1 do not tell us whether reasonable improvements in wages and working conditions in a particular country will always lead to job losses. For example, what would happen to employment if wages (and other components of labour costs) were to improve gradually in a low-wage country like Bangladesh?

Research into the impact that changes in real wages have on employment in the global apparel industry found no definitive relationship when other factors change along with wages (Pollin *et al.*, forthcoming). If other factors – such as prices, productivity or consumer demand – adjust appropriately when wages increase, space can be created to accommodate better standards without generating welfare-reducing job losses. An ILO (2000a: 43) study on the global garment and textile industries reaches similar conclusions: 'Labor costs remain an important cost factor, particularly in labor-intensive production such as footwear and clothing. Nevertheless ... they are no longer a decisive factor in determining competitiveness on world markets.' Similarly, research into the impact of changes in the minimum wage on poverty rates in developing countries has shown that higher minimum wages reduce poverty, although the impact may not extend to very poor households that do not participate in the paid labour force (Saget, 2001; Lustig and McLeod, 1997). This evidence does not suggest that improvements in labour standards have no impact on employment, but it casts doubt on the argument that better standards leave workers worse off on average.

To sum up: the impact of labour costs on employment cannot simply be dismissed as unimportant or trivial. However, empirical research suggests that a carefully designed system for implementing global labour standards that allows for other adjustments when labour costs increase can reduce (or possibly eliminate) the risk of job loss and can be welfare-enhancing for those workers who the policy aims to help.

Strategies for implementation: a brief history

Despite the potential that a system of labour standards possesses for raising the well-being of wage earners around the world, designing and implementing an appropriate set of institutions to realise this goal remains a significant challenge. A review of the past strategies put forward by social reformers and the consequent institutional changes that have occurred helps set the stage for a discussion of current efforts to realise a coordinated approach to labour standards.

Early support for international labour standards first emerged in the nineteenth century. Advocates included Robert Owen, the Scottish industrialist and utopian thinker; Charles Hindley, a British Member of Parliament from 1835 to 1857; and Daniel Legrand, a prominent manufacturer from Alsace. As early as 1818, Owen was suggesting that the governments of continental Europe should implement a system of labour standards to improve conditions among Europe's working classes (Lorenz, 2001: 41). Foreshadowing today's 'race to the bottom' arguments, Hindley argued that international standards would prevent competitive pressures from eroding working conditions in Britain – in particular, lengthening the working day (Follows, 1951). In a similar vein, Legrand promoted international labour legislation for Europe in the mid-nineteenth century (Follows, 1951). Legrand was strongly influenced by the Christian socialist tradition which advocated for reforming capitalism to produce humane social outcomes while condemning as heresies the demands of more radical socialist movements (Gide and Rist, 1948: 514–44; Lorenz, 2001: 41–4).

The work of these early proponents of international labour standards paved the way for the establishment of the International Labor Organization (ILO) in 1919 at the Versailles Peace Conference. After the turmoil of World War I, the creation of the ILO was seen as an important initiative to maintain peace, social stability, and shared prosperity in the world.[4] In 1946, the ILO became the first specialised agency of the United Nations (UN) and represents the only institution created by the Treaty of Versailles to survive today. It is also the only UN agency in which non-government organisations play a large institutionalised role in formulating policy.

The ILO operates by creating conventions that address a range of labour market policies through a process of stakeholder negotiations (in general, business, labour and government). The ILO then attempts to persuade governments to ratify the conventions, with the understanding that ratification implies that domestic legislation will be adjusted, when necessary, to comply with the conventions. Of all the conventions developed by the ILO, eight are deemed 'core conventions' covering four key areas of basic human rights: freedom of association and collective bargaining, the abolition of forced labour, the elimination of child labour, and non-discrimination.

While the ILO has had a significant impact on improving labour standards around the world, its approach has limitations. Ratification of an ILO convention does not guarantee enforcement of the standards in question. In many cases, the capacity to enforce labour laws is lacking, and widespread abuses are common. In addition, membership in the ILO is not conditional on ratification of the core conventions. For example, both China and the United States have only ratified two of the eight core conventions. Finally, with the growth of multinational production systems, a strategy aimed at influencing national policy on a case-by-case basis could be misdirected. Greater capital mobility and increased subcontracting mean that individual regulatory regimes are under pressure to relax controls or risk losing job-creating investments.

In reaction to the growing internationalisation of economic activity, influential global organisations began to develop corporate codes of conduct in an effort to regulate the actions of multinationals. The UN took the lead and, in 1974, established the Center on Transnational Corporations (UNCTC), which began developing a comprehensive code of conduct for multinational corporations covering many aspects of corporate behaviour, including labour practices (United Nations, 1986). The OECD launched its own Declaration on International Investment and Multinational Enterprises in 1976, which also set up a framework for governing corporate actions (OECD, 2000). In 1977, the ILO followed suit, with its Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy, which focused more directly on labour issues (ILO, 2000b).

These codes attempted to develop a universal set of standards that were to be sensitive to a country's level of development; they were meant to apply to all multinationals; and they were developed by prominent international organisations. However, not one has been implemented in a meaningful way. Despite several drafts, the UN code was never ratified and the Center on Transnational Corporations disappeared completely in 1993, having been incorporated into the United Nations Conference on Trade and Development, or UNCTAD (Jenkins, 2001). While the OECD and ILO codes achieved a higher level of consensus, there was no comprehensive plan for implementation, monitoring or enforcement. Compliance was voluntary, but the codes contained few, if any, incentives to encourage firms to change their practices.

Moreover, in the 1980s the global policy climate began to shift. Instead of questioning the behaviour of multinationals, many developing nations emphasised the need to attract a growing share of foreign investment. In this context of a new neo-liberal, market-oriented ideology, the ILO had trouble expanding its base of national governments that have ratified its more recent conventions extending protections into areas such as health and safety, let alone enforcing rules governing the behaviour of multinationals (Pearson and Seyfang, 2001). The ultimate outcome was that these early efforts to regulate global corporate behaviour failed to deliver (Tsogas, 2001: 61–2).

As these first codes of conduct faded into obscurity, there was little to replace them with until the 1990s. However, growing public awareness over sweatshop practices and human rights violations among the suppliers to brand-name manufacturers prompted the development of a new type of corporate code of conduct. These new codes were created by the multinationals themselves in response to the increasingly public accusations of profit-hungry corporations turning a blind eye to labour abuses. In 1991, Levi-Strauss & Co became the first brand-name corporation in this new wave of social responsibility to adopt a code of conduct. Many other US and European companies followed suit. Literally hundreds of different codes currently exist. Because these codes were developed with little coordination, there is an enormous amount of variation from one code to the next (Kolk *et al.*, 1999).

These corporate codes of conduct have numerous shortcomings. First, they suffer from the 'fox in the chicken coop' problem – corporations have an incentive to minimise the damage of a negative report by limiting the number of monitored suppliers or by restricting what information is made public. Second, they frequently pay scant attention to issues of implementation. Developing a code of conduct for public relations purposes receives much more attention than ensuring that the standards are actually implemented. Third, because of the variation in the content of the codes, consumers find it difficult to determine what compliance with a code of conduct really means. For the producers of the goods, the existence of multiple codes increases the difficulty of compliance. Many subcontractors accept jobs from different multinationals, each with a different code of conduct (Kemp, 2001). Often producers opt for the lowest common denominator and follow the codes that are easiest to implement.

In recent years, an alternative approach to implementing global labour standards links labour practices to the rules governing international trade. The idea of a 'social clause' would allow trade sanctions to be directed at countries in which sub-standard labour practices exist (Caire, 1994). Theoretically, a social clause would prevent 'social dumping' – for example, securing a competitive advantage from labour abuses or lax environmental protections. While the social clause was first framed within the context of the General Agreement on Tariff and Trade (GATT), today's debate focuses on the World Trade Organization (WTO), GATT's successor. Some have argued that the social clause should be a joint project of the ILO and the WTO (Ehrenberg, 1996).

The idea of a social clause has frequently been criticised for its potential to be used as a tool for disguised protectionism. Since it imposes trade sanctions on the offending country, the penalties could harm export workers in developing countries, making them worse off than they would have been without a social clause. Others have questioned whether the WTO is the appropriate institution for addressing labour standards. In particular, some have argued that introducing a social clause into the WTO would lead to inefficient negotiations, since it requires the simultaneous determination of domestic and international policies (Brown, 2001). In addition, the social clause sanctions a particular state for abuses found in a transnational production chain. It is unclear whether punishments directed at national governments are always the most appropriate measures for enforcing labour standards in the context of global production.

Commodity chains and global standards

The relationship between globalised production and a system of labour standards is best understood within the context of the global commodity chain. The global commodity chain refers to the way in which the production, distribution and sales of goods is organised across national borders. Global commodity chain analysis has been developed in the work of Gary Gereffi (1994) and others as a means of understanding the organisation and influence of different players in global production systems. For example, a commodity chain for the production of a pair of sports shoes includes the subcontractor which actually assembles the shoes, the intermediary (or 'jobber') which coordinates production among a network of subcontractors, the brand-name multinational which designs the shoe and builds the brand image, and the retailer which ultimately sells the shoe to the consumer.

The labour-intensive production of many consumer goods (for example clothing, electronics or footwear) is often characterised by buyer-driven commodity chains in which large retailers or brand-name corporations set up and influence a decentralised system of production and distribution.[5] Market power differs dramatically among the different players along the chain. The actual production is subcontracted out to small firms, which generally face extremely competitive conditions (Gereffi, 1994; Bonacich and Appelbaum, 2000). Therefore, subcontractors cannot easily raise the price of their output without risking a loss of business. On the other hand, retailers and brand-name multinationals enjoy some degree of market power, which they can use to keep prices low for the goods they purchase or to earn rents through the development of monopolistic brand identities.

Since subcontractors face intense competition, focusing adjustment strategies on these firms is likely either to fail completely or to produce the type of unintended consequences previously discussed. However, brand-name manufacturers and large retailers could use their market power to implement improvements in labour standards at the level of production by compensating subcontractors for the cost increases. For example, they could raise retail prices modestly and pass these revenues back to finance the improvements in employment conditions. Unintended job losses would be avoided since subcontractors who complied with the standards would receive the resources necessary to implement the improvements.

A study of the possibility of financing workplace improvements through such a scheme found that a 2–6 per cent increase in the final retail price could finance a 100 per cent increase in production-worker wages for a variety of different garments (Pollin *et al.*, forthcoming). The magnitude of this price increase falls well below the amount that consumers have said they would be willing to pay to ensure that their clothes are not produced under sweatshop conditions (see, for example, Elliot and Freeman, 2000). Therefore, by making adjustments in the upper segments of a global commodity chain, resources can be generated for financing substantial changes in working conditions at the point of production. Furthermore, since profits of large retailers and brand-name producers depend on the careful cultivation of their brand images and corporate reputations, an association with sub-standard labour practices could damage profitability. Similarly, a good reputation with respect to labour standards would enhance a company's competitive position.

Standardised codes of conduct for multinational commodity chains

In a departure from other approaches to global labour standards, there has been a movement towards establishing a standardised code of conduct, with independent monitoring and enforcement, to implement labour standards across entire commodity chains. Examples of organisations embracing this approach include the Fair Labor Assocation (US), the Ethical Trading Initiative (UK), the Clean Clothes Campaign (Europe), Social Accountability International (US), and the Worker's Rights Consortium (US). With these approaches, multinational firms ensure that labour practices meet a common set of standards across all their suppliers. These standards include issues of health and safety, hours of work, human rights, freedom of association, wages and discrimination. A process of independent verification through factory inspections and visits to production sites – including informal sector producers – ensures that the code has been implemented. Firms that meet the basic standards can use this seal of approval in marketing and promotion. Sub-standard labour practices that are not corrected are publicised with the result that the reputation and brand-image of the company in question suffers.

While these independent monitoring and certification organisations avoid many of the problems associated with corporate codes of conduct, certain constraints remain. Many limit themselves to one particular market or one particular industry (for example the university logo market or the apparel industry). There is no universal code of conduct and substantial variations among the established codes persist. Furthermore, many rely on professional auditors with little or no experience with the countries and communities involved. Finally, participation is voluntary. Therefore, compliance depends to a large extent on the strength of the incentives created.

However, these limitations can be addressed in a number of ways. Borrowing from the earliest codes of conduct, a single enforcement agency to monitor multinational behaviour could be housed in a well-established international organisation, such as the ILO. Of course, additional resources would need to be channelled to the agency for operational support – through fees paid by member corporations, an expanded budget for the international institution, or a combination of sources. Furthermore, the enforcement agency could establish a network of NGOs, trade unions, and informal sector organisations to develop a mechanism of lodging complaints and grievances. A subset of the local non-governmental and labour organisations could also be encouraged to undergo training to serve as external auditors in the certification programme. Such an arrangement would take into account relationships across the global commodity chain while providing space for input from more domestic organisations.

Limitations of global labour standards

Regardless of the implementation strategy, the limitations of any scheme along these lines to introduce global labour standards should be explicitly recognised. Most significantly, only a subset of the world's workforce would receive any benefits, since the standards are aimed at workers who produce goods for export. Workers producing non-traded goods and services would not be directly affected by interventions such as a standardised code of conduct or a social clause. In these cases, the on-going mission of the ILO to encourage states to implement and enforce better domestic standards remains invaluable. Furthermore, adopting expansionary macroeconomic policies could be more strategic for improving the well-being of all workers than a targeted set of labour standards. A coordinated approach involving a range of interventions – both macroeconomic and in terms of international regulation – would also reduce the tensions between better standards and job creation.

Despite the limitations of global labour standards, the potential that such interventions have for improving the working lives of a significant number of people should not be underestimated. Furthermore, the possible impact of such a system extends well beyond the benefits generated by its core policies. The development of an appropriate regulatory scheme for enforcing basic standards of decency could serve as a model for governing multinational economic activities more generally. Because of these possible contributions, striving to create an effective framework for global labour standards represents an important policy goal in this era of the new international division of labour.

Notes

1. The International Labor Organization (ILO) adopted this stance in its 1946 Declaration of Philadelphia. The Declaration was attached as an appendix to the ILO constitution.
2. For example, Sathar and Kazi (1989) found that Pakistani households in which women worked in more formal factory settings had a higher incidence of child mortality than households in which women were engaged in paid home-based production.
3. Data are taken from the United Nations Industrial Development Organization (UNIDO), Industrial Statistics Database 3-digit ISIC CD-ROM 2001.
4. See the 1919 Constitution of the ILO, especially the Preamble, for an eloquent justification for the founding of the organisation.
5. Buyer-driven commodity chains can be contrasted with producer-driven commodity chains in which large industrial enterprises set up the system of global production. The relatively capital-intensive manufacture of automobiles, aircraft and electrical machinery can be thought of as examples of producer-driven commodity chains.

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PART V

EUROPE AND NORTH AMERICA

13 Globalisation and productivity

Joseph Plasmans

1. Introduction

Labour productivity provides a simple, but powerful indicator of economic efficiency. It measures how much output is obtained per hour of work. It also has a straightforward connection to living standards as measured by per capita income: the more hours spent on work and the higher the level of productivity, the higher is per capita income. In a study based on annual data and published by The Conference Board – a not-for-profit research organisation based in the United States – McGuckin and van Ark (2002) show that, although some European countries have among the highest labour productivities in the industrialised world and despite the large GDP slowdown in the United States, US labour productivity (both level and growth) is still higher than that of the EU and Japan. Compared to 1995–2000, US labour productivity slowed by 0.2 percentage points during 2001. This slowdown was less than for the OECD as a whole (–1.1 percentage points), the European Union (–0.8 percentage points), or Japan (–2.5 percentage points). US productivity growth (1.8 per cent) also remained higher than in the other major regions of the OECD. This was achieved through a decline of 0.7 per cent in hours worked, as GDP growth was only 1.1 per cent in 2001. Hence, McGuckin and van Ark (2002) state that, despite the recession and the events of September 11, 2001, the (labour) productivity growth in the United States remained remarkably on trend, so that the developments of 2001 cannot be interpreted as a break in the phase of productivity acceleration that began in the mid-1990s. From 1995 to 2001, US labour productivity grew at about 2 per cent per year, compared to 1.1 per cent from 1990 to 1995.[1] In contrast to the United States, the (labour) productivity growth in the European Union – where growth had been slowing since the mid 1990s – registered a below-trend deceleration of –0.8 percentage points during 2001, over 1995–2000. Slowing to 0.6 per cent in 2001, the EU productivity growth was only one-third of that of the US. This reflects a continued increase in (total) EU working hours, at more than 1 per cent during 2001. Whereas the American acceleration in labour productivity since 1995 has been accompanied by a slight increase in working hours, the European employment growth went together with an almost halving of the (labour) productivity growth rate, but with much diversity across EU countries. Japan, where the (labour) productivity growth decelerated 2.5 percentage points in 2001,[2] was also below trend. This is a major change compared to the 1990s, when growth remained stable in Japan.

The sole OECD countries that showed a higher labour productivity than the United State in 2001 were four European countries: Belgium, Norway, France and the Netherlands.[3] The high labour productivity in the Benelux countries, and especially in Belgium, is particularly striking. As indicated in Table 13.1, Belgium had the highest labour productivity of all industrialised countries at 112.4 per cent of the US level in 2001 and the Netherlands came fourth at 100.9 per cent of the US level. Perhaps even more surprisingly, Belgium exceeded the United States in (labour) productivity growth during the whole of the 1990s.[4]

In the standard neoclassical framework, labour productivity is determined by the level of technology and the accumulation of capital. If marginal

Table 13.1 Productivity performance of the industrialised countries

		Labour productivity growth[2]	
	GDP per hour worked[1]	1990–1995	1995–2001
Belgium	112.4	2.2	2.1
Netherlands	100.9	1.1	0.9
France	101.8	1.5	1.0
Ireland	98.4	3.5	5.1
Austria	95.9	1.8	2.6
Denmark	93.5	2.4	1.2
Germany	92.5	3.2	1.5
Italy	88.0	3.1	0.7
Finland	86.3	2.8	2.5
Sweden	81.7	1.9	1.6
UK	79.5	2.5	1.7
Spain	75.6	2.3	0.1
Greece	58.5	0.6	2.6
Portugal	52.1	3.6	2.0
EU	87.4	2.5	1.3
US	100	1.1	2.0

Notes:
1 As per cent of US in 2001.
2 Average annual growth.

Source: McGuckin and van Ark (2002).

Table 13.2 *Growth in labour demand*

	Average annual growth of total hours worked (%)	
	1990–1995	1995–2001
Belgium	–0.7	0.4
Netherlands	1.0	2.3
France	–0.4	1.4
Ireland	1.1	3.6
Austria	0.3	–0.3
Denmark	–0.4	1.3
Germany	–1.5	0.1
Italy	–1.8	1.1
Finland	–3.4	1.8
Sweden	–1.3	1.0
UK	–0.9	1.0
Spain	–1.0	3.5
Greece	0.7	0.8
Portugal	–1.8	1.3
EU	–1.0	1.2
US	1.2	1.6

Source: McGuckin and van Ark (2002).

productivity of capital is diminishing, then the capital-to-labour ratio is determined by the level of technology also. Therefore it is not surprising that there has been a vast amount of literature on the issue of technological progress. 'Innovation' has become one of the key words in assessing the performance of economies. Many empirical studies have examined the linkage between R&D activities, which are regarded as the most important source of innovation, and productivity growth.

However, the neoclassical framework overlooks a number of important aspects of the economy that might contribute to raising productivity. In this chapter we focus on three non-technological aspects of the economy which could influence labour productivity, that is, fiscal and regulatory burdens on employment, imperfect competition and geography.

When costs of hiring labour are high (for example, through high taxation or heavy social charges), firms would substitute capital for costly labour, raising the capital to labour ratio and, hence, labour productivity. As a consequence of such substitution, the firm may have to offer lower returns on trend. This is a major change compared to the 1990s, when growth remained stable in Japan.

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Denmark	–0.4	1.3
Germany	–1.5	0.1
Italy	–1.8	1.1
Finland	–3.4	1.8
Sweden	–1.3	1.0
UK	–0.9	1.0
Spain	–1.0	3.5
Greece	0.7	0.8
Portugal	–1.8	1.3
EU	–1.0	1.2
US	1.2	1.6

Source: McGuckin and van Ark (2002).

productivity of capital is diminishing, then the capital-to-labour ratio is determined by the level of technology also. Therefore it is not surprising that there has been a vast amount of literature on the issue of technological progress. 'Innovation' has become one of the key words in assessing the performance of economies. Many empirical studies have examined the linkage between R&D activities, which are regarded as the most important source of innovation, and productivity growth.

However, the neoclassical framework overlooks a number of important aspects of the economy that might contribute to raising productivity. In this chapter we focus on three non-technological aspects of the economy which could influence labour productivity, that is, fiscal and regulatory burdens on employment, imperfect competition and geography.

When costs of hiring labour are high (for example, through high taxation or heavy social charges), firms would substitute capital for costly labour, raising the capital to labour ratio and, hence, labour productivity. As a consequence of such substitution, the firm may have to offer lower returns on investment or charge a higher price for its output. Moreover, employers' contributions to social charges could often turn out to be regressive; that is the firms have to pay relatively more for low productivity workers taking the quality of labour into account. Then firms may choose not to employ low-productivity workers at all. When less-skilled workers are left out from economic activities in this way, the output per worker could well be high but it is hardly a desirable outcome for the society.

If production involves fixed inputs, the degree of competition could also affect productivity. It is evident that in many industries, sizeable fixed costs such as overhead labour, R&D expenditures, and advertising costs are involved in the operation of the firms. The existence of fixed costs imply that technology exhibits increasing returns-to-scale. For a given level of demand for the industry's output, each firm would produce more when there are fewer firms competing in that industry. Hence, less competition allows each firm to exploit the economies of scale to a greater degree, thus increasing its productivity. Higher labour productivity does not imply a better outcome for the society in this case either, since consumers would have to pay higher prices and would find less variety in the product markets.

We will also examine the role geographical location may play in contributing to the very high labour productivity of Belgium. It could be argued that the location of Belgium on the European continent gives it high 'market potential'. Market potential is the idea that the potential demand for goods and services produced in a location is determined by that location's access to consumers for its goods. We will use a model in Hanson (1998) to examine the spatial aspect of the European economy. This spatial aspect of the economy is somewhat different from other aspects in so far that policy implications are less obvious. Transportation networks of the Benelux countries are well developed and there is a limited scope for obvious improvements. However, improvements in communications technology and growth of Eastern European countries may bring changes to relative advantages with respect to location.

The rest of this chapter is organised as follows. In Section 2 the possible effects of social charges are briefly discussed. The linkage between the intensity of competition and labour productivity is explored in Section 3. Section 4 examines the spatial aspects of the European economy and their relation to labour productivity.

2. Labour market and productivity

It is a well-known argument that fiscal and regulatory burdens on hiring workers in European countries have the effect of increasing the average labour productivity with strong insiders and weak outsiders. High social charges are a noted feature of many of the European countries and the occurrence of such heavy burdens is often cited as a reason for the poor performance of European labour markets in terms of job creation. Such high social charges could well have the effects of raising labour productivity, first by forcing firms to substitute capital in place of costly labour, and secondly by making it too costly to hire low-productivity workers.

In fact, the first point about the substitution of capital for labour does not necessarily follow from the existence of fiscal and regulatory burdens. As far as the capital-to-labour ratio is concerned, what matters is the relative price of labour and capital. There are also taxes on capital in the form of corporation tax and capital gains tax. The taxation system is invariably complicated in all countries, thus making international comparisons of the true *relative* cost of labour and capital difficult.

As indicated in Table 13.3, social charges, defined as the difference between personnel costs and gross wages and salaries, are very high in Belgium and France. However, the differences in the unit labour costs are smaller. It appears therefore that workers bear a large proportion of social charges in the sense that they are willing to accept lower wages.

Table 13.3 Social charges and unit costs

	Fiscal burdens on employment	
	Social charges[1]	Unit labour cost[2]
Belgium	58.8	40.73
Netherlands	18.31	–
Luxembourg	15.67	34.86
France	44.1	35.45
Germany (excluding ex-GDR)	23.2	40.75
UK	13.38	21.68

Notes:
[1] Social charges expressed as a percentage of wages and salaries.
[2] Unit labour cost refers to labour cost per employee.

Source: Eurostat. All figures are for manufacturing in 1995.

The maximum tax rate applied to corporate income is about 40 per cent in Belgium (becomes 33.5 per cent in 2003) and 35 per cent in the Netherlands. It is about 40 per cent in Germany and the United States, 35 per cent in

France, and 30 per cent in the UK. However, little can be inferred from these figures alone, because many other factors such as fiscal deductions and exemptions may be important. Moreover, when there are uncertainties, social regulations on firing workers also become a 'cost' to employers. To examine the extent of the 'substitution effect' on labour productivity, we need some estimates of the true relative cost of capital and labour as well as of the substitutability of labour, capital and other factors of production.

The idea that low-productivity workers are 'squeezed out' of employment due to fiscal and regulatory burdens is more straightforward. Employers' contributions to the social security system often turn out to be 'regressive', making it relatively more costly to employ low-productivity workers. Hence, such a fiscal burden on employers tends to discourage employment of low-productivity workers more than of high-productivity workers. Hence, people in employment would exhibit high productivity.

Eurostat provides data on the shares of workers with different educational attainment. Unfortunately, these data are restricted to manufacturing and a few other sectors and do not contain figures for the service sectors. We need information on the educational attainment of all employed persons and also of those who are out of work.

In order to assess the effect of fiscal burdens in squeezing out low-productivity workers, we need to make international comparisons of the educational level of the employees and the unemployed.

3. Imperfect competition and productivity

When there are fixed costs in production, average cost is decreasing in output. It implies that, when there is less competition so that the number of firms in the industry is lower and the firms are larger, economies of scale would give the firms higher productivity. This point can be illustrated with a model of monopolistic competition which makes the following assumptions for the product market and behaviour of the firms. Assume that there are n firms in the industry and that these firms produce differentiated goods. Product differentiation gives each firm a degree of monopoly power. It is assumed that each firm takes the prices of other firms' products as given when setting its own price. The total demand for the industry, denoted by $\overline{D}$, is treated as given. The demand facing firm i is then given by:

$$Q_i = \overline{D}\left[\frac{1}{n} - \gamma(P_i - \overline{P})\right]. \tag{13.1}$$

where Q_i is the demand for firm i's output, P_i is the price firm i charges for its output and $\overline{P}$ is the average price charged by firm i's competitors in the industry.[5]

It is assumed that production requires only one factor of production, labour, denoted by L_i. Units are taken so that the wage rate is equal to unit and $C_i = L_i$, where C_i is the total cost of firm i. The production is assumed to involve a fixed cost, so that the cost function is given by:

$$L_i = \alpha + \beta Q_i, \tag{13.2}$$

where α is a parameter representing the fixed cost and β is the marginal cost. The existence of a fixed labour input implies that labour productivity is increasing in output, Q_i. All firms in the industry are assumed to be symmetric so that $P_i = \overline{P}$ and $Q_i^* = \overline{D}/n$ in equilibrium. Therefore, for a given level of demand for industry output, $\overline{D}$, labour productivity is decreasing in the number of firms, n. Thus, when there is less competition (that is fewer firms in the industry), labour productivity is higher.

When there are fewer firms in the industry, the average cost is likely to be smaller than the price charged by the firm. It can be verified that labour productivity is positively correlated with the margin of the price over the average cost in this model. Profit maximisation leads the firm to set the price such that:

$$P = \frac{1}{n\gamma} + \beta. \tag{13.3}$$

The average cost of the firm is given by:

$$AC = \frac{\alpha n}{\overline{D}} + \beta. \tag{13.4}$$

If the firms are able to charge a mark-up, μ^a, on average cost, then we have:

$$\mu^a \left[\frac{\alpha n}{\overline{D}} + \beta \right] = \frac{1}{n\gamma} + \beta. \tag{13.5}$$

It is evident that:

$$\frac{\partial n}{\partial \mu^a} < 0. \tag{13.6}$$

Is it possible therefore that the high labour productivity in Belgium (and the Netherlands) is partly due to the lack of competition in these economies? For manufacturing at least, this is unlikely. Firms in Belgium tend to be small and the idea that firms achieve a high labour productivity by exploiting the economies of scale does not apply to Belgium. Konings *et al.* (2001) measure mark-ups in Belgium and the Netherlands and find that mark-ups are generally higher in the Netherlands. Ohinata and Plasmans (2002) find that, although the mark-ups of prices over average costs are similar in these countries, the mark-up of price over marginal cost is greater in Belgium, suggesting that the firms in the Netherlands exploit economies of scale more than their Belgian counterparts.

4. Geographic concentration and labour productivity

There has been a revival of interest in economic geography in the last decade. Krugman (1991a; 1991b; 1992) develops a model to show how an economy can become differentiated into an industrial core and its periphery. Interestingly, Krugman (1991a) makes the following comments in his introduction: 'It has been often noted that night-time satellite photos of Europe reveal little of political boundaries but clearly suggest a centre-periphery pattern whose hub is somewhere in or near Belgium.'

In Krugman's model, concentration of industry occurs due to an increasing returns-to-scale technology and the existence of transport costs attributes spatial agglomeration to product–market linkages between regions. The idea is related to the concept of 'market potential' in Harris' (1954) publication, which is the idea that the potential demand for goods and services produced in a location is determined by that location's access to consumers for its goods and services. Harris (1954) simply defines the market-potential function as that function which equates the potential demand for goods and services produced in a location with that location's proximity to consumer markets, or:

$$MP_j = \sum_{k \in K} f(Y_k) h(d_{jk}), \tag{13.7}$$

where MP_j is the market potential for location j. Y_k is income in location k, and d_{jk} is the distance between location (region) j and location k. The set K includes all regions where there is potential demand for goods produced by firms in location j. The function $f(\cdot)$ is increasing in income, Y_k, and can be interpreted as the potential demand for goods in the absence of transportation costs. The function $h(\cdot)$ is assumed to be decreasing in d_{jk} and $h(\cdot)$ can be considered as a discount factor to take transportation costs into account. Thus, the market potential of location j is the sum of the potential demands of all the regions to which the firms in region j can ship goods taking transportation costs into account.

In the presence of sizeable transportation costs, firms would want to set up a production unit in each and every market. However, this would be unecononomical in the presence of fixed costs. Hence, when there are transportation costs and technology displays increasing returns-to-scale, firms would have fewer and larger production units and locate them in a region with a high market potential.

It is easy to see that regions with higher market potential would have higher labour productivity. Regions with higher market potential would attract investment, and accumulation of capital would raise labour productivity unless the supply of labour is perfectly elastic. Moreover, it is reasonable to assume that the wage rate is largely determined by its productivity. In Europe, there are obstacles to labour mobility in the form of linguistic and cultural differences. Thus, it is reasonable to assume that a European region with a higher market potential would have a higher labour productivity and a higher corresponding wage rate.

Hanson (1998, 2001) carries out an empirical application of Harris' (1954) market-potential function (equation 13.7) and examines the spatial correlation of wages, employment and consumer purchasing power. We estimate two versions of the basic spatial wage equation. The first is a model which can be written as:

$$\log(w_j) = \alpha_0 + \alpha_1 \sum_{\substack{k=1 \\ k \neq j}}^{K} \log(Y_k) e^{-\alpha_2 d_{jk}} + \varepsilon_j, \tag{13.8}$$

where the dependent variable w_j is the nominal wage in location (region) j, α_0, α_1, and α_2 are the non-negative parameters to be estimated, and ε_j is a stochastic error term. In the core new economic geography model, the nominal wage equation (13.8) can be looked upon as a spatial labour demand function to the extent that wages (and, hence, labour demand) in a region are higher, the nearer this region is to areas with a high demand for this region's products. In other words, equation (13.8) implies that wages in a region reflect the demand for goods produced in that region, where consumer demand is determined by transport costs and the spatial distribution of income. The second version of the spatial wage equation is also used in Hanson (1998):

$$\log(w_j) = \beta_0 + \beta_1 \log\left(\sum_{\substack{k=1 \\ k = j}}^{K} (Y_k) e^{-\beta_2 d_{jk}} \right) + \varepsilon_j, \tag{13.9}$$

Typically, compensation for labour accounts for roughly two thirds of income. Thus, a shock to the wage rate could well be correlated with income which forms a part of the regressor. Therefore, we do not include income for the region $k = j$ when constructing the regressor.

4.1. *Data description*

Countries included in this study are nine continental European countries: Belgium, Germany, Denmark, Spain, France, Italy, Luxembourg, the Netherlands and Portugal. Offshore regions, namely Canarias (Spain), Départements D'Outre-Mer (France), Sicilia (Italy) and Sardegna (Italy), are not included. The variables in the estimating equations are the average wage, income and distances. The average wage is obtained by dividing 'wages and salaries' by 'number of persons employed'. Eurostat provides data for 'social charges as a percentage of wages and salaries'.

The figures for 1995 are used to convert wages and salaries into total personnel costs. To proxy income, GDP at the regional level is used.

Eurostat uses the Nomenclature of Territorial Units for Statistics (NUTS) to define regions. For 'wages and salaries' and 'GDP', regional data at the NUTS2 level are used. For the distance between two regions, the distance between regional capitals at the NUTS1 level are used. When Eurostat does not give the capital for a NUTS1-region, then the capital of a NUTS2-region which is given the number '1' is used. For example, the capital for the region Noroeste (code ES1) is not given. The region Noroeste is divided into three NUTS2-regions, Galicia (code ES11), Principado de Asturias (code ES12) and Cantabira (code ES13). In this case, the capital for Galicia, Santiago de Compostela, is used when measuring distances from other regions. The distance between two cities is the one that takes the shortest time when travelling by car. The cities used for measuring the distance between regions are listed in the Appendix.

The non-linear least squares estimates of the market-potential functions (13.8) and (13.9) using annual data for 1996 and 1999 and separately for

Table 13.4 Non-linear least squares estimation results for equation (13.8): standard errors between brackets

Dep. Variable	Ave. Personnel Costs		Average Wages and Salaries	
Year	1999	1996	1999	1996
$\hat{\alpha}_1$	0.005760 (0.000891)	0.006323 (0.000974)	0.005157 (0.000352)	0.005718 (0.000340)
$\hat{\alpha}_2$	0.000534 (0.000201)	0.000541 (0.000205)	0.000879 (0.00246)	0.000910 (0.000235)
Adj. R^2	0.741	0.754	0.693	0.739
No. of obs.	113	114	113	114

Table 13.5 Non-linear least squares estimation results for equation (13.9); standard errors between brackets

Dep. Variable	Ave. Personnel Costs		Average Wages and Salaries	
Year	1999	1996	1999	1996
$\hat{\beta}_1$	0.972534 (0.438127)	1.052398 (0.504990)	0.794685 (0.229267)	0.852830 (0.229629)
$\hat{\beta}_2$	0.000962 (0.000554)	0.000950 (0.000573	0.001277 (0.000560)	0.001294 (0.000527)
Adj. R^2	0.710	0.733	0.649	0.705
No. of obs.	113	114	113	114

average personnel costs and average wage and salaries are presented in Tables 13.4 and 13.5, where it is observed that there is empirical evidence supporting the idea of a spatial wage structure within the nine continental European countries selected, at least for the former equation (13.8) with significant distance parameters $\hat{\alpha}_2$.

5. Concluding remarks

Labour productivity provides a simple, but powerful indicator of economic efficiency. It measures how much output is obtained per hour of work. It also has a straightforward connection to living standards as measured by per capita income: the more hours spent on work and the higher the level of productivity, the higher is per capita income. The United States has high labour productivity, but Belgium had the highest labour productivity during the 1990s, which still applies today. We try to explain this feature.

In this chapter, we concentrate on three non-technological aspects of the economy which could influence labour productivity, that is, fiscal and regulatory burdens on employment, imperfect competition and geography.

A large fiscal burden on employers as in Belgium, and to a somewhat lesser extent in the Netherlands, tends to discourage employment of low-productivity workers. Hence, those in employment exhibit high productivity.

Is it possible that the observed high labour productivities in Belgium and the Netherlands are partly due to the lack of competition in these economies? For manufacturing at least, this is unlikely. Firms in Belgium tend to be small and the idea that firms achieve a high labour productivity by exploiting economies of scale does not apply to Belgium. We find that, although the mark-ups of prices over average costs are similar in Belgium and the Netherlands, the mark-up of prices over marginal costs is greater in Belgium, suggesting that the firms in the Netherlands exploit economies of scale more than their Belgian counterparts.

Recent theoretical work attributes the geographic concentration of economic activity to product–market linkages between regions that result from scale economies (spatial income distribution) and transportation costs. Based on annual data for provinces of nine EU countries (for 1996 and 1999) spatial nominal wages are found to be strongly, positively correlated with the simple market-potential function, so that our findings with non-linear estimations of spatial nominal wage equations are broadly consistent with the new economic geography hypothesis. In other words, wages are found to be higher in regions that are close to large consumer markets, where this effect falls off quite sharply with the distance to these markets. Hence, analogously to the gravity model in international trade theory, the market-potential function is found to be a valuable empirical tool for describing the spatial covariation of wages and consumer purchasing power. The empirical results suggest that demand linkages between surrounding regions in Continental Europe are not negligible at all and the observed high labour productivity in the Benelux countries can also be partly explained by the new economic geography argument.

Appendix

Cities used for measuring the distance between regions.

Codes	NUTS1 Regions	Cities
BE1	BRUSSELS HOOFDSTEDELIJKE GEWEST	Brussels
BE2	VLAAMS GEWEST	Brussels
BE3	REGION WALLONNE	Namur
DE1	BADEN-WURTTEMBERG	Stuttgart
DE2	BAYERN	Muenchen
DE3	BERLIN	Berlin
DE4	BRANDENBURG	Potsdam
DE5	BREMEN	Bremen
DE6	HAMBURG	Hamburg
DE7	HESSEN	Wiesbaden
DE8	MECKLENBURG-VORPOMMERN	Schwerin
DE9	NIEDERSACHSEN	Hannover
DEA	NORDRHEIN-WESTFALEN	Düsseldorf
DEB	RHEINLAND-PFALZ	Mainz
DEC	SAARLAND	Saarbruecken
DED	SACHSEN	Dresden
DEE	SACHSEN-ANHALT	Magdeburg
DEF	SCHLESWIG-HOLSTEIN	Kiel
DEG	THURINGEN	Erfurt
DK	DANMARK	Koevenhavn
ES1	NOROESTE	Santiago de Compostela
ES2	NORESTE	Vitoria Gasteiz
ES3	COMUNIDAD DE MADRID	Madrid
ES4	CENTRO (E)	Madrid
ES5	ESTE	Barcelona
ES6	SUR	Sevilla
FR1	ILE DE FRANCE	Paris
FR2	BASSIN PARISIEN	Paris
FR3	NORD – PAS-DE-CALAIS	Lille
FR4	EST	Metz
FR5	OUEST	Nantes
FR6	SUD-OUEST	Bordeaux
FR7	CENTRE-EST	Lyon
FR8	MEDITERRANEE	Montpellier
IT1	NORD OUEST	Torino
IT2	LOMBARDIA	Milano

Codes	NUTS1 Regions	Cities
IT3	NORD EST	Trento
IT4	EMILIA-ROMAGNA	Bologna
IT5	CENTRO (I)	Firenze
IT6	LAZIO	Roma
IT7	ABRUZZO-MOLISE	L'aquila
IT8	CAMPANIA	Napoli
IT9	SUD	Bari
LU	LUXEMBOURG (GRAND-DUCHE)	Luxembourg
NL1	NOORD-NEDERLAND	Groningen
NL2	OOST-NEDERLAND	Zwolle
NL3	WEST-NEDERLAND	Utrecht
NL4	ZUID-NEDERLAND	's-Hertogenbosch
PT1	CONTINENTE	Lisboa

Notes

1. While these data are annual averages, quarterly GDP and employment data show that (labour) productivity growth in the United States has been slowing throughout 2001. For example, the year-over-year growth in output per hour for the US business sector remained positive in the third quarter of 2001, but it was 0.24 per cent lower than in the second quarter of 2001.
2. The Japanese (labour) productivity growth became negative (–0.3 per cent) in 2001 (w.r.t. 2000) for the first time since 1983, and for only the second time since World War II! This drop was the combined result of the (pretty sharp) shrinking of the Japanese GDP (–0.7 per cent) and a fall in total working hours in Japan (–0.4 per cent).
3. Due to Europe's lower working hours (as a consequence of more part-time work, shorter workweeks, longer vacations) and lower labour participation rates, even countries with higher labour productivity than the United States have not translated their performance into higher per capita income. Specifically, if GDP per capita (in constant 1996 prices) is normalised to 100 in the United States in 2001, it is 75.3 per cent in Belgium (with labour productivity 12.4 per cent higher than in the US!), 83.3 per cent in Norway (9.7 per cent higher labour productivity), 69.1 per cent in France (1.8 per cent higher labour productivity), 74.5 per cent in the Netherlands (0.9 per cent higher labour productivity than in the US), 67.1 per cent for the whole EU, and 72.4 per cent in Japan, stressing the US advantage in the standards of living.
4. This was partly due to an initial decrease in total working hours (with a negative average annual growth rate of total hours worked of –0.7 per cent between 1990 and 1995, but with a positive average growth rate of 0.4 per cent between 1995 and 2001 (see Table 13.2). For another recent study on productivity in European economies, see a report by the European Economic Advisory Group (2002) at CESIfo.
5. See Salop (1979) for the derivation of this demand function.

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14 European integration and the 'euro project'

Philip Arestis and Malcolm Sawyer

Introduction

The introduction of the euro at first as a 'virtual' currency in January 1999, and then as a 'real' currency in January 2002, has been a significant step in the integration of the economies of those countries which form the European Union (EU), and more notably for the 12 countries which have so far adopted the euro and created the Economic and Monetary Union (EMU). The adoption of the euro is not just a matter that a single currency now prevails across the euro zone with reduced transactions costs for trade between member countries. It is more notable that the euro is embedded in a particular set of institutional and policy arrangements which can tell us much about the nature of the economic integration which is occurring in the EU. Specifically we argue that the euro is one relatively small step along the path to further economic integration at the global level, and the neo-liberal nature of the agenda of globalisation can be clearly seen from the ways in which the euro has been introduced.

The adoption of the euro can be viewed as a further step in a process of economic integration which began with the signing of the Treaty of Rome by the six founder member countries (see Arestis, Brown and Sawyer, 2001, especially Chapter 2, for discussion). Proposals for a single currency began in earnest with the Werner report in 1970, which advocated the movement toward economic and monetary union by 1980. The European Monetary System (EMS) was launched in March 1979, seeking to establish monetary and exchange rate stability, based around the introduction of the Exchange Rate Mechanism (ERM) and centred around the European Currency Unit (ECU). In 1986 the EU amended the Treaty of Rome with the Single European Act, and set the end of 1992 as a target date for the removal of all remaining barriers to the free flow of goods, services and resources.

The count-down to the single currency can be seen to have started with the signing of the Maastricht Treaty (or Treaty on European Union to give its full title). The so-called convergence criteria, which were to determine whether a national currency would join the single currency, provide some insights into the nature of the euro project and are discussed in the next section. The introduction of the euro has also been accompanied by the adoption of the Stability and Growth Pact with its constraints on fiscal policy; this is taken up in the section that follows that of the Maastricht Treaty discussion. The creation of the European Central Bank (ECB) with a counter-inflationary agenda and related matters are introduced in the last two sections before we summarise and conclude this short contribution.

The Maastricht Treaty and all that

The convergence criteria under the Maastricht Treaty for a country's membership of the single currency and, by implication, membership of the independent European System of Central Banks (ESCB), comprising the ECB and national central banks of those countries that belong to the EMU, are: (1) a high degree of price stability, with an inflation rate within 1.5 per cent of the three-best performing member states; (2) 'healthy' government finance, defined as a maximum ratio of 3 per cent government deficit to GDP at market prices, and a maximum ratio of 60 per cent of government debt to GDP at market prices; (3) observance of the normal ERM fluctuation margins for at least two years without any devaluation among the member state currencies; and (4) long-term interest rate levels that do not exceed two percentage points from the nominal long-term government bond rates of the three best-performing member states in terms of price stability. Countries are also required to enact legislation for their Central Banks to become 'independent'.[1]

The Maastricht Treaty, which provides the institutional framework for the introduction of the single currency, was signed in late 1991, a time when political power in most EU countries was held by the Right, and the terms of the Treaty reflected the dominance of neo-liberal ideas. Despite some electoral success by centre-left parties (especially at the end of the 1990s), these neo-liberal ideas still prevail. The neo-liberal agenda has been embedded into the institutional and policy arrangements surrounding the operation of the euro.

The general thrust of these convergence criteria was deflationary – many countries were required to cut budget deficits, to reduce public debt and to bring down inflation and interest rates to meet the criteria. The relatively poor economic performance of many of the EU economies during the 1990s may to some degree be attributable to the striving of countries to meet those criteria. From 1992 to 1999, the growth of national income averaged 1.7 per cent per annum in the eurozone countries, compared with the UK average of 2.5 per cent per annum. Over the same period, the unemployment rate fell substantially in the UK (and also in the US and Canada), but tended to rise in the eurozone countries – notably in France, Germany and Italy (Ireland being the notable exception as unemployment fell dramatically).

These convergence criteria related to what may be called nominal variables – that is inflation rate, interests rate and budget deficit. There is some rationale for concerns over convergence of inflation and interest rates if a single currency is to be formed, since a single currency area will have a single monetary policy (and hence a single Central Bank interest rate). It is also unlikely that a single currency area could function with substantial differences in the rate of inflation within the area. But any rationale for the inclusion of the convergence of budget deficits to less than 3 per cent of GDP and for government debt to be less than 60 per cent of GDP has been generally lacking. The adoption of these criteria not only brought in a deflationary element to the Maastricht Treaty, but also reflected the general rejection of Keynesian economics and the use of fiscal policy to stimulate employment.

It is also evident that there is no reference to what may be termed real convergence, that is the convergence of economic growth, unemployment levels, level of national income per head, the business cycles and the like. Indeed there remain massive differences in living standards and unemployment rates across the EU. The single currency is much more likely to operate effectively if there is some real convergence between participating economies; yet those concerns were dismissed (Arestis, Brown and Sawyer, 2001).

The theoretical and institutional background to the Maastricht Treaty and the EMU are embedded in the monetary policy operated by the ECB and in the Stability and Growth Pact (hereafter SGP). We turn our attention to these two institutions, beginning with the SGP in the section that follows. The rest of this section discusses the institutional framework of the EMU focusing on the ECB, leaving the theoretical framework to be dealt with in the section entitled Neoliberalism and the euro.

The institutional macroeconomic policy framework, within which the euro has been introduced and has begun to operate, has three key elements. First, the ECB is the only effective federal economic institution. The ECB has the one policy instrument of the rate of interest (the 'repo' rate) to pursue the main objective of low inflation. The single monetary policy has a euro area-wide perspective. A quantitative definition of price stability has been adopted in the form of, in effect, a 0–2 per cent target for the annual increase in the Harmonised Index of Consumer Prices (HICP) for the euro area. The ECB has adopted a 'two-pillar' monetary strategy to achieve this target through the policy instrument of interest rates. The 'first pillar' is a commitment to analyse monetary developments for the information they contain about future price developments. This is the quantitative reference value for monetary growth, where a target of 4.5 per cent of M3 has been imposed. The 'second pillar' is a broadly based assessment of the outlook of price developments and the risks to price stability. This broad range of indicators includes: the euro exchange rate; labour market indicators, such as wages and unit labour costs; fiscal policy indicators; and financial market indicators, such as asset prices.

Second, the ECB and the national central banks are linked into the European System of Central Banks (ESCB) with a division of responsibility between them. The ECB has the responsibility for setting interest rates in pursuit of the inflation objective, and the national central banks have responsibility for regulatory matters.

Third, the ECB is intended to be independent of the EU Council and Parliament and of its member governments. Thus, there is a complete separation between the monetary authorities, in the form of the ESCB, and the fiscal authorities, in the shape of the national governments comprising the EMU. It follows that there can be little coordination of monetary and fiscal policy. Indeed, any attempt at coordination would be extremely difficult to implement. For apart from the separation of the monetary and fiscal authorities, there is also the requirement, cited elsewhere in this chapter, that national governments (and hence the fiscal authorities) should not exert any influence on the ECB (and hence the monetary authorities). Any strict interpretation of that edict would rule out any attempt at coordination of monetary and fiscal policies.

The Stability and Growth Pact

The SGP, alongside the Maastricht Treaty, creates four rules for economic policy. The four rules are that the ECB was granted independence from political influence; the rule of no-bail out of national government deficits was introduced; the monetary financing of government deficits was prohibited; and member states must avoid 'excessive' deficits (defined as more than 3 per cent of GDP).

The core elements of the SGP with respect to fiscal policy are three: (a) to pursue the medium-term objectives of budgetary positions close to balance or in surplus; (b) the submission of annual stability and convergence programmes by the member states; and (c) the monitoring of the implementation of the stability and convergence programmes. The main feature of the core elements is the requirement that the national budget deficit does not exceed 3 per cent of GDP, and failure to meet that requirement could lead to a series of fines depending on the degree to which the deficit exceeds 3 per cent. It is also necessary for national budgetary policies to 'support stability oriented monetary policies. Adherence to the objective of sound budgetary positions close to balance or in surplus will allow all Member States to deal with normal cyclical fluctuations while keeping the government deficit within the reference value of 3% of GDP'. Furthermore,

> Member States commit themselves to respect the medium-term budgetary objective of positions close to balance or in surplus set out in their stability or convergence programmes and to take the corrective budgetary action they deem necessary to meet the objectives of their stability or convergence programmes, whenever they have information indicating actual or expected significant divergence from those objectives (Resolution of the European Council on the Stability and Growth Pact, Amsterdam, 17 June 1997).

Penalties can be imposed by the Council on a country which appears to be running 'excessive' deficits with some escape clauses in case of severe recessions.

Each year a country has to submit a stability programme to the Commission for scrutiny, containing, *inter alia*, information about the paths of the ratios of budget deficit to GDP and national debt to GDP. If the stability programme reveals that a country is significantly diverging from its medium-term budgetary objective, then the council will recommend that the stability programme is 'strengthened' – that is, cuts in public expenditure and increases in taxation will be imposed. If the situation persists then the member state will have been judged to have breached the reference values. The Pact details 'escape' clauses which allow a member state that has an excessive deficit to avoid sanctions.

The separation of the monetary authorities from the fiscal authorities and the decentralisation of the fiscal authorities will inevitably make any coordination of fiscal and monetary policy difficult. Since the ECB is instructed to focus on inflation while the fiscal authorities will have a broader range of concerns, there are considerable grounds for potential conflict. This suggests a need for the evolution of a body that would be charged with the coordination of EMU monetary and fiscal policies. In the absence of such a body, tensions will emerge in the real sector when monetary policy and fiscal policy pull in different directions. But so far the SGP has in effect resolved these issues by establishing the dominance of the monetary authorities (ECB) over the fiscal authorities (national governments).

Neo-liberalism and the euro

The policy rules governing the euro are based on a more general theoretical framework, the ingredients of which we identified elsewhere and termed 'new monetarism' (Arestis and Sawyer, 1998). The essential features of this theoretical framework are as follows (Duisenberg, 1999; Arestis, Brown and Sawyer, 2001; Tsakalotos, 2001):

(i) politicians in particular, and the democratic process in general, cannot be trusted with economic policy formulation, with a tendency to make decisions which have stimulating short-term effects (reducing unemployment) but which are detrimental in the longer term (notably a rise in inflation). In contrast, experts in the form of central bankers are not subject to political pressures to court short-term popularity, and can take a longer-term perspective where it is assumed that there is a conflict between the short term and the long term. The logic underpinning this reasoning mirrors that found in the rules versus discretion debate. Policy makers' scope for using discretion should be curtailed and the possibility of negative spillovers from irresponsible fiscal policy must be reduced.

(ii) inflation is a monetary phenomenon and can be controlled through monetary policy. The money supply is difficult (if not impossible) to control directly, and the demand for money is thought to be highly unstable. However, the central bank can set the key interest rate (the 'repo' rate) to influence monetary conditions, which in turn influence the future rate of inflation. Central banks have no discernible effects on the level or growth rate of output in the long run, but do determine the rate of inflation in the long run. Thus, inflation is still a monetary phenomenon and ultimately it is central banks that determine the inflation rate.

(iii) the level of unemployment fluctuates around a supply-side determined equilibrium rate of unemployment, generally labelled the NAIRU (non-accelerating inflation rate of unemployment). The level of the NAIRU may be favourably affected by a 'flexible' labour market, but is unaffected by the level of aggregate demand or by productive capacity.

(iv) fiscal policy is impotent in terms of its impact on real variables (essentially because of beliefs in crowding out and that fiscal policy is inflationary), and as such it should be subordinate to monetary policy in controlling inflation. It is recognised, though, that the government budget position will fluctuate during the course of the business cycle but in the context of an essentially passive fiscal policy.

The structure of the ECB clearly conforms to the first point. The sole objective of the ECB is price stability, and decisions are made by a governing body composed of bankers and financial experts. There are, and can be, no involvement by any other interest groups or any democratic bodies. The only EU-level policy on controlling inflation is monetary (interest rate) policy, which presumes that monetary policy is a relevant and effective instrument for the control of inflation.

The implementation of what is in effect a balanced budget requirement at the national level under the SGP (albeit over the course of the cycle rather than for any particular year) and the absence of fiscal policy at the eurozone level has eliminated the use of fiscal policy as an effective instrument for the reduction of unemployment (or indeed of inflation). This approach to fiscal policy fits in very well with our fourth point listed.

Inflation, unemployment and inequality

The ECB is the only EU-level economic institution and it operates with the objective of attaining low inflation. There are three points of note here. First, this key institution is undemocratic in nature (indeed it is barred from taking instructions from democratic organisations) and operates in a secretive and non-transparent way. The ECB decision makers are central bankers, and there is no representation of other interests (such as industry, trade unions) in the decision-making process. It is only the interests of bankers and the financial sector which are represented.

Second, the only objective addressed through macroeconomic policy (and then that is monetary policy) at the EU level is price stability (with inflation of less than 2 per cent, a target which has been generally missed over the past two years). Employment targets have been set by the EU. For example, the overall EU employment rate is currently targeted to be 67 per cent (57 per cent for women), rising to 70 per cent and 60 per cent respectively by the year 2010. These objectives are part of the European Employment Strategy, and are to be achieved through measures such as increased labour market flexibility, life-long learning and so on. There is no macroeconomic policy, based on fiscal or monetary policy, designed to create high levels of employment. Indeed the general tenor of macroeconomic policy runs counter to the creation of high levels of employment.

Third, this policy operates according to the notion that monetary policy is the relevant policy for the control of inflation. Yet, monetary policy has become interest rate policy, and the linkages between changes in interest rates and changes in inflation are at best weak, and at worst obscure. Any significant upswing in inflation would reveal that the ECB is unable to control inflation or even possess policy instruments which can effectively tackle inflation. The eurozone would be revealed to be bereft of any counter inflation policy. The emperor would be revealed to have no clothes!

The eurozone itself has no weapons with which to fight recession as there is no significant government expenditure at the EU level, and further no ability to run any fiscal deficit. At the national government level, the ability to run budget deficits is severely constrained by the SGP.

The response of the ECB to the economic slowdown of 2001–2002 is a worrying one in view of its argument that

> It is natural for an economic slowdown to have adverse effects on member countries' budget position. However, for countries with a budget position still not close to balance or in surplus, it is important to adhere to their medium-term consolidation plans. A short-lived slowdown should not significantly change the scope for reaching the targets set in the countries' stability programmes.

Further, 'as adjustment needs are likely to become more visible in periods of less vigorous economic growth, policy makers must now step up the reforms rather than allowing efforts to abate' (ECB *Monthly Bulletin*, October 2001, p. 6). In this context, 'reforms' means further deregulation of labour markets.

There is no fiscal policy operated at the European level. The size of the European budget is relatively small at less than 1.2 per cent of combined EU members' GDP in 1997, and is still dominated by the needs of the Common Agricultural Policy (about 50 per cent). Yet, the MacDougall Report (1977) suggested that monetary union would not be viable without a sufficiently large community budget for fiscal policy (7.5 per cent of members' GDP). It is also the case that the EU budget must be balanced. The interaction of those two elements means that there is no scope for active fiscal policy (or indeed for any fiscal policy), and that the EU budget is too small to operate as an effective stabiliser or to re-distribute funds from richer regions to poorer ones in any significant manner.

The disparities of unemployment across the regions of the eurozone (and associated disparities in living standards and employment) present a major challenge and pose a considerable threat to the successful operation of the single currency. The disparities between the regions of the eurozone (which number 65) and the states of the United States of America may provide a reasonable basis for comparison. For the USA, unemployment rates between states ranged from 2.2 per cent to 5.9 per cent in 2000, and per capita disposable income from \$18 467 (Mississippi) to \$31 697 (Connecticut) in 1999. For the eurozone, unemployment rates ranged from 3 per cent to 37 per cent, and GDP per head (in 1998) from 6536 euros per head (Ipieros, Greece) to 40 353 euros per head (Hamburg), that is by a factor of 1:6. But the SGP and associated policies contain no remedies for these levels and disparities of unemployment.

The achievement of full employment does require an appropriate high level of aggregate demand, and that requires some combination of increased demand for exports, for consumption, for investment and for public expenditure. Whether such a level of aggregate demand would require a substantial budget deficit inevitably depends on what happens to the other sources of demand. But a high level of aggregate demand is only one, albeit rather important, condition for the achievement of full employment. In the context of the eurozone, there are two rather obvious and significant obstacles to the achievement of full employment. The first is the lack of productive capacity in many regions to provide high levels of employment. Estimates by the OECD of the 'output gap' are currently around zero, that is actual output is about equal to potential output; yet this is combined with over 8 per cent unemployment. In a similar vein, the OECD's estimates of the non accelerating inflation rate of unemployment (NAIRU) average 8.8 per cent for the eurozone (in 1999), again close to the current experience. Interpreting the NAIRU as an indicator of a capacity constraint suggests capacity problems. In this context, higher levels of aggregate demand would place pressure on capacity and could well have some inflationary consequences. The second obstacle is the disparity of unemployment – a general increase in demand would push some regions to or even above full employment.

A major weakness of the present institutional arrangements is the separation between monetary policy conducted by the ECB and the constrained fiscal policy operated by national governments. There is clearly a requirement for the coordination of economic policy across the member countries of the EU, and for the emergence of appropriate institutional arrangements and policies at the European level. Economic policy at the EU level faces the additional issue of the disparities of economic performance in terms of employment and unemployment rates and of the level of GDP per capita across the regions and countries of the EU.

Concluding remarks

The establishment of the euro and the European Monetary Union has been undertaken within a specific institutional and policy framework.[2] The institutional framework gives prominence in policy formulation to an undemocratic and unaccountable European Central Bank. It is a policy framework that emphasises the control of inflation over the reduction of unemployment, although it provides a weak instrument (monetary policy) for the control of inflation and generates macroeconomic policies which tend to increase rather than diminish the level and disparity of unemployment.

Notes

1. These convergence criteria were to be applied to countries entering the euro at its creation, though in the event many of the criteria were fudged (see Arestis, Brown and Sawyer, 2001). In principle these criteria would also be applied to countries seeking to join the euro in the future.
2. See Arestis, McCauley and Sawyer (2001) for proposals for an alternative policy framework for EMU.

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15 The North American Free Trade Agreement: context, structure and performance

Jim Stanford

1. Introduction and overview

The North American Free Trade Agreement (NAFTA) came into effect on 1 January 1994, and created the world's largest regional free-trade zone. The NAFTA includes Canada, the United States and Mexico, with a total (as of 2000) combined population of 410 million inhabitants, and combined GDP of over US$11 trillion. The NAFTA was constructed on the framework of an earlier bilateral agreement between the United States and Canada, which was implemented on 1 January 1989.

In terms of both population and GDP, the NAFTA zone is larger than the 15-country European Union (see Table 15.1), although the intensity of integration is much deeper in Europe than in North America. The NAFTA is not a customs union (that is, each member nation continues to set its own external tariffs and trade policies independently); border crossings continue to operate between the three member countries; no form of monetary union is presently considered; the NAFTA includes only minimal provisions for mobility of particular kinds of specialised labour between NAFTA countries; and there are no supranational political or democratic institutions established as part of the NAFTA. In contrast to the EU, then, the NAFTA represents a less ambitious effort to establish a common continental market for goods and services, and common protections for private investors and businesses, with little attention or interest devoted to developing a continental political or institutional dimension.

Table 15.1 Comparison of the North American and European Free Trade Areas, 2000

	NAFTA	EU
Member countries	3	15
Combined population (million)	410	370
Combined GDP (US$ trillion)	11.1	7.8

Source: *United Nations Development Program (2002).*

This overview of the context, structure and performance of the NAFTA will consider the following particular topics. First, an overview of the economic and political context in which the NAFTA was negotiated is provided. Then the NAFTA's specific provisions are described, followed by a summary of the agreement's apparent effects. Finally, the discussion concludes with a consideration of the potential for future expansion or deepening of the NAFTA.

2. Economic and political context

The NAFTA is dominated, both economically and politically by the United States, which accounts for about 70 per cent of its population, and nearly 90 per cent of its economic output. Consequently, the negotiation and implementation of the NAFTA were much more important events in Canada and Mexico, than in the US itself. For both of those countries, the implementation of free trade with their much-larger neighbour was an event of decisive historical importance, culminating a decades-long evolution in their respective bilateral relationships with the US. A former Prime Minister of Canada, Pierre Trudeau, once described Canada's relationship with the US as being akin to 'a mouse in bed with an elephant'. Similarly, a Mexican parable asks for pity for Mexico because it is 'so far from heaven, and so close to America'. In both countries, choices regarding how to manage the dominant and complex relationship with the US are of immense political and economic importance. And for both countries, the decision to embark on a course of tighter continental economic integration marked a defining moment in their national histories. For the US, on the other hand, the implementation of a North American free trade zone represented an important but hardly epochal development, one which mostly served to reinforce its already-existing economic and strategic dominance on the continent.

Despite their increasingly tight economic relationships, great economic and political differences continue to exist between the three NAFTA members (see Table 15.2). The US economy is the richest of the three, measured in per capita incomes, and its political economy reflects an extreme of deregulation and market orientation that is unique in the industrialised world. Canada's economy is somewhat less developed than that of the US (although it still ranks in the top ten nations of the world, according to per capita income), and has traditionally exhibited a more mixed pattern of development – with a larger economic role for the state, and a range of social programmes and protections similar in spirit (if not in extent) to the social-democratic traditions of Europe. Mexico is a middle-income, industrialising economy. Its average per capita real income is roughly one-quarter that of the US.[1] Income inequality (measured by the ratio of income received by the top decile of the population compared to that of the lowest decile) is twice as severe in Mexico as in the US, where inequality in turn is

Table 15.2 Characteristics of NAFTA member countries, 2000

	Canada	Mexico	US	US as % NAFTA total
Population (million)	30.8	98.9	283.2	69
GDP (US$ billion)	688	575	9837	89
GDP per capita (US$)[1]	27 840	9023	34 142	
Foreign trade (% GDP)[2]	86.8	64.7	26.2	
Manufacturing (value-added as % GDP)[3]	18.4	21.1	17.7	
Average labour cost (manufacturing, US$ per hour)[4]	16.05	2.08	19.72	
Government spending (% GDP)[5]	37.7	15.8	29.9	
Life expectancy (years at birth)	78.8	72.6	77.0	
Infant mortality (per 1000 live births)	6	25	7	
Inequality (ratio of income of top 10% of population to bottom 10%)	8.5	32.6	16.6	

Notes:
1. Evaluated at purchasing power parity exchange rates.
2. Sum of exports and imports of goods and services.
3. 1998 data.
4. Includes wage and non-wage forms of compensation.
5. All levels of government, programme spending plus debt service.

Source: International Monetary Fund (2001), Organization for Economic Cooperation and Development (2001a, 2002a), United Nations Development Program (2002), *Bureau of Labor Statistics* (2002).

twice as severe as in Canada. Both Mexico and Canada continue to rely on the production and export of a range of natural resource staples (especially energy, and especially to the US market) as an important economic activity, and both have also taken active measures to stimulate the development of value-added manufacturing industries (with Mexico relying on its abundant and relatively inexpensive labour resources, and Canada attempting to develop nascent higher-technology capacities). The US economy demonstrates a more mature industrial structure, with a greater reliance on high-technology and high-value service industries as the leading drivers of economic growth. The traditional US industrial base has declined in relative importance during the last two decades, producing a consequent polarisation in the economy and labour market between high-wage and low-wage service industries. These important structural and institutional differences among the NAFTA partners help to explain why the NAFTA has limited its scope to the deregulation of trade and investment flows within the NAFTA zone, rather than attempting a deeper, European-style political and regulatory harmonisation.

The NAFTA was created in the wake of the 1989 Canada–US Free Trade Agreement (FTA). The initial push for this bilateral treaty reflected a historic shift in the thinking of Canadian business leaders. Through much of the post-war era, Canada had pursued a relatively interventionist and nationalist development strategy, relying on a range of regulatory measures to promote a pattern of industrial development that was oriented toward the country's small domestic market. This general strategy had both its successes and its failures (Eden and Molot, 1993; Clement, 1997). Through most of this period, Canada's economy grew significantly faster than its southern neighbour, and its living standards (especially considering the generous expansion of social benefits) increased rapidly; at the same time, however, the economy remained structurally underdeveloped, and was more reliant on foreign direct investment than any other major industrialised economy.

In the wake of negative experiences with inflation, fiscal imbalances, and unsettled labour relations which Canada (like most other industrialised countries) endured in the 1970s and early 1980s, Canada's business and political elites began to cast about for a new economic and social direction. A defining point in this process was the so-called Macdonald Commission on Canada's economic future (Royal Commission on the Economic Union and Development Prospects for Canada, 1985). Chaired by a former finance minister in the Liberal-nationalist government of Pierre Trudeau, the commission issued a surprising call for the negotiation of a general free trade agreement with the US. The proposal was taken up enthusiastically by the newly-elected Conservative federal government of Brian Mulroney, who agreed with Ronald Reagan – at a famous 'Shamrock Summit' meeting in 1985 – to negotiate a comprehensive bilateral free trade deal. The proposal was strongly supported by Canadian business, indicating their rejection of domestically-oriented development strategies and their embrace of America: both of the American market for Canadian exports, and of the American model for domestic economic and social policy. A draft agreement was reached in late 1987, and put to the test in Canada in a uniquely passionate federal election in November 1988. Although the majority of Canadians voted for parties opposed to free trade (the Liberals[2] and New Democrats), the pro-free-trade Conservatives won a majority of seats in that election, and the FTA was implemented on 1 January 1989. In the US, in contrast, the FTA was not controversial, and was endorsed overwhelmingly by the US Congress with little public debate.

Following the successful passage of the FTA, the new US government of George Herbert Walker Bush initiated negotiations to expand the free trade area to include Mexico. In Mexico, too, the free trade negotiations reflected a historic evolution in the economic and political thinking of that nation's business and political elite. Mexico had been governed since the 1920s by the Partido Revolucionario Institucional (PRI). During the post-war decades, the PRI had followed a heavily interventionist strategy relying on widespread state ownership of industry, an alliance with a powerful class of domestic industrialists, tariffs and other trade policies to promote manufacturing development on the import-substitution model, and the widespread communal ownership of land in agricultural regions. This statist development strategy demonstrated a strong initial vitality, generating annual average expansion in real GDP of over 6 per cent between 1950 and 1980. By the late 1970s, however, the strains of this inward-focused strategy became more apparent, manifested in the form of growing external imbalances, growing public sector deficits, and rising inflation. Weakening world prices for oil (a major Mexican export) and rising global interest rates triggered a major financial crisis culminating in August 1982, when Mexico announced its inability to service its large sovereign debt. The regime of Miguel de la Madrid, which took power in the wake of this crisis, began to move the economy in a more market-oriented direction, implementing drastic reductions in public spending, weakening labour market regulations, and opening the economy increasingly to foreign investment and competition.

This broadly neo-liberal direction in economic and social policy was put to the test in the 1988 Mexican federal election, which was even more historic and bitterly contested than the Canadian election of the same year. The austere policies of the PRI were challenged by an insurgent electoral campaign led by former PRI minister Cuauhtemoc Cardenas. The PRI won a narrow victory, amidst allegations of widespread electoral fraud and corruption, and the election ushered in a new and even more market-oriented administration under Carlos Salinas de Gortari, confirming the general direction of Mexican policy. The Salinas government went on to negotiate the NAFTA and implement other business-oriented structural reforms in the economy (Lustig, 1992).

A draft NAFTA was signed by Salinas, Bush and Mulroney on 17 December 1992. The ratification of this treaty was much more controversial in the US than the FTA had been, because of widespread opposition from union members and others concerned with the potential flight of investment and employment to low-wage Mexico. Independent candidate Ross Perot made opposition to the NAFTA a major theme of his upstart campaign in the 1992 US presidential election. But incoming Democratic President Bill Clinton abruptly softened his initial scepticism regarding the NAFTA and began to work energetically for its passage. To this end, the US insisted on negotiating two rather superficial 'side-agreements' to the NAFTA: one governing the regulation of labour standards within the NAFTA free trade zone, and one governing environmental standards. These side-agreements contain no legislative force, and have been dismissed by labour and environmental advocates as transparently symbolic; at the time, though, they were important in helping Clinton to shift his position on NAFTA and lobby Congress (backed by powerful US business interests) for its ratification. Ironically, then, while the NAFTA was negotiated (from the US side) by a business-friendly Republican administration, it eventually required a Democratic administration (with its ability to discipline traditional Democratic constituencies) to ensure its ultimate passage.

To sum up, the decisions by the Canadian and Mexican governments to enter into a free trade agreement with the US signalled an important change of course on the part of business and political elites in both countries. A post-war tradition of more interventionist economic and social policy was largely abandoned in both countries, in favour of an outward-oriented and business-led development strategy. For Canada and Mexico, therefore, the advent of continental free trade has marked a decisive turning point in the historical evolution of those societies. In the US, on the other hand, the advent of the NAFTA represented no dramatic change in the domestic political economy. The decision to forge a bilateral free trade agreement with Canada, and then to expand that agreement to include Mexico, was for US elites mostly a matter of common sense in both economic and foreign policy. The NAFTA would draw both neighbours more closely into the US sphere of influence, reducing the perceived geopolitical risk to US interests that had been posed by occasional outbreaks of nationalist and/or interventionist sentiment in those two countries. The freedoms and protections accorded to US business throughout the continent would also be enhanced – although, as discussed below, that is a quite distinct matter from whether or not the NAFTA was good for the US economy.

3. Provisions of the NAFTA[3]

The NAFTA contains 22 chapters, several appendices, and two 'side-agreements'. The effect of these provisions is summarised under the following sub-headings:

Tariff elimination

The tariff reduction schedule provided for under the NAFTA is fully described in just one section of NAFTA's Chapter 3. Tariffs on bilateral trade between Canada and the US were already being phased out according to a 10-year timetable prescribed by the 1989 Canada–US FTA; the NAFTA confirmed the continuing elimination of those residual tariffs, and virtually all Canada–US merchandise trade now occurs on a duty-free basis.[4] The NAFTA then set a similar 10-year timetable for the gradual elimination of tariffs on merchandise trade between Mexico and the US, and between Mexico and Canada. These tariffs will be fully eliminated by 2003. To qualify for tariff-free status within North America, a product must meet North American rules of origin that are specified on a sector-by-sector basis. The relatively straightforward nature of tariff reduction, and the small amount of text required to describe it in the NAFTA document, indicate that the NAFTA in its entirety represents far more than simply the elimination of tariffs on continental merchandise trade. The other, lengthier sections of the agreement describe a more far-reaching process of integration and deregulation within the continental economy.

Reduction of non-tariff barriers

The NAFTA prescribes the easing of a wide range of non-tariff barriers to trade in goods and services within the NAFTA zone. These non-tariff liberalisation initiatives include strong statements of national treatment and market access; the specification of acceptable customs and clearing procedures; limits on the application of food inspection and health standards that may inhibit trade; limits on the application of other technical standards that may limit trade; and restrictions on government procurement practices (requiring federal-level, and some lower-level, governments and agencies to competitively tender their purchases without regard to the intra-NAFTA origin of competing providers).

Deregulation of key industries

For the most part, specified government regulations governing output, investment and pricing in particular industries could be grandfathered under the NAFTA.[5] The agreement did, however, restrict the incremental policy-making leeway of national governments by prohibiting or limiting the further expansion of regulations (especially those specifying domestic content, domestic ownership, or other trade-restricting outcomes). And in some cases, the NAFTA itself required the pro-active elimination of government regulations and restrictions on private business. Most notable in this case were commitments that the Mexican government made under the NAFTA to privatise and/or deregulate sections of its energy, banking, insurance, advertising, communications and trucking industries. These measures indicate again that the main goal of the NAFTA, from the perspective of both the Mexican government and of foreign companies operating in Mexico, was to facilitate and solidify the broader deregulation of the Mexican economy – not just to facilitate greater two-way trade in goods and services.

Enshrinement of investment rights

The NAFTA contains provisions to protect the economic interests and legal status of foreign investors that are unique in international trade agreements.

and which prefigured similar provisions which were subsequently proposed in multilateral fora (such as the failed OECD Multilateral Agreement on Investment, and later investment initiatives at the World Trade Organization). The pathbreaking Chapter 11 of the NAFTA guarantees a wide range of protections for intra-NAFTA foreign investments, including: specified national treatment rights for investors (supplementing the broad national treatment provisions that apply to other provisions of the NAFTA); the prohibition of performance requirements on foreign investors (including those defined with respect to trade balances and other foreign trade variables); the prohibitions of restrictions on transfers of ownership, financial transfers and capital flows; and the prohibition of restrictions on the nationality of investors and corporate directors. Other sections of the NAFTA (in particular, Chapter 12, which deals with intellectual property issues) further reinforce the cross-national rights of investors and private corporations operating in the continental free trade zone.

Dispute settlement

The Canada–US FTA had introduced a unique new form of dispute settlement, in the form of special tribunals which were empowered to rule on the acceptable use by a member country of countervail measures and other trade remedies.[6] These tribunals were expanded under the NAFTA, with the creation of a special dispute settlement procedure to enforce the investor rights provisions contained in Chapter 11 of the agreement. Under these provisions, which have probably proved to be the most controversial aspect of the entire NAFTA, private corporations are given the power to file complaints against NAFTA-member governments for alleged violations of the investment protections of the agreement. These complaints are then reviewed and decided upon by quasi-judicial trade tribunals, acting independently of standard legal channels in the member countries. By late 2002, a total of 24 business complaints had been filed under this NAFTA provision, involving total claims for damages from member governments in excess of US$5 billion (see Table 15.3). Most of these cases involve corporate objections to government rules and regulations concerning a range of important public policy issues, including environmental protection and public health. Confirmed tribunal judgements against the governments of Canada and Mexico demonstrate that the Chapter 11 tribunals are willing to interpret NAFTA commitments in a broad manner, and that they are equally willing to impose significant monetary penalties on governments which are held to violate the business protections provided by the agreement. The operation of this unique investor-state dispute settlement mechanism, on top of the generally far-reaching investor protections contained in the NAFTA, has fuelled the argument of NAFTA critics that the agreement actually represents a new 'corporate constitution' for the continent

Table 15.3 Summary of cases filed under NAFTA Chapter 11 provisions (to October 2002)

Respondent country	Number of cases filed	Total damages claimed ($US)	Disposition[1]
Canada	8	$2.55 billion	1 settled out-of-court with payment of damages; 1 decided against Canada with damages awarded; 1 decided against Canada with damages being considered; 3 pending; 2 withdrawn by complainants
US	6	$1.98 billion	1 dismissed; 5 pending
Mexico	10	$404 million	1 decided against Mexico with damages awarded; 1 dismissed; 8 pending

Note: 1. As of late October 2002.

Source: Government of Canada, Department of Foreign Affairs and International Trade website (www.dfait-maeci.gc.ca). US Department of State website (www.state.gov).

– not just an agreement to promote more international trade in goods and services.

Mobility for specialized forms of labour

In general the NAFTA does not address issues of migration or freedom of movement of persons between the member countries, with one exception. Chapter 16 of the agreement provides for temporary entry of certain classifications of business persons and professionals. Beyond this exception, each country's existing immigration laws and procedures continue to apply.

Side-agreements on labour and the environment

To support its efforts to have the NAFTA ratified by Congress, the incoming US administration of Bill Clinton in 1993 negotiated two side-agreements to the NAFTA regarding the protection of labour and environmental standards (Bolle, 2002; Compa, 1997; Kirton and de Castro, 1997). These side-agreements contain no measures with legislative force, but rather simply commit each government to greater transparency in reporting on labour and environmental conditions, and to the enforcement of existing national labour and environmental laws. With few exceptions, the side-agreements (and the small tri-national institutions which have been set up to oversee their operation and effect) are not viewed as a meaningful or important feature of the NAFTA.

4. Effects and performance of the NAFTA

The negotiation and implementation of the NAFTA sparked important debates, both among economists and in the public at large, regarding its likely economic effects. These discussions were influenced importantly by numerous efforts to quantitatively estimate the effects of continental economic integration using a range of different modelling techniques (US International Trade Commission, 1992; Stanford, 1995). Conventional neoclassical models generally predicted positive but small mutual trade effects, produced by the usual sector reallocations and efficiencies associated with the expansion of comparative-advantage-based trade. More critical approaches suggested that the main effects of the NAFTA would be felt through other structural channels – such as the impact of the agreement on investment decisions (a factor that was not considered by most conventional approaches), and the impact of neo-liberal policy reforms within Mexico. Among economists, however, both advocates and opponents agreed that the impact of the NAFTA on overall output and employment levels in the continent would be small, and this prediction has proven to be correct. The following sub-sections consider several of the particular effects and outcomes of the NAFTA:

Structure of NAFTA trade

Trade patterns within the NAFTA conform largely to a 'hub-and-spoke' structure, with the US located at both the geographical and the economic centre of the continent. Bilateral trade flows are largest between the US and Canada, and are also large between the US and Mexico. Bilateral flows are small between Canada and Mexico (see Table 15.4). Canada and Mexico are the largest trading partners of the US – and, of course, the US is the largest trade partner for each of Canada and Mexico.[7] Not surprisingly, relative to GDP intra-NAFTA trade is most important to Canada and Mexico, accounting for roughly 60 and 50 per cent of national GDP, respectively, and far outstripping each country's trade with the rest of the world. In contrast, intra-NAFTA trade flows are equivalent to just 6 per cent of US GDP, and account for less than one-third of America's total foreign trade. This reinforces the conclusion that the implementation of the NAFTA was a much more significant event in Canada and Mexico, than it was in the US.

Table 15.4 *Merchandise trade flows within NAFTA, 2000 ($billion, and growth since 1994)*

		IMPORTER		
		Canada	US	Mexico
EXPORTER	Canada		$233.7 (+78%)	$1.4 (+151%)
	U.S.	$178.9 (+56%)		$111.2 (+120%)
	Mexico	$8.1 (+167%)	$136.8 (+173%)	

Source: Author's calculations from Statistics Canada (2002a, 2002b), Bureau of Economic Analysis (2002).

Expansion of trade

Intra-NAFTA trade expanded notably in each of the three member countries following the transition to free trade on the continent, although that expansion was most dramatic for Canada and Mexico. Canada's trade within North America has roughly doubled since the advent of the Canada–US FTA, measured as a share of domestic GDP: from about 30 per cent in the late 1980s, to 60 per cent by 2000 (see Figure 15.1). Since Canada's trade with the US is about 45 times larger than its trade with Mexico, almost all of this expansion must be attributed to the post-FTA expansion in Canada–US trade, rather than to the subsequent effects of the NAFTA (which may have actually undermined Canadian trade with the US, through trade-diversion effects). In contrast, Canada's foreign trade flows with the rest of the world did not increase at all during the last decade (despite the general process of economic integration at the global level), indicating that for Canada the growth of intra-NAFTA trade may have been a substitute for other trade relationships. In Mexico, on the other hand, an equally dramatic expansion in the importance of intra-NAFTA trade (which doubled from 25 per cent of GDP in the early 1990s, to 50 per cent by 2000 – see Figure 15.2) was complemented by a significant expansion in trade with non-NAFTA partners. This is consistent with the conclusion that for Mexico the NAFTA represents part of a broader package of deregulatory initiatives, which served to open Mexican markets in a broader sense. Finally, in the US case (Figure 15.3), the discrete impacts of the FTA and the NAFTA are not even perceptible in trade data, which indi-

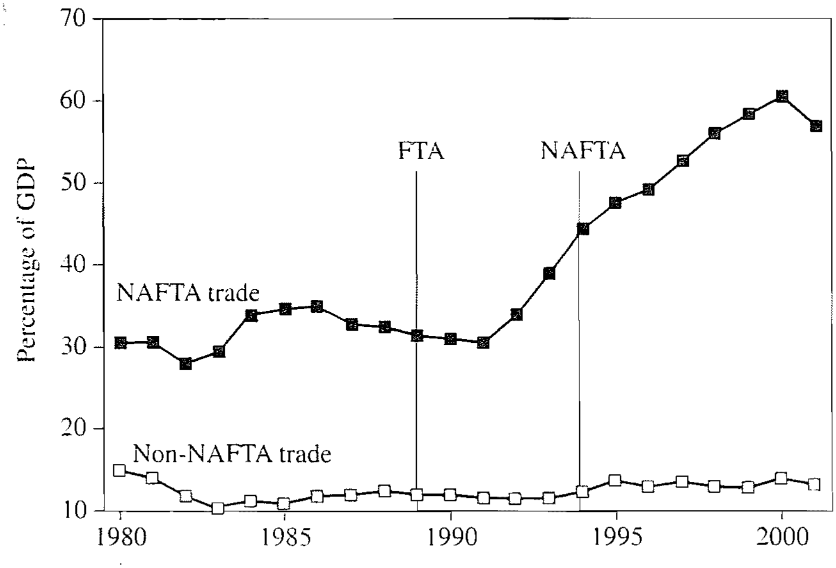

Figure 15.1 Canada's trade

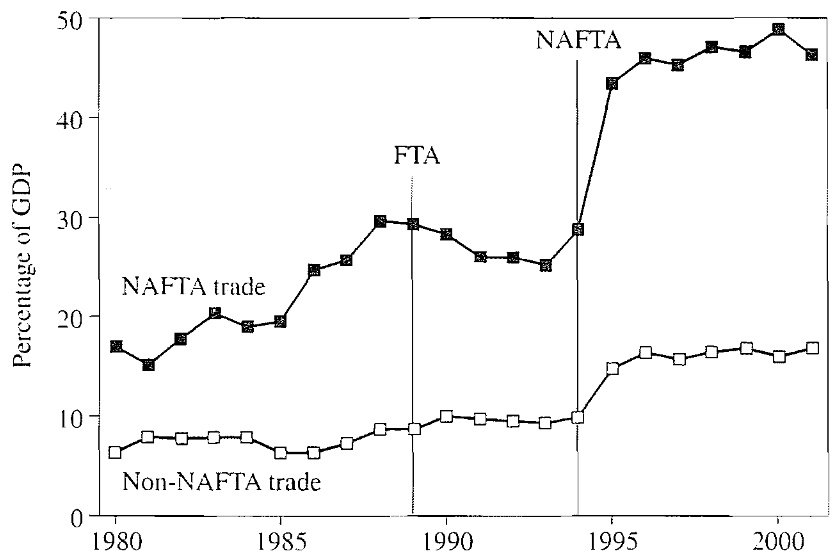

Figure 15.2 Mexico's trade

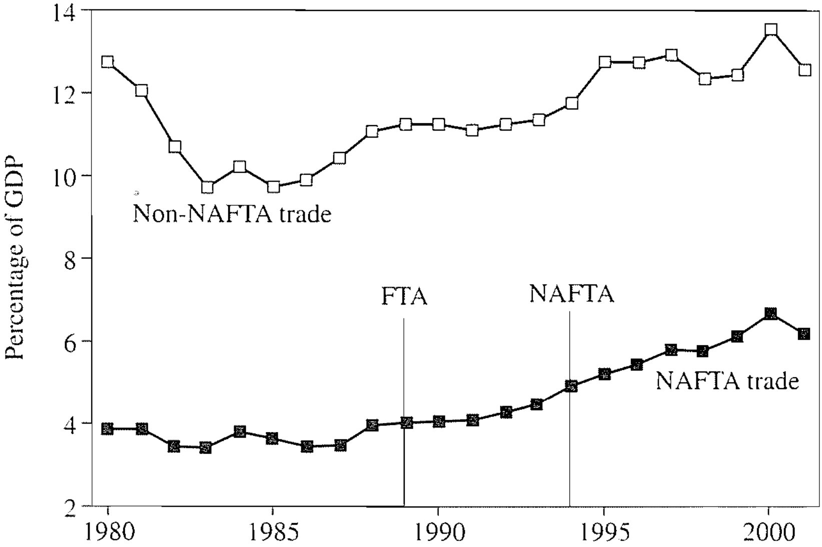

Figure 15.3 US trade

cate a longer-term, more gradual expansion in the relative importance of foreign trade with both NAFTA and non-NAFTA partners.

Trade imbalances

Merchandise trade flows within North America are characterised by significant bilateral imbalances. These imbalances have fuelled arguments, especially in the US, that NAFTA trade flows undermine domestic employment and output levels (Scott, 2001). The US experiences large merchandise trade deficits with both of its NAFTA partners: some $55 billion (US) with Canada in 2000, and roughly half that much with Mexico (see Table 15.5). In each case, the imbalance represents over just one-tenth the total value of the two-way trade flow (indicating that the US imports roughly $5 from its NAFTA partners for every $4 that it exports to them). Proportionately, the bilateral flow between Canada and Mexico is the most unbalanced, with Canada's merchandise trade deficit equivalent to a full 70 per cent of the value of total bilateral trade (so that, in effect, Canada imports $6 from Mexico for every dollar it exports there).

Employment

There has been much debate in all three NAFTA countries regarding the aggregate employment impacts of continental free trade (Campbell *et al.*,

Table 15.5 Merchandise trade imbalances, NAFTA, 2000

Surplus partner	Deficit partner	Imbalance (US$ billion)	Imbalance as % bilateral trade
Canada	US	54.8	13.3
Mexico	US	25.6	10.3
Mexico	Canada	6.7	70.5

Source: Author's calculations from Statistics Canada (2002a, 2002b), Bureau of Economic Analysis (2002).

1999; MacDonald, 2000; Scott, Salas, and Campbell, 2001; US International Trade Commission, 1997). Within Canada, the Canada–US FTA was widely blamed for a precipitous decline in manufacturing employment during the first years of that agreement; Canada lost nearly 20 per cent of its manufacturing employment during the first four years of the FTA, in an unprecedented wave of plant closures and industrial restructuring. In retrospect, much of this decline was the result of a very aggressive anti-inflation monetary policy that was implemented in Canada during the same period (Gaston and Trefler, 1997), and while the FTA clearly sparked a one-time process of adjustment in Canadian industry (which was forced to evolve away from its previous reliance on the domestic market) it cannot be argued to have promoted a broad deindustrialisation in Canada. Later in the 1990s Canadian manufacturing expanded strongly, and Canada's share of total North American manufacturing grew; by 1998 manufacturing employment in Canada exceeded its pre-FTA peak. In the US, labour advocates point to large trade deficits with Canada and Mexico to suggest that NAFTA trade flows have undermined domestic employment levels. On the other hand, US labour market conditions (marked by low unemployment and rising real incomes) have been the strongest of the three NAFTA countries during most of the post-NAFTA period. In Mexico, meanwhile, the promise that the NAFTA would spark a wave of job-creation in export-oriented industries has been unfulfilled. Export-oriented employment did expand in the late 1990s, especially in the northern border zone of *maquiladora* export production facilities; but the number of new jobs created in those industries remained relatively trivial compared to the overall size of Mexico's labour market.[8] By 2001 export-oriented employment in Mexico began to decline in the wake of a slowdown in exports to the US (Organization for Economic Cooperation and Development, 2002b). In none of the three countries, therefore, can a convincing argument be made that continental economic integration has had a major impact on labour markets, whether positive or negative. While trade and investment flows are obviously an important determinant of employment patters, overall labour market conditions in each country continue to reflect other more important factors (such as demographic trends and macroeconomic and labour market policies).

Economic growth

It is hard to argue that continental free trade has had any perceptible impact on real economic growth rates on the continent, which also continue to reflect primarily domestic factors (such as the stance of monetary policy and the general vitality of business investment). None of the NAFTA-member countries have exhibited stronger economic growth in the wake of continental free trade, than before it (Table 15.6). This finding seems particularly damaging to the claim of NAFTA proponents that pro-competitive structural changes in the Mexican economy, implemented in conjunction with the NAFTA, would significantly enhance economic growth there (Fernandez-Arias and Montiel, 2001). Mexico's growth under the NAFTA has been no stronger than in previous periods (and remains significantly slower than during the golden years of import-substitution industrialisation from the 1950s through the 1970s); indeed, Mexican growth under NAFTA has been no faster than average growth rates recorded elsewhere in Latin America during this time (Organization for Economic Cooperation and Development, 2001b).

Table 15.6 *Real growth rates, NAFTA countries, 1980–2001 (average annual growth rate, real GDP, %)*

	1980–89 (pre-FTA)	1989–94 (FTA)	1994–2001 (NAFTA)	1980–2001
Canada	3.1	1.2	3.4	2.8
United States	3.3	2.2	3.5	3.1
Mexico	2.4	3.9	2.9	2.9

Source: Author's calculations from Organization for Economic Cooperation and Development (2001a, 2002a).

Structural change in Mexico

The negotiation and implementation of the NAFTA was a key part of a broader effort by Mexico's government and business leaders to restructure the national economy more closely along neo-liberal lines – and to signal forcefully to the rest of the world (and foreign investors in particular) that this restructuring was both thorough and permanent. As if to demonstrate that the creation of the NAFTA did not solve all of Mexico's economic and social problems, the very day of its inauguration (1 January 1994) marked the beginning of a campaign of armed insurrection and political mobilisation by the radical Zapatista National Liberation movement (based in the southern Mexican state of Chiapas) and like-minded supporters elsewhere in Mexico. Indeed, the year of the NAFTA's implementation would be a very difficult one for Mexico, beginning with the rebellion and ending with the onset of another financial crisis in December 1995. This 'peso crisis' was the culmination of large and unsustainable financial capital flows which had inundated Mexico in anticipation of the NAFTA, producing equally unsustainable current account deficits and other financial imbalances in the national economy (Blecker, 1996; Ros and Lustig, 2000). The responses of the Mexican government and monetary authorities to the crisis included dramatic (if temporary) increases in interest rates, the abandonment of a fixed peg for the exchange rate (which subsequently depreciated by over one-half), and a further retrenchment in fiscal policy. The painful consequences of this crisis on the Mexican macroeconomy swamped any initial benefits that NAFTA advocates had expected from the free trade agreement, and the country entered a recession.

Mexico's financial and macroeconomic situation subsequently stabilised, however, and by the late 1990s the real economy improved considerably. In light of the damaging effects of periodic financial crises in Mexico's recent history, the post-NAFTA stabilisation of key monetary and financial indicators has been especially important. Mexico experienced a steady process of

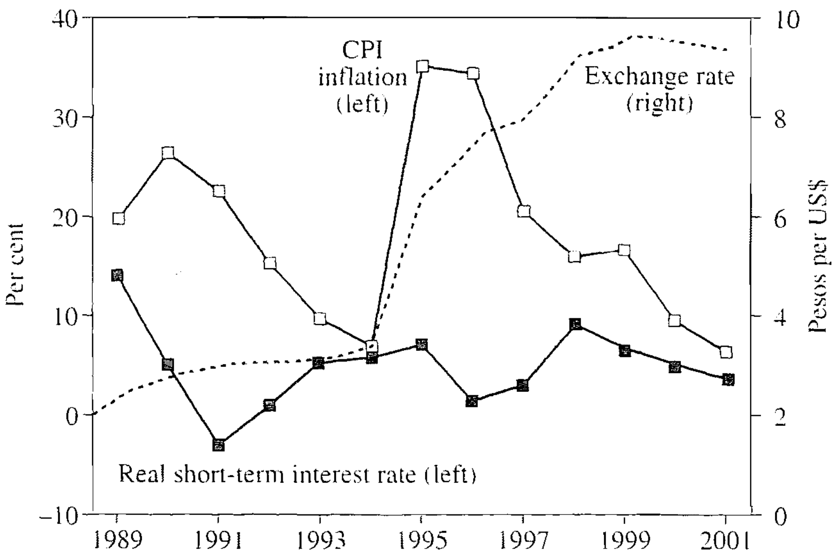

Figure 15.4 Mexico's exchange rate, interest rate and inflation

disinflation through the late 1990s, accompanied by a corresponding decline in real interest rates (Figure 15.4). In addition, the exchange rate stabilised at a nominal level approximately one-third its pre-1995 fixing.[9] Of particular note is the fact that Mexico's financial system was not significantly affected by contagion effects resulting from the Argentine financial crisis of 2001–02, a crisis which impacted many other Latin American economies. If Mexico's membership in the NAFTA has given foreign investors and Mexican wealth-owners alike a strong assurance of a stable and predictable institutional and policy environment (and this, in fact, was a central goal of Mexico's participation in the NAFTA), then the resulting macroeconomic and financial stability may prove to be the most important and lasting benefit of the continental agreement.[10]

Another indirect but important impact of the NAFTA on Mexico could prove to be its influence on political and democratic processes. After seven uninterrupted decades of rule, the PRI was defeated in the 2000 federal election by the right-wing Partido de Accion Popular (PAN), led by Vicente Fox Quesada. The largely peaceful transition to a new administration has been accompanied by other improvements in the transparency and functioning of Mexican political and legal institutions (although corruption and violence still mar democratic and government practices in many regions and sectors of Mexican society). For example, the Mexican trade union movement is making some initial progress in freeing itself from decades of state-sponsored PRI oversight and forming itself into a more authentic and independent social force. The NAFTA is often credited with playing a supporting role in these democratic improvements, since all sides within Mexico understand that perceived violations of democratic process in Mexico would have probable repercussions for Mexico's increasingly important economic links with the US.

5. Future directions

Despite initial debates within each country regarding the desirability of continental economic integration, the NAFTA now seems well-established as a central fixture of the North American economy. In the US, broad bipartisan support exists for the NAFTA – although that support does not necessarily extend to granting the US administration authority for further trade negotiations, including the potential expansion of the NAFTA. In Mexico, the newly-elected PAN strongly supports NAFTA, and even the left-wing Partido de la Revolucion Democrata, led by Cuauhtemoc Cardenas (now the mayor of Mexico City), accepts the agreement (while arguing for reforms that would recreate the authority of national governments to conduct a wider range of economic and industrial policies, and enhance the rights of Mexican immigrants in the US). In Canada, only the left-wing New Democratic Party still opposes continental free trade, and few free-trade critics there suggest that the NAFTA itself could be annulled. Instead, the constituencies in all three countries which initially opposed the agreement have turned their focus to resisting the further expansion of the NAFTA, in terms of both its geographical scope and its depth of effect. Four sets of issues in particular could eventually produce a more powerful form of economic integration in the Western Hemisphere, although in each case it is clear that the further expansion of continental economic integration faces formidable political and economic barriers.

Hemispheric free trade

Political leaders throughout the Western Hemisphere[11] have initiated negotiations to create a hemisphere-wide Free Trade Area of the Americas (FTAA), building on the framework of the NAFTA (Wise, 1998; Lee, 2001). The plan received initial tentative approval at hemispheric political summits in Miami in 1994, Santiago in 1998, and Quebec City in 2001, and working groups have been established to identify key issues for negotiation. The Quebec City summit adopted an 'action plan' in which the progress of free trade negotiations would supposedly be linked to the maintenance of democratic rights through the continent. Subsequent political events, however, have cast doubt on the prospects for the FTAA. The Argentine financial and political crisis has sparked widespread opposition there to the FTAA and other forms of globalisation; the electoral strength of the anti-FTAA Worker's Party in Brazil will certainly affect that nation's participation in the negotiations; and continuing political instability in countries like Columbia and Venezuela (where the US government has supported groups attempting to remove the elected government of Hugo Chavez from power) undermine the claim that hemispheric economic integration will be associated with stability and democracy.

Monetary union

Unlike the EU, the NAFTA contained no provisions for harmonisation in monetary or exchange rate policy. Each member country continues to have its monetary policy determined by its own central bank, and each country's currency trades flexibly on international markets. The continued course of continental economic integration has sparked some calls in Canada, however, for a parallel process of monetary integration, which would culminate in the development of a common continental currency (or, more likely, the use of the US dollar as a *de facto* continental currency). The introduction of the euro beginning in 1999 provided additional momentum to this discussion. In this context, some prominent conservative voices in Canada have proposed that Canada should work towards a continental currency (Courchene and Harris, 1999). Unlike free trade with the US, however, this proposal as yet enjoys only minority support from Canada's business and financial communities (who continue to favour an independent Canadian currency), and is widely opposed by members of the general public. Unless and until there is a widespread agreement among Canada's economic and political elites of the sort that presaged free trade negotiations with the US in the 1980s, the issue of continental monetary union is unlikely to become a serious political possibility in Canada. The issue has not received any serious attention in the US or Mexico.

Migration

Within Mexico, more concern has been expressed regarding the absence of provisions within the NAFTA for greater mobility by persons within North America, and of measures to protect the interests and standing of Mexican migrant workers in the US (Weintraub *et al.*, 1997). An estimated eight million Mexican citizens live in the US, half of them illegally. The new Fox government in Mexico has made the issue a major priority in its relationship with the US. Here, too, however, it is unlikely that the concern will result in concrete changes in the actual provisions of the NAFTA. In the wake of the terrorist acts of September 11, 2001, the American political climate has become more inward-focused and xenophobic than usual, and there will be little political support there for measures which would allow freer cross-border flows of people within North America. For the foreseeable future, it seems, North American economic integration will continue to be affected by flows of commodities and flows of capital, more than by flows of human beings.

Borders

Another consequence of the September 11 terrorist attacks was the exacerbation of growing problems of congestion and traffic delay at Canada–US and Mexico–US border crossings. An immediate US security crackdown in the wake of September 11 produced unprecedented backlogs in cross-border traffic, and while those disruptions were temporary they did highlight the extent to which North American businesses have been dependent on cross-border flows of inputs – and hence vulnerable to disruptions and delays in those flows. High-level initiatives have since been taken to enhance traffic flows at both borders, including the expansion of physical infrastructure and the introduction of new high-speed screening measures for regular pre-screened shipments. These measures will certainly improve the congestion problems at both borders. As yet, there is no significant discussion in North America about European-style efforts to eliminate border crossings within the free trade zone; this approach would require a prior harmonisation of immigration, customs and security policies which is not considered feasible in any of the NAFTA countries.

6. Conclusion

The implementation in 1994 of the NAFTA, building on the earlier framework of the 1989 Canada–US FTA, marked a watershed in the historical political–economic evolution of Canada and Mexico. The implementation of the NAFTA was a much less important event for the US. The relatively simple task of eliminating tariffs on intra-NAFTA merchandise trade constitutes a modest portion of the overall NAFTA package. More important has been the NAFTA's attempt to establish a continent-wide regime of deregulated, market-oriented economic development. Indeed, the Mexican government's primary interest in the NAFTA may have been precisely to commit itself publicly and permanently to a broadly neo-liberal development strategy, thus winning the confidence and approval of both international investors and domestic wealth-holders. The NAFTA has had a significant impact on the structure of trade flows within North America, but no visible effect on aggregate economic activity or employment. The prospects for the expansion of NAFTA to include other countries in the Western Hemisphere, or for the deepening of the NAFTA to include topics such as monetary integration or greater freedom of migration, seem relatively dim.

Notes

1. This four-to-one cross-national gap in average living standards within the NAFTA zone is twice as wide as the corresponding gap within the EU. The NAFTA zone therefore incorporates a much wider range of living standards and income levels than does the EU.
2. The Liberal party subsequently reversed its opposition to continental free trade. It regained power in the 1993 federal election, promising only to fight for changes in the draft NAFTA which had been signed the previous year; even that mild promise was not fulfilled, and the Liberal administration under Prime Minister Jean Chretien has become a staunch supporter of NAFTA and its expansion throughout the Western Hemisphere.
3. A searchable text of the entire NAFTA can be viewed at the website of the NAFTA Secretariat, www.nafta-sec-alena.org.
4. Some tariffs are still allowed to be charged on a small number of agricultural tariffs.
5. These exemptions were most important in the cases of Canada and Mexico, whose economies continued to reflect the legacy of more interventionist economic policy approaches adopted in earlier times. But important US measures, such as the Buy America Act (requiring US content in federally-funded public developments) and the Jones Act (requiring US content in inshore shipping and shipbuilding), were also protected under this approach.
6. The creation of these tribunals represented an attempt by US negotiators to mollify their Canadian counterparts, who had entered the FTA negotiations demanding full exemption for Canadian products from US trade remedies. The US was unwilling to grant this exemption, so instead agreed to the creation of special tribunals which would determine whether existing trade remedies in one country or another had been reasonably and legitimately applied (within the grounds of the domestic laws governing those remedies). The operation of these panels since 1989 is generally viewed to have been unsatisfactory: a particularly discouraging indication has been the failure of the panels, despite repeated

rulings against the US, to overturn punitive US countervailing duties applied to Canadian exports of softwood lumber.

7. Mexico ranks as Canada's fourth-largest bilateral trade partner, while Canada is Mexico's third largest trade partner.
8. By 2001, the *maquiladora* export-processing facilities in the northern tier of Mexico employed a total of just over 1 million workers – representing a small share of total formal employment in Mexico of some 40 million workers, and a total economically active population of closer to 60 million (Instituto Nacional de Estadistica Geografia e Informatica, 2002).
9. In real terms, the exchange rate appreciated during this period, since Mexico's inflation rate – while declining – was still higher than that of its trading partners.
10. In this context, the numerous quantitative models which were used to estimate the economic effects of continental free trade and relied almost exclusively on the inter-sectoral trade reallocation effects predicted in conventional neoclassical trade theory can be seen to have completely misidentified the likely economic significance of the NAFTA.
11. Cuba has been excluded from the process.

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16 The low road to competitive failure: immigrant labour and emigrant jobs in the US

Charles Craypo and Frank Wilkinson

Introduction

The dominant system of ideas structuring the US productive system has been described as *corporate liberalism*. Corporate liberalism is a reworking of the core beliefs of liberal economics to accommodate large corporations, and is given effect by legislation and judicial ruling (Berk, 1994). Liberal economics is rooted in a utopian vision of self-regulating markets that transform the inherent selfishness of individuals into general good. The market is seen as providing the opportunity and incentives for individuals to exploit to the full their property (labour in the case of workers) but prevents them from exploiting any advantage they might have by throwing them into competition with others. For liberal economists, market forces deliver distributional justice and optimal economic welfare and this gives them supremacy over man-made laws and institutions. Unless these conform to the laws of the market they risk being in *restraint of trade* and economically damaging.

The charge of restraint of trade is particularly targeted at worker organisation and protective labour laws because they are interpreted as hindering market forces. By contrast, market dominance by large firms is tolerated on the grounds that, as the products of successful competition from efficient and innovating entrepreneurs, they are the consequences of the effective working of market forces. In a similar way, the stock exchange has come to be theorised as efficient markets for corporate control, the means by which shareholders can punish inefficient and malfeasant managers and reward successful and reliable ones by selling them their shares. By these means, the consolidation of market power by hostile takeovers is justified by the working of the market, which by definition serves the general interest (Deakin and Slinger, 1997). Thus the corporate liberal position is that although the market concentrates economic power, it also yields important benefits for society in the form of technical progress and economic growth. What is good for business is also good for society, and although the excesses of dominant firms need checking, it would check progress if their market opportunities were unduly restricted.

The reality is that the imbalance of power between labour and capital that exists in unrestricted markets guarantees workers little more than the freedom to be exploited. The recognition of this, together with the failure of corporate America to deliver full employment, led to a dilution of corporate liberalism to encompass state intervention to secure full employment, establish a safety net of basic employment and social rights, and legitimise trade unions and collective bargaining. The validity of these reforms was increasingly questioned, however, as US competitiveness faltered and with the growing inflationary crises in the 1970s. This led to a corporate liberal revival resulting in the strengthening of the rights of business and a weakening of the economic and social rights of workers and communities.

Deregulated markets, short-term corporate performance objectives and overriding shareholder and executive claims on resources, now dominate the US productive system. These, together with the increasing globalisation of this system, encourage corporations to cut pay and worsen conditions of work – moves that workers are increasingly powerless to resist. When dominant firms drive down labour costs in this way, others are forced to follow suit or risk operating at considerable disadvantage. This builds on a long historical tradition of wage cost competition based on cutting the pay of existing workforces, recruiting other workers who will work for less, or by simply relocating production to more employer-friendly sites. Within the global productive system, US employers increasingly resort to importing low-wage labour and exporting production processes to low-wage countries. Immigrant labour and emigrant jobs have thus become the hallmark of US labour relations and production strategies.

The impact on US employment structures and standards has been dramatic. Deindustrialisation has been progressive. In 1957, goods-producing and support industries together accounted for 48 per cent of all jobs, service-providing industries for 38 per cent and government for the remaining 14 per cent. By 1998 the ratios had shifted to 25 per cent in goods-producing and support industries, a drop of nearly half; 59 per cent in services, an increase of more than half; and 16 per cent in government. Under the impact of these profound structural shifts and worsened job opportunities for blue-collar – and many white-collar – workers, wages and benefits have progressively worsened, and work intensity has increased, despite brief periods of respite, as in 1996–2000 (Mishel *et al.*, 2001, Chapter 2). For the first time in the US there is a widespread feeling amongst the younger generation that they will be worse off than their parents.

Globalisation thus coincides and interacts with other adverse trends to reduce the ratio of good jobs and lower overall labour standards in America. Either cheaper labour is brought into the US or contested jobs are moved out of the US as part of larger corporate labour and product market strategies. It is, therefore, a matter of either immigrant labour or emigrant jobs, or some combination of the two.

Immigrant labour

In a geographically large and populous country like the US, relocating production from the more progressive and unionised northern and coastal states to the conservative, non-union south and south-west, provided an opportunity to cut labour costs. Thus textile, garment and other light manufacturers moved wholesale to the south before and after World War II, and electrical components, car parts, fabricated steel, tyre and other metal and durable goods producers followed in the final decades of the twentieth century. Then, with the revival of conservative political forces and the consequent decline of 1930s New Deal and 1960s Great Society programmes and regulations, with the advent of enabling technological advances in communications and transportation, and with the emergence of new business norms, goals and methods, the US search for cheap labour became global.

As a result, the US is now experiencing the greatest influx of immigrant labour in nearly a century. 'In terms of sheer numbers, the 1980s witnessed the largest infusion of foreign-born persons for permanent settlement in the history of the United States'. Without much debate or analysis, says Vernon Briggs (1992, p. 1), 'the level of immigration slowly began to rise during the mid-1960s; it accelerated in the 1970s; it soared in the 1980s; and, as a consequence of the significant statutory, judicial, and administrative actions taken during that decade, the phenomenon [became] institutionalized as a fact of life for the 1990s'. Why the 1980s? Simply put, the federal government, led by the Reagan White House, acceded to business demands for low-wage immigrant labour. Unfortunately for blue-collar workers, this coincided with a rapid decline in employment in the goods-producing and support industries when the children of high-wage industrial workers were being forced into rapidly expanding but low-paying service and retail jobs. Large supplies of immigrant labour put a lid on already low wage levels, and made unionisation even more difficult than it had become in the face of increasing employer, judicial and administration hostility.

The composition of the current immigrant labour force, including both legal and illegal entrants, is so varied that they are employable at every level of the occupational hierarchy. Those who lack occupational credentials and job experiences have to work in low-wage, dead-end occupations: 'backroom' jobs in restaurants; domestic cleaning and care-giving in the personal service sector; office cleaning in the business service sector; field work in agriculture; labourer jobs in construction; hourly production jobs in garment, food processing and other light manufacturing industries. For a few, at most, low-level employment in these industries can, with time and appropriate effort and attitude, progress to middle level positions. At the high end of the job ladder, by contrast, employment often starts at or near the top, as in the case of immigrant physicians, engineers and electronic information specialists.

This chapter focuses on the impact of low, middle and high-level immigrant labour on US workers and unions in the global setting.

Low-end immigrant occupations

Low-end immigrant labour is increasingly indispensable to the comfortable living standards enjoyed by middle and upper class Americans. Women and men from Mexico, Central America, the Philippines, the Caribbean and elsewhere perform home and landscape tasks making life easier for their employers. It is now estimated that one-half of all American households employ directly or indirectly one or more immigrant workers as nannies, gardeners, house cleaners and other domestic service providers. (National Public Radio, 'Marketplace', 6 September 2002.) As more and more mothers and wives become permanent members of the workforce, the need for domestic help arises even among those families that send two or more wage earners into the labour market, increasingly of necessity, and that would not and could not have afforded this luxury in the past. Cheap labour for domestic work also enables employers to pay less for the labour of working mothers (Johnson, 2002).

These immigrants are an exploitable labour force at a time when US employers are under increasing incentive – or, pressure as the case may be – to hold down labour costs. Increased labour demand in the non-durable goods-producing and service sectors of the economy might have exerted upward pressure on wage levels, but this has been more than offset by increased supplies of immigrant workers. Immigrant labour simply adds to the already large pool of disadvantaged workers created by the need for households to put additional members into the labour market to maintain living standards after nearly three decades of falling real wage levels, by the large numbers of displaced factory and support workers and of their children who are now joining the labour force, and by other disadvantaged workers having few if any resources with which to compete (Cormier and Craypo, 2000).

Meatpacking illustrates the undermining effect of the use of immigrant labour on labour standards. The job and labour force stability that characterised beef and pork packing plants and communities in the decades following World War II has given way to low-wage, transient, dangerous work in the huge, state-of-the-art slaughtering and processing factories of the high plains states including Kansas, Nebraska and Texas. Until the late-1960s, hourly wages in beef and pork packing plants were much above the average for manufacturing and only 10 to 15 per cent below those in car assembly plants and basic steel mills. Two meatpacking unions together represented nearly the entire production workforce and coordinated rather than competed in negotiating strong pattern settlements on a company-wide basis. In the early

1960s, however, aggressive new entrants broke the old oligopoly that had dominated meatpacking since the turn of the last century and took over the industry, in part by keeping unions out and refusing to accept industry pattern settlements where they inherited unions in acquired plants. Before long, meatpacking became synonymous with low wages, unsafe jobs, transient labour and community discord (Craypo, 1994).

Unable to hire and retain local residents at the wages and working conditions they offered, the new breed of packers brought in immigrant labour to break the union and drive down labour standards. They have recruited refugees who are desperate for work and therefore willing to tolerate the low standards and harsh conditions which have come to characterise the industry. At first Asian boat people were employed, then Hispanic workers escaping high unemployment levels and subsistence incomes at home. More recently, recruitment efforts have involved Bosnians and other refugees from the Balkan wars.

Much the same has happened in the poultry processing plants in the South and Mid-Atlantic states, except here labour standards have never been high and mainly Central American immigrants have displaced African Americans. Also unlike beef and pork, poultry plants are located mainly in the eastern half of the country. When native workers began unionising in the 1980s, the major employers brought in immigrants. But, in a repeat of earlier immigrant history, they too have begun to fight back. Some of the poultry processors have been forced to recognise and bargain with the union (Craypo, 1994, pp. 87–8).

Finally, recent and shocking discoveries of boatloads of undocumented Chinese males stranded in US waters and hundreds of Asian women being held as captive workers in garment shops in New York, Los Angeles and other major American cities have unveiled well organised networks of illegal Chinese immigration, much of it coming from the southern province of Fuzhou, China's most impoverished region. Such networks, operated by the notorious 'snakeheads', funnel low-wage, vulnerable workers into US labour markets. The full extent of these networks is not known, although overall Chinese emigration has reached 180 000 a year.

Middle and high-end level immigrant occupations

Among those at the middle and high end of the immigrant labour force are registered nurses, physicians and other health care professionals; computer specialists and other technical workers in the information industries; advanced degree holders in maths, science and engineering; and, from Latin America, baseball players. In order to import foreign workers having the necessary credentials to take high-paying jobs, employers have to obtain H-1B visas from the US Labor Department. These allow US employers to hire foreign workers to fill specific job vacancies on the grounds that they cannot find US workers.

Acting at the request of employers for more H-1B visas – based on a 1980s report by the National Science Foundation predicting a shortfall of at least 675 000 scientists and engineers in America by the end of the century – Congress enacted the Immigration Act of 1990, more than quadrupling the number of skilled immigrant workers allowed into the country. The Labor Department also cooperated. More legal immigrants entered the US the following year than ever before in American history. Altogether during the 1990s, hundreds of thousands of high tech workers received H-1B visas. But then in 1990–93, contrary to the expectations of the NSF report, US universities saw the graduation of twice as many highly skilled technical workers as there were job vacancies. So great was the combined effect of the number of new graduates and the influx of foreign workers that professional occupational groups, unions and academic analysts warned that the current oversupply threatened the future labour supply by discouraging Americans from entering these occupations. This time Congress responded by providing funds for increased domestic training and education, but at the same time increasing yet again the number of job visas. In 2000 it passed legislation providing nearly 600 000 more such visas although it did double the fee employers had to pay for each immigrant visa from $500 to $1000, with the proviso that the money collected be used to finance training and education for US workers (*Washington Post*, 7 October 2000, p. A-8).

One of the most visible and publicised examples of immigrant labour in middle- and high-range employment today involves computer technicians. The US industry is said to confront a serious shortage of skilled workers in this fast-growing sector and therefore needs to import more foreign labour to fill the gap and in the process keep America globally competitive. A major recruiting ground is India, where well-educated and trained individuals are in abundance, including Cambridge and Oxford graduates.

By the beginning of the new century, however, Indian software programmers in turn were being under-priced by equally capable programmers from even lower-wage countries. Notable was the progress made by Vietnam. By 2002 Ho Chi Minh City-based Quantic Software was filling work orders from North America, Europe and Asia, including computer giants such as Nortel, Japan's NTT and Cisco Systems. But Quantic was not alone. The industry had expanded from a handful of software companies two years earlier to more than 250 domestic and foreign-owned companies. So rapid was its growth that industry analysts agreed that it was only a matter of time before Vietnam became a world-class player. And what was Vietnam's competitive advantage? Low wages. Independent analyst Research Vietnam estimated that corporations pay about $20 000 a year per Vietnamese programmer compared to $30 000 in Russia and Romania, and $40 000 in India. 'If you want fast turnaround, go somewhere established like India', said Research Vietnam's director, 'But if you're looking for a long-term, cost-effective partner, Vietnam has the potential to be that' (Tran, 2002). Of course the same thing could have been said about India a decade earlier, that is, before India's labour costs were undercut by Vietnam.

Another example involves registered nurses (RNs) from the Philippines. For years Philippine development policy has involved exporting labour, including nannies, housekeepers, sailing crews and trained nurses. Again, US hospitals and other health care institutions claim they cannot recruit enough RNs and constantly petition government for more foreign workers, in this case often from the Philippines. Permission is usually granted but on condition they pay wages comparable to those in the region, which the employers dutifully promise. Government agencies seldom check to see whether in fact they do pay the advertised wage, but in the few instances where they did it was discovered that many imported nurses were paid below area standards.

Thus in both low- and high-end labour markets, in both traditional and newer industries, immigrant workers increasingly satisfy the growing employer demand for cheap labour. Briggs (1992, p. 227) estimates that at the end of the 1980s immigrant labour accounted for 30–40 per cent of the annual increase in the US labour force. Employers justify recruiting so many immigrants on grounds that not enough domestic workers want to do this work and therefore they have no choice. Critics counter that no domestic workers will or can afford to work at the terms and conditions being offered.

Emigrant jobs

If an immigrant worker is one that has arrived and is employed, an emigrant job is one that has left the country, either through imports of foreign-made goods and services or through actual relocation overseas by domestic producers. Notable examples of emigrant jobs as a result of imports are the US auto and steel industries. The loss of these jobs, the highest paying mass manufacturing employment in the country, has been stupendous. In 1999 the Auto Workers union, historically one of the most powerful in the US, bargained for 44 per cent fewer car workers than it had in 1978, 379 000 as opposed to the earlier 675 000. In 2003 they will bargain for 269 000 at most (*Monthly Labor Review*, various years; Hudson, 2002, p. A9). In steel the cuts have been even more severe and the outlook is more dim.

The stories of steel and auto decline and the impact on unions, workers and communities are generally known and well documented (for example, Hoerr, 1988; Mangum and McNabb, 1997; Serrin, 1993; Lichtenstein, 1997; Green and Yanarella, 1998; Katz, 1985). More germane to this discussion, however, is the impact of globalisation on the high-tech glamour industries that were supposed to replace the electro-mechanical dinosaurs of the last century as the source of good manufacturing and service jobs. Two key high-tech sectors in this regard are the electronic communication and information processing industries and commercial aircraft parts and assembly. What we find upon investigation is that both immigrant labour and emigrant jobs, particularly the latter, have destroyed hundreds of thousands of jobs and eroded labour standards in these sectors.

Household appliances and audio/visual systems

Post-World War II analysts predicted that America's seemingly insurmountable technology lead and production know-how in consumer electronics guaranteed a future of good jobs and strong exports. Within a few decades, however, it had become clear that this was not to be. Experiences in the important household appliances and audio/visual equipment industries illustrate the overall story. Firms making these products employed well over a million workers in the 1950s and 1960s and were still contributing to positive US trade balances. By the end of the century they employed little more than a quarter of that number.

Take the case of TV sets. Bad business decisions by RCA, GE and other electronic oligopolists in the post-World War II decades decimated an important basic industry. Television technology and manufacturing had developed mainly in the US. But by the mid-1960s technological know-how was universal and both domestic and foreign manufacturers were taking advantage of labour cost differentials to make black-and-white receivers in developing countries. More important, large US producers were licensing fast-growing Japanese electronics manufacturers like Sony and Mitsubishi to make and sell colour sets. The latter had nothing to do with wage differentials but with short-term profit maximisation at the expense of long-term market position. The number of domestic production workers consequently fell from roughly 130 000 in 1966 to fewer than 60 000 by the late 1970s and then to barely 20 000 in the early 1990s (Cowie, 1999: 93–6, 127–30).

Having done this, domestic manufacturers then accused the same Japanese companies of illegal export dumping (that is, pricing below cost) and the Japanese government of having strategically targeted the US electronics market. Although US courts dismissed the charges, it was later made clear that the Japanese had in fact targeted the industry as part of its larger industrial growth strategy, which included an array of TV export subsidies to the US and TV import barriers into Japan (Magaziner and Reich, 1983, p. 177).

The final chance for American workers to make TV sets of any kind came and went with high-definition television (HDTV). Again the promise was that US electronic manufacturers would use their technological edge to develop a superior product, one that would stimulate domestic sales, just as colour TV had in the 1970s and large screen sets had in the 1980s and 1990s, only this time they would be made in the US. Again, it was not to be. After considerable delay and much confusion, global industry leaders and government officials in North America, Europe and Japan agreed on a production and distribution network that kept financial and technological control of HDTV in the advanced industrial nations under the leadership of Phillips, the largest European consumer electronics producer, and located manufacturing of HDTV receivers mainly in low-wage countries.

Between 1980 and 2000, therefore, the number of production workers in household appliances, by far the most highly unionised segment of the electronic and electrical equipment group, declined by a quarter. Figures are not available on changes in overall hourly employment for this sector but total employment fell slightly during 1980–2000, from 1.77 to 1.70 million. Electronic components and accessories, the only segment in which hourly jobs grew, remains largely non-union (*Statistical Abstract of the United States, 2001*, Table 609; Hirsch and MacPherson, 1997, Table 7a).

In numerous small and large cuts under CEO Jack Welch, General Electric, the largest US producer of such equipment, slashed its workforce by nearly half during these years. Fearing competition from Japanese producers, he concedes, he transformed the company by divesting the household appliance, electronics and military hardware divisions, and instead moved into broadcasting, medical equipment, and telecommunications (Welch, 2001). At the end of the 1960s, the International Union of Electrical workers (IUE) represented some 150 000 GE workers. (Ten other unions divided the remaining roughly 35 000.) In 2002 the IUE, still the major organisation, represents about one-tenth as many GE workers, if that. Moreover, although GE made many acquisitions and started many new businesses after Welch took over, no union has organised a GE plant in the US during his chairmanship, indeed not since the mid-1980s (Wypijewski, 2001).

Communications and information industries

By the 1980s there was no more talk of consumer and industrial electronics replacing auto and steel as a source of good jobs. Now it was computers and information processes. But events involving relationships among US firms and those in developing countries would soon frustrate these hopes.

In 1986 the Indian government decided that the country's comparative advantage in the global economy was in the English-speaking, highly educated segment of its labour force. The logical target was the information industry. Modern technology made it possible. 'Even if the client is situated 10 000 miles away from the software company in Asia, the client is still able to monitor the software development on a minute-by-minute basis, ensure quality checks, communicate with the programmers as if they were just next door and get efficient software developed', observed the New Delhi trade association.

The Indian government therefore set about establishing a Department of Electronics of India, whose task it was to develop the necessary physical infrastructure and provide a package of industry incentives and subsidies for the purpose of exporting computer software services. This was largely accomplished by 1990, with a number of computer parks complete with state-funded office space, electricity, and satellite hook-ups to the West.

The programme was an immediate success. Why pay a domestic computer specialist \$50 000 to \$70 000 a year plus benefits when you can indirectly hire someone in India with a master's degree from Cambridge or Oxford for less than \$10 000, American businesspeople asked themselves? By the mid-1990s, Hewlitt-Packard, Digital Equipment, Motorola, Novell, Texas Instruments, Oracle, IBM, Zenith, Microsoft and Apple, among others, were outsourcing computer programming and related work in India. Bangalore was becoming the Silicon Valley of Southern Asia.

After a trip to India in 1989, GE's Jack Welch decided to outsource the company's entire information system. 'The cost-of-living in India, about one-sixth that of the United States, provides capability for extremely cost-effective solutions' he explained to his employees back home, some of whom certainly had reason to fear the outcome, considering how many of the company's employees he had shed in his rise to the top and after. Welch began with a pilot of five outsourcing contracts but when the experiment proved even more productive than anticipated he signed 37 more involving projects in eight GE divisions. Even though 30 per cent of the work was still done in the States, project savings were said to total 60 per cent on each year of work effort (Barlett and Steele, 1996, pp. 97–9).

Finally, there is the matter of computer manufacturing. Americans probably buy and use more computers than any other people. Making computers is a major industry, but it is done largely by contractors rather than computer companies and outside the US except for final assembly, the way it was with TV sets before production left the States altogether. Household names like Dell, Compaq, Sony and HP sell them but little-known contractors like Flextronics, Jabil Circuit and Solectron make them, or at least the parts that go into them. This is because the leading computer sellers want to focus on product design and marketing rather than on making the sizeable (and often risky) investments of time and money that are involved in parts manufacturing when the consumer neither knows nor cares where they come from or who makes them.

The preferred location for parts production is Mexico. Labour is cheaper there, which of course is important in this price-competitive business. But perhaps more important, Mexico is closer to the US market than are the Asian countries that make many of the electronic components sold in the US. The sooner a product that has such a short life cycle as computers have can be produced and put on the retail shelf the sooner it can be sold. Seven of the ten largest computer parts contractors thus have chosen to manufacture in Mexico.

Within Mexico, the preferred location to date is Guadalahara, an interior city of 3.2 million inhabitants. This is not the result of random selection. Guadalahara was Mexico's shoe manufacturing centre before cheap Asian imports wiped it out. With generous business tax breaks, lots of golf courses and an ideal climate, the city set out to attract high-tech US manufacturers when the North American Free Trade Agreement took effect in 1994. But the determining factor, officials say, were Guadalahara's seven universities and dozens of technical schools, assuring contractors a trained labour force. 'Here, we get the best and the brightest', commented one of the major contractors. The strategy worked. In 1995 the electronics industry employed 5000 Guadalaharans; in 2000 it employed 60 000. 'As darkness falls each day, planes owned by cargo handlers Federal Express and United Parcel Service take off from the airport here for a short hop to US cities, their bellies full of modems, routers and other essential paraphernalia of the Information Age' (Friedland and McWilliams, 2000, p. A1).

Boeing Company commercial aircraft

'We're not talking about shirts or shoes moving to low-wage countries', complained the US machinists' union official. 'We're talking about the most advanced manufacturing technologies in the world. These are the high-tech skilled jobs, remember, that were going to be our future, that were supposed to save us in the global economy' (Greider, 1997, p. 127). He was commenting on the loss of hundreds of thousands of high-paying jobs at the world's largest commercial aircraft manufacturer, an ominous trend since aircraft and aerospace is the largest US manufacturing exporter and the nation's second largest manufacturing employer.

Boeing Company is still the world's biggest aircraft company and the largest US manufacturing exporter. The latter may be changing, however, as the European consortium Airbus Industrie, the only other major producer, gains global market shares at Boeing's expense and as developing economies, especially China, pursue infant industry strategies in developing capability in aircraft production (Bloomberg, 2000). Jobs at Boeing's main plant in Seattle and smaller ones in Kansas and Philadelphia have plummeted. In 1990, Boeing employed 156 000 high-paid hourly and salaried workers. It began cutting jobs dramatically during the early 1990s, however – 50 000 in Seattle alone. By 2002, Boeing employed about 30 000, some 26 000 of them represented by the blue-collar International Association of Machinists (IAM) and most of the remainder by the white-collar Society of Professional Engineering Employees in Aerospace (SPEEA). In 2002, hourly production workers at Boeing earned an average of \$52 000 a year and salaried technical and professional employees \$72 000.[1]

The problem for them is not wages but outsourcing, which often takes the form of offset production agreements between Boeing and foreign governments. To Boeing workers the problem is endemic. Outsourcing involves domestic and foreign contracts, usually the latter, in which parts-manufacturing – work traditionally done by union members in Boeing's US plants – is transferred overseas. Offset production agreements occur when Boeing agrees to manufacture assembly parts in, transfer technology to, and even build and equip plants in other countries – in exchange for sales contracts to those countries.

Boeing's Moscow Design Center, for example, uses 500 engineers (averaging \$10 000 a year) and technicians designing parts for Boeing's 777 and others jetliners – work previously performed by SPEEA members. Chinese parts vendor Xian Aircraft was making wing components for the Boeing 747 and complete tail sections for the Boeing 737. Polish vendor WZK-Mielec was turning out doors for the Boeing 757. And Mexican vender Mexmil produce fuselage-insulation blankets for all of Boeing's jetliners. In Japan, Mitsubishi, Kawasaki and Fuji are all offset partners with Boeing in its 777 production, so much so that 500 Japanese workstations are connected to Boeing Seattle on Seattle time. At one time there was talk of developing an Asian aircraft consortium involving Boeing, China and Japan, the object being to design and produce a 100-seat regional jet, mainly in China. Boeing's long-term objective doubtless was to keep out Airbus.

As a result of myriad offset production arrangements, it is estimated that half or more of Boeing's latest model aircraft components are being made overseas. This has been a progressive phenomenon. None of Boeing's commercial lead carrier of the 1950s, the 707, was ever outsourced; no more than 2 per cent of its 1960s 727; less than 10 per cent of its 1970s 737; 15 per cent of its 1980s 767; and 30 per cent of its 1990s 777. What explains this increase? Outsourcing contracts usually came about when foreign governments (or airlines) agreed to purchase Boeing planes in return for vendor rights. The Chinese, for example, insisted that in exchange for signing a \$5 billion order for 737s Boeing would contract parts production there, but also give to Chinese engineers access to the company's basic aircraft production and, more important for the long term, help China develop its own aircraft industry. Accordingly, Boeing supplied the necessary tooling technology, flight and maintenance training and safety instruction. Boeing also opened a support office in Beijing.

Outsourcing is transforming Boeing from being a vertically integrated producer that made its own parts for assembly, to a final assembly producer increasingly dependent on foreign suppliers. CEO Philip M. Condit acknowledged the transition: 'We are an assembler, an integrator', he told reporters at a July 2002, British air show. 'We will probably [make fewer] parts, which are most efficiently made by people who focus on doing that.' Condit could hardly deny the trend. He had himself just appointed former US foreign ambassador Thomas Pickering as Boeing senior vice-president in charge of finding additional 'strategic partners' with which to negotiate new outsourcing agreements. In defence of the practice Boeing argued that it had to outsource in order to be competitive.

Such agreements nevertheless enable Boeing to cut labour costs significantly as part of the deal by giving it access to cheap labour. The wage differentials are enormous. As a result of all the job cuts in the US, Boeing's hourly labour force averages 46 years of age and $54 000 a year in earnings. In addition, according to investigative reporters Donald Barlett and James Steele (1996, pp. 51–2), the Boeing-China deal 'was also made at the expense of the American taxpayer – on two counts'. First, the US government's Export–Import Bank guaranteed $1.4 billion in loans for the Chinese to purchase Boeing aircraft.

Second, Boeing and the rest of the civilian aviation industry, perhaps more than any other industry, owe their technology leadership to the tens of billions of taxpayer dollars spent on research and development of military aircraft. Now some of Boeing's technology is being given away to China.

Boeing's outsourcing strategy was short-term and self-destructive, the trade unions charged. Giving too much work to parts suppliers and sub-assemblers erodes both worker skills and company control over critical design and production processes. This has already happened, claims the IAM's chief negotiator. Between 1997 and 2002, he points out, Boeing executives spent $10 billion buying back Boeing stock in order to raise share prices. This is about how much money it takes a major aircraft manufacturer to develop a new model jetliner, he says, leaving Boeing with nothing more to show during these years than a 777 upgrade, as Airbus meanwhile introduced three new models. 'So while Boeing is giving money back to investors, Airbus is ensuring that it will dominate [product] market share in years to come.'

In addition, union officials say, Boeing should compete by producing more efficiently at home. 'We're looking at being partners at creating value – or adversaries who will be fighting over an ever-shrinking pie', explained IAM strategic-resources director. Several Boeing technical professionals reportedly support the union's position. A senior Boeing engineer, for example, reminded top managers that McDonnell Douglas outsourced to the point that it diverted so much revenue and profit to suppliers that it went into the long-term decline that led to Boeing's takeover of commercial aircraft and eventually of McDonnell itself. In any event, it appears the union is right, for while

Boeing officers busied themselves buying back shares, Airbus was proceeding with plans to develop the 500-seat A380, the world's largest passenger jet, at an estimated cost of $11 billion. It already had at least one firm airline order in hand. Then, in late 2002, Easy-Jet, Europe's largest discount airline, announced a $6 billion order for 120 new jets from Airbus after having purchased exclusively from Boeing. The effect was to cut Boeing's expected deliveries of commercial jets to little more than half its 2001 output. Boeing officials blamed the loss on cut-rate Airbus prices! (Allison, 2002)

About this time a previously undisclosed Federal Aviation Administration special audit of Boeing was obtained and reported by a Seattle newspaper. The FAA found no fewer than 107 production and quality control failings in the past year, 87 of them in Boeing's production system – many its outsourced parts – and 20 in its engineering design system. It attributed these and other assembly problems to a 'systemic breakdown' of operations. The audit produced an unprecedented five areas of further investigation based on the agency's concerns about the scope of the difficulties. Ten separate teams would have to conduct thorough checks and data collections for all of Boeing's commercial jet models aimed at future 'systemic process improvements'. This revelation came on the heels of an unrelated FAA announcement of a record $1.24 million in penalties against Boeing for poor supervision of parts suppliers and failure to report cracked parts promptly (Wallace, 2002).

For years both unions have been, understandably, in conflict with Boeing management over job preservation and related issues. The parties have never engaged in worker participation programmes and never negotiated profit sharing, productivity gains or any of the other jointly beneficial systems found in other basic industries (Erickson, 1994). A 69-day strike by the Machinists in 1995 was settled only after Boeing agreed to give the union a chance to match the costs of job bids by offshore vendors. When this failed to stem the flow of work overseas, another stoppage in 1999 was avoided when Boeing accepted limited guarantees against further outsourcing. These too failed. Following the attacks of September 11, Boeing laid off nearly 30 000 employees in response to subsequent airline cancellations of and reductions in aircraft orders. But Boeing also continued outsourcing despite union protests. Both unions made outsourcing overseas the major bargaining item. 'They have to stop boxing up our work and sending it to Moscow', SPEEA's executive director complained.

Union concern over outsourcing and the impact of job losses on an ageing workforce shaped its demands in bargaining a new contract in 2002. The already deteriorating relationship between the parties had only worsened following Boeing's announcement that it was relocating company headquarters from the West Coast to Chicago. The union interpreted the move as another signal that Boeing had no long-term commitment to domestic production or, for that matter, to production of any kind. Lately, company officials had taken to saying that Boeing is in the 'aerospace solutions' business, one more indication of a diminishing interest in the production end.

Union negotiators proposed a formula to preserve the jobs it still had. Under it, Boeing would guarantee a minimum number of jobs that would rise or fall with the company's total revenue or number of planes on order. 'If your revenues are up, if your orders are up, you hire more workers, you don't ship work overseas. But we understand that if your revenues are down, then you may lay people off', explained the union's chief negotiator. Boeing rejected the proposal: 'The market realities are such that even with our efficiencies, even with our abilities to squeeze cost out of our product, we're still not cost effective', countered the company negotiator. 'We've got to become more competitive.'

The parties were so far apart that government mediators were called in to assist in the talks. The contract had expired, Boeing refused to compromise on anything and the members were free to strike if they chose, but they did not. They rejected the company final offer by a wide margin but, fearing a lengthy walkout at a time when Boeing production was down by half, they failed to provide the two-thirds majority necessary for the union to call a strike, which under its constitution meant Boeing's final offer was accepted. The agreement gives workers modest wage and pension improvements but allows Boeing to continue contracting and adds an estimated $2000 a year to the amount that each employee must pay for health care coverage. Boeing's president was elated: 'We're looking forward to getting back to the business of building airplanes', he said, without specifying where.

Finally, it is worth noting in all of this that shortly before its demise as a major commercial aircraft producer McDonnell Douglas had also struck up a sales deal with the Chinese requiring it to produce in that country the MD-180s it was under contract to sell there. McDonnell Douglas also justified the arrangement on grounds of its dwindling market share – 10 per cent of the commercial market: 'We're in the business of making money for our shareholders', explained the company president, 'If we have to put jobs and technology in other countries, then we go ahead and do it' (Greider, 1997, p. 126). All for naught, as Boeing promptly drove McDonnell Douglas out of commercial aircraft and eventually acquired it for its military know-how and Pentagon contracts – what would turn out to be valued properties for Boeing when the civilian market later collapsed.

Aircraft engines

Boeing is not the only aircraft manufacturer shedding domestic jobs in order to meet short-term performance goals and long-term structural objectives. In this instance the transfer of domestic union jobs overseas is less a matter of substituting low-wage for high-wage labour than of forming strategic corporate alliances. Pratt & Whitney (United Technologies) and GE are the world leaders in manufacturing large turbo-jet engines, together having accounted for 85–90 per cent of the market over the past three decades. Both are profitable businesses. Yet during the 1990s they cut domestic hourly and salary jobs altogether by about 35 per cent while succeeding in keeping union wages flat at their major plants. At the same time, US imports of turbine engine parts increased from less than 5 per cent to roughly 30 per cent, all from advanced industrial economies – France, the UK, Germany, Canada and Japan, in order of importance.

Both GE and Pratt & Whitney are in fact getting out of the business of manufacturing jet engine parts and assembling the final product. Like Boeing, they see themselves as aerospace conceptualists engaged in designing, marketing and servicing jet engines for the global market rather than in making them. Both have acquired corporate partners who are more than happy to join in developing new commercial engine designs and more than willing to assume the high-end production and processing function. Simply stated, GE and Pratt & Whitney are abandoning the kinds of investments that increase or even sustain high-wage jobs domestically. 'Under the banner of focusing on their "core competencies", the leading [US] producers have been gradually getting out of the business of building equipment in favor of designing, marketing, and servicing aircraft engines', says IAM researcher Beth Almeida.

> At this time [2000], there is not a single large commercial turbofan engine in production at GE or Pratt & Whitney that was not developed and is not being produced without some involvement of overseas partners. Foreign firms have in many cases moved on from simple 'build to spec' arrangements to key roles in prototyping and design work (Almeida, 2000, p. 180).

Conclusions

The founding principle of the US was individual freedom. This found expression in the US productive system in the Adam Smithian notion of benefits of unrestricted markets. With the increasing concentration of economic power in larger and larger corporations the unrestricted rights of the individuals in markets was extended to corporations on the pretext that markets work to select and foster those forms of power that benefit economic performance. On the other hand, any suggestion that such benefits can arise from collective action was denied on the grounds that they restrain the market forces generating efficient economic outcomes. Corporate liberalism therefore served to legitimise the power of large corporations whist illegitimatising the power that workers and small organisations can mobilise by working together. The incorporation of corporate liberalism into the law and policy in the US productive system means there are few legal constraints on big business and that there are few inter-mediating institutions and organisations between large corporations and individuals. Consequently, the US productive system evolved arm's length non-cooperative relations between firms, low commitment employment relations and antagonistic work organisation.

The freedom of US corporations to single-mindedly pursue their own interests allowed them in the past to rapidly develop new products, processes and organisational forms so that the US productive system became highly dynamic. However, whilst the US productive system is highly creative it is also highly destructive. The paucity of the rights of workers and communities allows corporations to engage in unrestricted competition and single-mindedly to pursue their controllers' interests in the knowledge that they can cover their downstream risks by firing workers, decimating communities and reneging on commitments to their customers, suppliers and creditors. The lack of corporate accountability puts a premium on innovation in opportunism which extends from new ways of breaking faith with employees, trading partners, host communities and creditors to major corporate frauds of which Enron, WorldCom and Global Crossing are only the latest examples to come to light. As with its counterpart in primitive agriculture, this slash and burn approach to economic activity is destructive of the long-term viability of the US productive system by progressively eroding its skill and technology base and the probity of its labour, product and financial markets, and denying labour market resources to large segments of its production labour force.

This reality has become increasingly clear over the past 40 years. Until the 1960s, technological leadership, large-scale mass production and a free-wheeling market system appeared to give the US productive system competitive supremacy. But the market success of US corporations was also based on the almost complete closure of the US market to foreign competition. Furthermore, the high demand for products based on rapidly growing real incomes in the early post-war period created a seller's market. In these benign conditions oligopolistic producers could impose upon their customers the variety and quality of goods dictated by their production priorities and the price and non-price consequences of their conflictual relations of production. From the early 1960s, however, the US markets were progressively opened up to foreign competition to which US producers increasingly succumbed. Big Three cars, for example, were mechanically unreliable, functionally obsolete and operationally inefficient compared to European and Japanese models. Big Steel was handicapped by structurally obsolete plant and equipment, price inflexibility, poor product quality and managerial desire to divest operations into unrelated businesses. Big Four tyre makers adamantly refused to phase out cross-ply tyres in favour of radials until it was too late. As performance continued to worsen in these domestic industries, they have either closed or relocated production facilities rather than contest lost markets or, in the case of tyres, they have been acquired by foreign producers.

This 'new competition' (Best, 1990) came from productive systems that gave the quality of productive relations much higher priority than did US corporations. It originated with Japanese and European producers who had evolved high degrees of cooperation with their workers and suppliers. Within these productive systems, employment relations tend to be non-hierarchical and overtly cooperative and inter-firm links are relational rather than hands-off. Priority is also given to good faith in contractual relations, and the state, trade associations, trade unions and other organisations and institutions intervene separately and in collaboration to set norms, rules and standards for the regulating of labour, product and financial markets. The consequence has been the more effective mobilisation of the skills and knowledge of workers, higher rates of product and process innovation, improved design, greater variety and higher quality, as well as keener prices than could be achieved in the US.

The demonstration effect of foreign competition was not the only pressure for a change to more cooperative forms of productive relations: management theory also moved in that direction. With the evolution of the theory and practice of work organisation from Taylorism to human resource management the role of management has been recast from that of an authoritarian initiator, organiser and director of work to that of a democratic 'facilitator' of a participatory, cooperative and self-regulating system (Wilkinson, 2002). In this process, workers have been recast from factors of production to full partners in cooperative production. There can be little disagreement regarding the benefits to be derived from close cooperation in production. Not only does it allow for the close working together needed to raise and maintain productivity, but it also fuels learning within organisations by which new information is generated, new knowledge is created and diffused, and product, process and organisational innovations are encouraged. The resulting operational and dynamic efficiencies are crucial determinants of competitive success, as are the ability to create new opportunities and to respond quickly and flexibly to changing circumstances.

Close cooperation between workers and management is therefore a potent force for improving industrial performance. Effective cooperation requires workers to accept high levels of responsibility for operating, coordinating and developing production to high levels of quality and efficiency and to be completely open with any knowledge and suggestions they might have to improve production. To be successful, this requires goodwill, trust and long-term commitment. But the commitments made by corporations are highly conditional when they are pursuing short-term competitive strategies and prioritising shareholder demands for short-term gain. The unconditional demands made by management require workers to be totally committed to organisational objectives and to collectivise their effort, while conditional promises managers make mean that risk is individualised and that workers are readily disposable. Considering the illustrative nature of managerial priorities in electronics and aircraft, it is not surprising that high performance work systems have proved difficult to implement and sustain in the US (Appelbaum and Batt, 1994; Konzelmann and Forrant, 2002).

The need for high levels of cooperation extends to technical change. As competition has intensified, innovation has become more and more important and this has been shown to require close collaboration within and between firms, and between business and research institutions (Keeble and Wilkinson, 1999 and 2000). Innovation can best be understood as a process, the beginning stage of which is the development of radical new ideas from the science and technology base and the end stage of which is the wide diffusion of new products and processes. For any productive system, acquiring the full value from technical advance requires a balance between a high quality scientific and technology base, a high-technology sector for developing the commercial capabilities of new research findings, and an industry tradition in which innovations are embodied into new products and processes. The process of developing and using new technology also requires an institutional framework that supports technological diffusion and the necessary learning processes within and between these sectors (Wilkinson and Moore, 2000).

During the process of innovation, new technology passes from the 'newly emerging' and 'widely diffusing' technologies (McArthur, 1990). The US played a leading role in the 'newly emerging' phases of most recent new technologies. However, the lead in the wide diffusion of these generic changes has usually passed to other productive systems. This relative failure by American business can be accounted for by the lack of success in fostering cooperative learning processes in the workplace, in supply chains, and with the science and technology base because of extreme individualism and antagonistic inter- and intra-firm relationships. It can also be explained by the prevalence of adversarial work relations and the idea that skilled work can be readily replaced by technology. The corollary of this supposed deskilling effect of technology is a concentration of education and training at higher scientific, technological and managerial levels and a neglect of the middle range technical skill base – the low levels of which place limitations on organisational learning (Lazonick, 1997). This absence of effective collaboration within the technology development chain and the weakness of the skill base explain why, for example, America lost to Japan the world lead in the development and sale of machine tools, a primary route for the diffusion of electronics and computing into manufacturing (Forrant, 1997). Finally, the US failure to capitalise on its technological lead is explained by the speed with which US corporations internationally outsource the production of new products and services and in the process externalise knowledge transfer, learning processes and expertise and skill development necessary to deepen the technological base.

Thus, America's relative failure at the 'widely diffusing stage' can be explained by a failure to make radical innovations in work and industrial organisation and related policies to support its lead in radical new science and technology, and the speed by which these processes are outsourced abroad. This conclusion reinforces the argument that the lack of organisational flexibility will lessen the ability to meet the challenge of radical change. The locking-in of American business into a mode of rationality (Pratt, 1996) typified by extreme individualism, cut-throat competition, and adversarial employment and business relationships inhibited learning capabilities (Lazonick, 1991) and serves as a barrier to the full exploitation of radically new knowledge from its scientific base.

The twin strategies of sucking in cheap immigrant labour and expelling jobs to low-wage areas is a witness to the locking in of the US productive system into low road competition at the expense of the high road, and evidence of its long-run competitive decline. In the process of switching from US to global sourcing, and in moving from concentrating on producing goods and services to concentrating on maximising shareholder value – or, more recently, CEO compensation – American corporations have effectively hollowed out the technical capabilities of the US productive system and reduced its capacity to innovate and compete. The resulting collapse in productive sector jobs precipitated a fall in real wages, which was exacerbated by an increase in household labour market activity to stave off a fall in the standard of life, and by the rising tide of cheap immigrant labour. This was to the advantage of what Galbraith (1992) described as the contented classes whose real income, linked to corporate financial success, has been further enhanced by the declining cost of personal and other services provided by the low paid. However, many of these became less contented as the inward migration of highly skilled workers and the outward migration of highly skilled jobs eroded their earning and job opportunities.

It is also argued that the relocation of production out of the US merely reflects the comparative advantage of developing countries in the price of low-skilled labour (Wood, 1994). But as was shown above, the labour migration and job emigration now affects all grades of workers and the driving force of labour immigration and job emigration is tapping sources of low pay whatever the level of skill. Moreover, it is not altogether clear how the immiseration of a large proportion of the US population benefits world development even if jobs are created elsewhere. And, there must be a question of the overall effect on jobs as the lowering of pay relative to productivity to enhance profits reduces the capability of the world's workers to consume what they produce and therefore the overall level of effective demand. There can be no doubt that the transfer of technological enterprise accompanying the global activity of US corporations has advantages for other countries but this is offset by its destructive capabilities. But the greater threat to the world economic order is the globalisation of corporate liberalism, the dominant ideology of the US productive system, with its insistence on low-wage and *flexible* labour markets, reduced levels of welfare provision and of unrestricted corporate activity, however exploitative and destructive that might be. As a consequence, despite the superior economic performance of the productive systems that lead in establishing the comparative advantages of high road competitive strategies, they are currently being pressed to move to the low road by deregulating their labour, product and financial markets to free-up their corporate sectors. How this propels them down the route pioneered by the US will determine the extent to which they replicate that productive system's poverty, inequality and operational and dynamic inefficiencies.

Note

1. Unless otherwise noted, the Boeing discussion is based on Greenhouse 2002a and 2002b; and Lunsford 2002a and 2002b.

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PART VI

GOVERNANCE

17 An 'ation' not a 'nation': the globalisation of world politics

Richard Woodward

During the Cold War mainstream theories contented themselves with the knowledge that world politics was synonymous with international relations. Theories of international relations, as the name implies, presuppose nation states to be the locus of the world's political power and authority. From this it elegantly follows that the study of states and relations between states was a necessary and sufficient basis for understanding and explaining world politics. In short, world politics amounted to the study of inter*national* political processes. The backdrop of the Cold War gave these theoretical insights practical emphasis. The existence of two world powers standing on the brink of mutual annihilation underscored the idea that states constituted the most powerful actors on the world stage. The conclusion of the Cold War ushered in a period of uncertainty and conjecture about the nature and meaning of world politics (see for example Cox *et al.*, 2000). A voluminous literature appeared purporting to reflect the essence of the nascent post-Cold War order. This ranged from the liberal triumphalism trumpeted by Fukuyama's (1992) 'end of history' thesis to Huntington's (1993) prophecy about an impending 'clash of civilisations' and those who foresaw the arrival of a 'new medievalism' (Ruggie, 1993; Cerny, 1998; Kobrin, 1998). Though these accounts propounded radically different views of the new world order they nevertheless shared a common theme. Namely that the image of a world of states inadequately captured the intricacies of world politics in a post-Cold War environment. In particular, the adoption of the state and the states system as the basic framework for inquiry produced an unnecessarily restrictive conceptualisation of world politics that squeezed out consideration of non-state forms of power and authority. It was against this backdrop that commentators began to contemplate the impact of 'the globalisation of world politics' (Baylis and Smith, 2001).

The implications of globalisation for the theory and practice of world politics is the subject of intense debate. Differing interpretations of the terrorist atrocities of September 11, 2001 provide a clear illustration of this continuing controversy. For many, the events of September 11 were symptomatic of the profound transformations in world politics stemming from globalisation. These authors suggested that globalisation had diffused power away from states 'empowering individuals and groups to play roles in world politics – including wreaking massive destruction – that were once reserved for governments of states' (Nye, 2002, x; see also Keohane, 2002). Others were more conservative. They claimed that there is little evidence to support the assertion that globalisation has led to any fundamental reordering of the global political system and, if anything, the terrorist attacks and their aftermath have served to vindicate more traditional state-centred understandings of world politics (Gray, 2002; Waltz, 2002). This chapter argues that globalisation does have important ramifications for the way we think about and study world politics. The central contention is that the novelty of globalisation, whether it is used to describe a process or to connote an end condition, derives from its designation as an '*ation*' not a '*nation*' (Woodward, forthcoming). This is not just a semantic subtlety but is emblematic of the way in which globalisation has challenged the disciplinary trajectory of world politics. Whereas 'international' perspectives are imbued with the assumption that world politics is the exclusive province of the nation state, globalisation as an 'ation' makes no prior hypothesis about the main actors or the dominant patterns of world politics, enabling us to think of world politics in a more inclusive manner. As Baylis and Smith (2001, p. 2) put it, world politics viewed through the lens of globalisation 'is meant to denote the fact that our interest is in the politics and political patterns in the world, and not only those between nation-states'. States remain crucial but ultimately represent just one, albeit important, thread in the fabric of world politics. For this reason, states are a necessary but not sufficient focus for those seeking to understand world politics under conditions of contemporary globalisation.

World politics as international relations

The dominant theoretical approaches to international relations proceed from the premise that world politics is organised around the system of states first formalised by the Treaty of Westphalia in 1648. Embedded into these theories is a political geography which divides the world up into hermetically sealed parcels of land, each governed by a sovereign body wielding absolute and exclusive authority. Political power and authority are predicated on conceptions of place, and conceptions of place are dictated to an overwhelming extent by the territoriality of the state. In this way the state monopolises power and authority in the world political system. As Walker (1995, p. 29) observes 'because states are, other forms of politics cannot be... it is not possible to make claims about *world* politics, except as a way of describing *relations* among states' (emphasis in original). This is not to say that non-state actors were ignored entirely. Theories of international relations acknowledged that other actors including international institutions and multinational enterprises participated in world politics. However, it was thought that the overarching framework provided by inter-state relations determined the behaviour of these actors (Waltz, 1979). To borrow an analogy from Kenneth Waltz (1979, p. 94) while states scripted and acted out the main contours of the drama, non-state actors were the supporting cast working within the play's main narrative.

In the 1970s and 1980s it became increasingly obvious that certain aspects of world politics, particularly those pertaining to the management of the global economy, were becoming less susceptible to interpretation by approaches which emphasised an exclusive focus on inter-state relations. Scholarly apprehension about the potential shortcomings of analyses that overlooked or marginalised the role of non-state actors stimulated a series of theoretical innovations. Work on transnational relations (Keohane and Nye, 1972; Strange, 1976), interdependence (Keohane and Nye, 1977) and international regimes (Krasner, 1983) all assigned a more prominent role to non-state actors. These ideas appeared to convey a more complex image of world politics, where outcomes were mediated by a variety of different types of actors. However, beneath the surface these theories clung to the belief that states continued to be the major sources of power and authority. Non-state actors were invariably seen as truncating, conditioning or contributing toward state action. That is to say they were important only to the extent that they shaped the preferences of states and hence inter-state relations, denying them the ability to possess or exercise authority in their own right.

These theoretical innovations were important to the extent that they revealed underlying concerns about the deficiencies of state-centric approaches and expanded world politics' empirical terrain to encompass more detailed consideration of non-state actors. Nevertheless the value of these theories was compromised because of their reluctance to seriously challenge international relations' epistemological and ontological foundations. This did not disguise the fact that many commentators doubted whether a model of international relations was capable of offering a comprehensive explanatory framework for understanding world affairs.

The globalisation of world politics

The debate on globalisation has largely been conducted between two diametrically opposed schools of thought. Conventional wisdom informed by what Held *et al.* (1999, p. 3) have labelled the 'hyperglobalisation thesis' maintains that globalisation has diffused power and authority away from the state to regional, global and private actors. Scientific advances in communications and technology have permitted political, social and economic processes to be organised on a global scale generating alternative forms of social organisation which are seen to be progressively displacing the state. The state, far from being the principal source of political power and authority, is portrayed as a peripheral actor on the global stage. This has devastating consequences for theories of world politics founded on the principle that states are the main actors. If the state has ceased to be the sole or the main 'structure of authority' (Rosenau, 1997) then studies of inter-state relationships are unlikely to tell us much about contemporary world politics. Those adopting a more 'sceptical' (Held *et al.*, 1999, p. 5) stance on globalisation have challenged these assertions. Sceptics accept that the world is becoming more integrated, but that these changes are superficial. Firstly, they point to the fact that current levels of interconnectedness are not unprecedented and that therefore we cannot be said to be living in an environment which is qualitatively different from the past. Secondly, they argue that the evidence points not to globalisation but to intensified *internationalisation* (Hirst and Thompson, 1999). This careful use of language infers that the majority of the world's political interactions continue to be between states, allowing them to argue that globalisation is a myth, the state is unmolested, and that it should continue to form the primary focus for those engaged in the discipline of world politics.

The perspectives of the hyperglobalisers and the sceptics are now widely regarded as epistemologically and empirically suspect. From a methodological standpoint the state and globalisation are inaccurately presented as competing forms of social organisation engaged in a zero-sum battle for power and authority in world affairs where any advance for the forces of globalisation is automatically assumed to weaken the authority of the state (Clark, 1999). This overlooks the reality that many of the trends discussed under the rubric of globalisation are sanctioned and enthusiastically supported by states. Empirically speaking it is difficult to sustain the position implied by the sceptics that nothing is changing in world politics. Equally it is difficult to sustain the hyperglobalisers' position that globalisation has swept away states and the state system.

The obsession with the effect of globalisation on the state's power and authority has deflected attention away from the more complex transformations of power and authority wrought by contemporary globalisation. The real significance of globalisation for the study of world politics lies in its specification as an 'ation' not a 'nation'. Most writing on globalisation now concludes that the state endures as a significant actor but that at the same time authority is more diffuse. The 'ation' suffix suggests that authority is not monopolised by the state. World politics can no longer be viewed as a world of states but is instead a vibrant mosaic of ceaselessly changing authoritative actors that includes but is not reducible to the state. The clear, straightforward and parsimonious conceptualisation of world politics offered up by international relations perspectives is being supplanted by a vision of the world political system that is messy and 'turbulent' (Rosenau, 1997). Using these observations the remainder of the chapter will advance three related propositions regarding the way we conceive of and study world politics as an 'ation'. Firstly, states continue to form an integral part of our physical and imagined landscape and so states and inter-state relations form a proper avenue of inquiry for those seeking to explain and understand world politics. Secondly, scholars of world politics should be sensitive to the redefinition of the role of the state and its impact on the way that inter-state relations are conducted. Finally, while states are still important, world politics is constituted by a plethora of other actors, and consideration must be given to how non-state structures of authority contribute to world order.

World politics as an 'ation'

The state has proved to be a remarkably robust and successful method of organising political space but this has not prevented periodic consideration about its impending or actual demise. The onset of the nuclear age had paradoxical implications for the power of the state. On the one hand nuclear weaponry was the means through which states could produce massive destruction and as such represented a potent symbol of the state's enduring power and authority. On the other hand, states were vulnerable to destruction from nuclear warheads owned by their enemies. States were effectively rendered obsolete because they could no longer fulfil their basic function of guaranteeing the security of their citizens through maintaining their territorial integrity (Herz, 1957). Subsequent events have shown this to be a spectacular miscalculation. The state has not only survived, it has positively flourished. Over the past 40 years over 100 new sovereign states have come into existence sponsored largely by decolonisation and, more recently, the collapse of the former Soviet Union. Given the rapid expansion in the number of states plus the many nationalities who aspire to statehood it seems unrealistic to forecast the disappearance of the state in the near future. The real debate is not whether the state will persist but about what roles it will play in world politics.

Most authors now assert that despite the intensification of globalising tendencies the system of sovereign states is still one of the dominant patterns of world politics. These bilateral and multilateral interactions and the treaties, institutions and organisations arising from them provide the 'scaffolding' (Brenner, 1999) on which globalisation depends. If anything globalisation has forced states to increase the intensity and the frequency of their contacts as they grapple with urgent new problems arising out of globalisation including the environmental degradation, financial crises and instability and the proliferation of weapons of mass destruction. In many areas the power and authority of the state is paramount and international relations tend to predominate. If one takes the example of security, the world's flashpoints of conflict are normally the result of, and resolved by, state mediation. Notwithstanding the emergence of terrorist organisations and worries about their ability to acquire and deploy weapons of mass destruction or disruption,[1] the fact remains that they are peripheral actors. They are no match for the state in terms of their ability to finance and sustain violent conflict. Moreover their involvement in world politics tends to be transient. They drift in and out of world politics rather than constituting the overarching set of political relationships. In other areas such as the politics of the global economy and the environment the state's grip on power and authority is perhaps more tenuous. Nevertheless vast swathes of economic activity are governed, nominally at least, by intergovernmental arrangements, most notably by international institutions such as the International Monetary Fund and the World Trade Organisation. Similarly global environmental governance has been marked by a growth of international law and regimes (Young, 1997).

However, the state is not a static entity. There are many who argue that states and inter-state relationships are undergoing profound upheaval. Some observers believe that the traditional conception of the state as a unitary body is outdated. They believe that the state 'is disaggregating into its functionally distinct parts'. In turn these distinct parts – including government departments, regulatory agencies, executives and legislatures – are 'networking with their counterparts abroad, creating a dense web of relations that constitutes a new, transgovernmental order' (Slaughter, 1997, p. 184). In other words alternative forms of inter-state consultation now supplement traditional inter-state bodies. This phenomenon can be seen across a wide range of fields but is has arguably proceeded furthest in the field of global financial governance. Since 1974 the Basle Committee on Banking Supervision (BCBS), composed of officials from the central banks and main regulatory authorities of the so-called Group of 10, has promulgated broad supervisory standards designed to promote best practice and improve the quality of banking regulation. Similar bodies exist for the regulation of the securities industry (the International Organisation of Securities Commissions (IOSCO)) and the insurance sector (the International Association of Insurance Supervisors (IAIS)).

Finally it is now widely recognised that inter-state relationships are enmeshed in much broader patterns of world politics. Two things are worth noting about non-state actors in contemporary world politics. Firstly there are a lot more of them. The growth of international non-governmental organisations (INGOs) is indicative of the explosion in the total number of non-governmental actors. In 1996 there were 5472 INGOs, over 30 times the number that existed in 1909 (Held *et al.*, 1999, p. 53). Secondly, and more importantly, scholars of world politics are no longer seeing non-state actors as mere adjuncts to the state system but to be the possessors of political power and authority which supplement and on occasion supplant the authority of the state. A number of volumes have recently been dedicated to assessing the role and the extent of private and non-state structures of authority in world politics (see for example Cutler *et al.*, 1999; Higgott *et al.*, 2000; Ronit and Schneider, 2001). The general consensus is that private and non-state structures of authority in world politics have neither been dormant nor insignificant but the novelty in the current epoch is in the breadth and depth of their influence. The surveys also signify that there are very few aspects of world politics that have not been penetrated by alternative structures of authority and where such authority does not operate. Private arrangements now govern significant portions of global affairs from the Internet and telecommunications through to insurance and pharmaceutical and chemical safety standards. Non-state organisations have thrived in part because of the emergence of global issues and problems that states and their various collaborative institutions have proved ill-suited or unwilling to deal with. There are areas of global politics that are governed largely by private structures of authority. The esoteric and arcane world of financial markets has proved to be a fertile area for the growth of private authority. This is exemplified by the politics of developing standards for accounting and auditing, something that has been brought into sharp relief following the recent corporate scandals in the United States. International standards have been almost entirely developed by the International Accounting Standards Board and its predecessor, the International Accounting Standards Committee. However, areas where private authority is dominant are still the exception. In most cases states share the stage with non-state actors, with world order being shaped by a morass of authority structures. For example an inter-state body, the Financial Action Task Force (FATF), is at the forefront of efforts to combat money laundering. However FATF is now augmented by a series of initiatives launched by the private sector, most notably the Wolfsberg Anti-Money Laundering Principles launched in 2000 by 11 leading international private banks in conjunction with Transparency International (an INGO).

There are a great number and diversity of authoritative actors in world affairs. States retain their status as critical structures of authority in world affairs but we inhabit a world where 'international' no longer embraces much of what transpires across national boundaries (Rosenau, 2000, p. 171) and where many of the world's political problems are resolved by a multitude of authoritative actors.

Conclusion

Globalisation as an 'ation' is fundamentally altering the way world politics is conceived. For many years the state was held to be the main structure of authority in world politics. Analysts earnestly believed that the door to the mysteries of world politics could be unlocked by probing states and their interactions. This image of world politics was increasingly at odds with how many people viewed and experienced the world. The early literature on globalisation was insufficiently nuanced, advocating the need for either wholesale change or essential continuity in our understanding of world politics. More recent literature emphasises that globalisation points to aspects of both continuity and change in world politics. There are many areas of world politics, such as in the military domain, where states persist as the pivotal structures of authority and where inter-state relations do largely account for the outcomes that are observed. At the same time there are other areas, such as the economy and the environment, where state authority is contested, compromised or gradually evaporating and where the slack is being picked up by structures of authority from beyond the state system. Unlike 'national' approaches to world politics the 'ation' approach views states as just one set of coordinates that should be used to plot patterns of power and authority; they should not define the map. We ought to be suspicious of approaches that certify inter-state relations to be the totality of world politics.

Finally, and on a more cautious note, the recognition that world politics is more complicated than state-centred analysis insinuates is only a first step. Theories of world politics that are capable of reflecting and deciphering the puzzles posed by our global age remain in their infancy. The challenge confronting scholars is to refine these theories to enable us to better understand world politics as we move forward into the twenty-first century.

Note

1. The idea of 'mass disruption' refers to the use of tactics designed to cripple the communications and logistical infrastructure upon which modern societies depend (Homer-Dixon, 2002). Weapons of mass disruption might include unleashing computer viruses, attempts to interfere with the production and distribution of energy supplies and the contamination of water supplies.

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18 Global governance

Mathias Koenig-Archibugi

Globalisation represents a major challenge to governance. Indeed, for many the concept of globalisation itself is inextricably linked to the idea of *ungovernability*. This association is comprehensible, since the classic locus of governance is the state, and the debate on globalisation concerns mainly the allegedly declining capacity of states to regulate what happens within their territories as a result of their growing enmeshment in cross-border flows and networks.[1]

This chapter does not address to what extent the governance capacity of states has been curtailed by global forces: other chapters in this volume assess the extensive literature on this question. Its aim is rather to review a substantial body of research which shows that the performance of governance functions is not limited to the actions of governments exercising sovereign powers over their jurisdictions, but occurs also at supranational and transnational levels. Governance – understood as the establishment and operation of rule systems facilitating the coordination and cooperation of social actors – is conceptually distinct from government – understood as an organisation in charge of administering and enforcing those rules (Young, 1999). The literature discussed in this chapter (originating mostly from political scientists and international relations scholars) maintains that governance is not co-extensive with government, and that government should not be seen as a necessary condition of governance. More specifically, it shows that the absence of a world government does not mean that governance is impossible beyond the level of individual states. Global issues such as ozone depletion, the spread of financial crises, and the prohibition of certain kinds of weapons are managed by governance structures that do not conform to the hierarchical model of rule setting and enforcement that is typical of states. The combination of these structures can be said to form a system of global governance.

What is global governance?

During the 1990s, 'global governance' emerged as the key term of a political programme for international reform[2] as well as a conceptual tool in political research.[3] Disparate issues have been examined through the lens of global governance, such as environmental standard-setting,[4] civilian police,[5] remote sensing,[6] gender relations,[7] weapons bans,[8] AIDS,[9] and the reform of the United Nations system.[10]

Lawrence S. Finkelstein (1995, 370–1) probably provided the most comprehensive description of what global governance is about:

> Governance should be considered to cover the overlapping categories of functions performed internationally, among them: information creation and exchange; formulation and promulgation of principles and promotion of consensual knowledge affecting the general international order, regional orders, particular issues on the international agenda, and efforts to influence the domestic rules and behavior of states; good offices, conciliation, mediation, and compulsory resolution of disputes; regime formation, tending and execution; adoption of rules, codes, and regulations; allocation of material and program resources; provision of technical assistance and development programs; relief, humanitarian, emergency, and disaster activities; and maintenance of peace and order.

The complexity of this description reflects the problem of conceptualising governance with precision. The term 'governance' itself has been used in a variety of contexts.[11] What is common to most uses of the term 'governance' is that it denotes a form of social steering that does not necessarily rely on hierarchy and command, as the concept of government implies, but also on processes of self-organisation and horizontal negotiation. In systems of governance, problem solving is not the preserve of a central authority able to impose solutions on subordinate agencies and individuals, but the result of the interaction of a plurality of actors, who often have different interests, values, cognitive orientations, and power resources.[12]

Sceptical views on global governance

To the extent that governance implies the possibility of 'order without hierarchy', it is especially relevant to the discussions about the management of problems in the global arena, where no supreme political authority exists. But to conceive the international or global system as orderly does not necessarily imply the recognition that a form of global governance has been established. Order is not *ipso facto* governance. According to the so-called 'realist' tradition of international studies, the main feature of the international system is anarchy – that is, the absence of a world sovereign. The international system can nonetheless be orderly, but realists hold a restrictive view of the conditions leading to international order. Order is said to be possible only through two mechanisms (stressed by two different strands within the realist tradition): the balance of power or the hegemony by one state over the rest. In the first case, order emerges as a by-product of alignment decisions made by states seeking survival.[13] In the second case it results from some degree of 'steering' by the most powerful actor in the system.[14] In both cases, order is unstable as inter-state rivalry always threatens to disrupt economic relations and generate armed conflicts for supremacy.

Other components of the realists' conception of international order contribute to their scepticism towards the idea that global governance exists or is a concrete possibility.[15] First, this tradition is interested in *international* order, understood as *inter-state* order. States are considered by far the most important actors in world affairs. To the extent that other actors have an impact on global political and economic conditions, this happens within a framework constituted and governed by states.[16] Second, in the realist conception of international order there is little room for international institutions. International institutions are either irrelevant or epiphenomenal, that is devoid of autonomous causal power.[17]

Institutionalist perspectives on international governance

To date the most elaborate response to this restrictive conception of order comes from the so-called 'institutionalist' approach to international relations. Institutionalist scholars generally retain realism's emphasis on the centrality of states, but deny that institutions have no real role in creating and preserving orderly and cooperative relations between states. On the contrary, international institutions can affect deeply how states behave towards each other, and enable them to cooperate in matters where otherwise conflictual relationships would have prevailed.[18]

The institutional form that has attracted more attention and study is international regimes, that is 'sets of principles, norms, rules, and decision-making procedures around which actor expectations converge in a given issue area of international relations' (Krasner, 1983, 2). It is the pervasive presence of regimes that enabled several scholars to conclude that 'governance without government' is a real feature of the global system (Rosenau and Czempiel, 1992).

While all institutionalists agree that international regimes *do* matter in international politics, they disagree on the best way to characterise their impact. This disagreement reflects a more general divide between rationalist ('thin') and sociological ('thick') institutionalism in political science.[19] According to the former, institutional rules operate as external constraints, providing incentives and information to rational actors whose preferences are exogenously determined (or assumed for heuristic purposes). According to sociological institutionalists, on the other hand, institutions affect actors' choices in a broader range of ways: by defining standards of culturally and normatively appropriate behaviour and common world views, they structure not only external incentives but also the basic goals and identities of actors. Institutions affect not only what actors can do, but also what they want to do and even who they are.

These differences are reflected in the study of international regimes (Young, 1999). Rational-choice institutionalists in international relations theory often draw on transaction cost economics and other economic approaches, but the most developed theoretical framework for studying 'cooperation under anarchy' (Oye, 1996) derives from game theory. Non-cooperative game theory examines social situations in which rational actors cannot enter binding agreements and identifies the conditions under which cooperation is nonetheless possible (Axelrod, 1984). These results have been applied to the study of international regimes, originating a flow of theoretical and empirical work that shows how states – conceived as rational egoists – can benefit from an institutionalised environment when interacting with each other.[20]

For sociologically minded regime theorists, on the other hand, the institutional environment in which states interact does not simply affect their strategies, but participates in shaping their identity and goals.[21] Cooperation under anarchy is possible because states' actions are not oriented only to 'logics of consequences' (rational behaviour designed to maximise exogenous utility) but also to 'logics of appropriateness' (rules, roles and identities that stipulate appropriate behaviour in given situations).[22] Norms have an independent causal impact on the behaviour of actors, which have been socialised through domestic and international learning processes. The recent wave of constructivist theorising presents in a different form some of the insights of the English school, which depicted the international system as an 'anarchical society' (Bull, 1977) where order is assured by a mix of power politics and common values.

The effects of international institutions in general and of regimes and organisations in particular on the behaviour of states are summarised in Table 18.1.

From international regimes to global governance

Regime theory has produced an impressive amount of theoretical and empirical knowledge on various aspects of international affairs. This body of knowledge is an indispensable foundation for the study of global governance. Conventional regime theory, however, tends to ignore the contribution of non-state actors to the management of cross-border issues. The concept of governance, on the contrary, is frequently used to convey the idea that public actors have no monopoly over the resolution of public problems and that they increasingly collaborate with other actors in various stages of the policy-making process (Koenig-Archibugi, 2002). This section provides an overview of the literature on the contribution of non-state actors to global governance, and focuses on three types of non-state actors: not-for-profit non-governmental organizations (NGOs), business entities, and the staff of intergovernmental organisations (IGOs).

Over the last decade there has been a proliferation of studies on NGO participation in global public policy, which have examined several issue

Table 18.1 Functions of international institutions and organisations according to institutionalist approaches to world politics

	INTERNATIONAL INSTITUTIONS AND ORGANISATIONS:
Rationalist institutionalism	provide information about common problems
⇓	provide information about preferences
	facilitate the signalling of intentions
	constrain bargaining strategies
	provide focal points in negotiations
	facilitate tactical issue linkage
	increase the credibility of promises
	multiply interactions
	disseminate information about past behaviour
	define obligations and cheating
	define appropriate sanctions for non-compliance
	improve the monitoring of compliance
	coordinate decentralised sanctioning
	define standard operating procedures
	stabilise routines
	generate cognitive models
	define rules of appropriate behaviour
⇑	consolidate normative world views
Sociological institutionalism	shape the formation of identities

areas: human rights,[23] rules of war,[24] humanitarian emergencies,[25] gender issues,[26] economic development,[27] demography,[28] health policy,[29] business regulation,[30] and environmental protection.[31] Several studies provide comparisons across issue areas or general reflections on public–private cooperation.[32]

According to Thomas Risse (2001), it is no longer disputed that NGOs and other 'not for profit' transnational actors make a difference in world politics: now the interesting question is why, and under what conditions. Some go as far as claiming that, in the steering of global affairs, states have been joined by other actors that are 'equally important' (Rosenau, 2000, 187).

The available evidence does not support the 'equal importance' thesis: global public policy making is characterised by conspicuous asymmetries in power and tasks, and the current balance of power (still) favours states. Having said that, it seems indeed indisputable that NGOs are nearly ubiquitous, having established their presence in virtually all international policy domains. They are well entrenched in traditional areas such as development policy, humanitarian assistance and environmental protection, but their presence is increasing also on previously less accessible issues like finance (debt cancellation) and arms control (land mines). Wolfgang Reinicke and his associates (2000) showed that a number of important global problems are dealt with by tripartite networks, bringing together public agencies, business actors and advocacy groups on an informal basis. It has even been argued that 'human rights NGOs are the engine for virtually every advance made by the United Nations in the field of human rights since its founding' (Gaer, 1996, 51).

On the other hand, presence is not necessarily influence. For instance, the authors of a comprehensive study of the relationship between three global social movements (environmental, labour and women's movements) and three multilateral economic institutions (the IMF, World Bank and WTO) conclude that some change in the way the institutions make policy has occurred as a result of this relationship, but they add: 'While signalling an alteration to the method of governance, it is less clear that there is a change either in the content of governing policies or in the broad interests they represent' (O'Brien *et al.*, 2000, 206). Another study, comparing NGO 'participation' in the UN World Conferences on the environment, human rights and women held during the 1990s, shows that NGOs were granted high visibility and access to many official fora, but there is little evidence that the states accepted the NGOs' perspective on the problems debated. Considering moreover that access itself was conditional, the authors conclude: 'state sovereignty set the limits of global civil society' (Clark *et al.*, 1998, 35). In sum, the existing empirical literature on the contribution of NGOs to global governance does not seem to allow general conclusions yet.

With regard to the role of the business actors in the management of cross-border activities and exchanges, several recent studies demonstrate that this is significant. Some sceptics hold that 'International firms create the need for improved international governance, but they do not and cannot provide it' (Grant, 1997, 319), but other researchers have shown that, in many areas, business actors have established transnational regimes that give order and predictability to the massive flow of transactions that takes place across state borders. A major study on global business regulation finds that in all the sectors considered 'state regulation follows industry self-regulatory practice more than the reverse' (Braithwaite and Drahos, 2000, 481). Other researchers have highlighted several regimes whose members are mainly or exclusively private actors.[33] These transnational regimes overlap with and sometimes are functional equivalents of the international regimes established by governments. In addition, business actors – that is interest associations or powerful corporations – participate regularly in the international policy-making process, and in many cases have a decisive influence on the outcomes.[34]

Conventional regime analysis tends to neglect not only non-state actors such as NGOs and companies, but also international organisations *as organ-*

isations. Most institutionalist analyses focus on the operation and effectiveness of regimes, which are not actors in their own right and affect outcomes only by influencing the behaviour of members and others subject to their provisions. In comparison, less attention has been paid to intergovernmental organisations, which often are at the centre of a regime and which in principle *are* capable of agency.

Research on IGOs as autonomous policy-making actors has been quite scarce.[35] However, in the past few years a number of studies have advanced interesting hypotheses about the goals, functions and power of IGOs, which can provide a theoretical foundation for further empirical research.[36] Case studies of multilateral negotiations have already highlighted the active role of the bureaucrats who staff international organisations, showing that they are able to exercise influence by forging strategic alliances, sponsoring research, mobilising technical expertise, raising public awareness, and playing a leadership role in negotiations.[37] This involves a certain degree of operational autonomy, that is the officials' capacity to act independently of their 'principals' – namely, the governments that have collectively delegated functions to them.

In sum, the management of global affairs is not the preserve of governments, but involves a broad range of actors, at the domestic and transnational levels. Specifically, global governance implies that firms and NGOs are not simply the passive recipients of the rules negotiated by governments above their heads, but participate in various ways in the formulation of those rules through public–private partnerships, or even by establishing purely private regimes to regulate certain domains in their common interest. Therefore, *actor pluralism* should be added to the *possibility of non-hierarchical order* and the *role of institutions* as a defining characteristic of global governance.

Normative perspectives on global governance

This chapter had focused on analytical and empirical work on global governance, but normative approaches to the problem deserve at least a brief mention. The legitimacy of global governance can be assessed from a variety of perspectives, most of which are based on the commitment to democracy as an essential condition for the legitimisation of political orders.[38] Roughly two main positions can be distinguished: democratic inter-governmentalism and democratic cosmopolitanism.

According to democratic inter-governmentalism, global governance cannot receive direct democratic legitimisation, but must obtain its legitimacy indirectly through the participation of democratically elected governments in global policy making.[39] In this view, democracy requires a public sphere, and no transnational public sphere exists now or is in sight. There are at least two formidable obstacles to the formation of a public sphere beyond the nation state, one cognitive and one affective. On the one hand, democratic deliberation is impossible when *de facto* the majority of people is excluded from global networks of political communication, notably because of insufficient foreign language skills. Deliberation in supranational fora would be monopolised by educated elites and therefore remain undemocratic. On the other hand, the acceptance of the results of collective and possibly majoritarian decisions requires a degree of solidarity and sense of common belonging that is extremely weak beyond the national level.

According to democratic cosmopolitanism, democratic legitimacy can and should be conferred through multiple channels, in a pattern that corresponds to the pluralistic character of global governance. Moreover, the democratisation of international institutions itself can extend the focus of concern and loyalty of individuals and groups beyond the national dimension, and for this reason democratic restructuring should be conceived as a dialectical process of mutual reinforcement. Cosmopolitan institutions (such as a global assembly of peoples and international tribunals) will enhance the effectiveness of global public policy making by increasing its legitimacy and at the same time they will promote domestic democracy.[40]

Notes

1. Held *et al.*, 1999; Hirst and Thompson, 1999; Koenig-Archibugi, 2003.
2. Commission on Global Governance, 1995.
3. Rosenau, 1997; Held and McGrew, 2002.
4. Clapp, 1998.
5. Johansen, 1999.
6. Litfin, 1999.
7. Meyer and Prügl, 1999.
8. Price, 1999.
9. Söderholm, 1997.
10. Knight, 1995
11. See the overview in Hirst (2000).
12. Rosenau, 1997; Pierre, 2000.
13. Waltz, 1979.
14. Gilpin, 2001.
15. Gilpin, 2002.
16. Waltz, 1979; Krasner, 1995.
17. Strange, 1983; Mearsheimer, 1994/95.
18. Koenig-Archibugi, 2001.
19. Hall and Taylor, 1996; Scharpf, 2000.
20. Stein, 1982; Keohane, 1984; Snidal, 1985; Oye, 1996; Martin, 1999; Haftendorn *et al.*, 1999.
21. Kratochwil, 1989; Katzenstein, 1996; Finnemore, 1996; Ruggie, 1998; Wendt, 1999; Risse, 2000.
22. This distinction stems from March and Olsen (1989).
23. Cohen, 1990; Gaer, 1996; Korey, 1998; Thakur, 1994; Tolley, 1994.
24. Finnemore, 1999; Price, 1999.
25. Natsios, 1996; Weiss, 1995.
26. Berkovitch, 1999.
27. Chabbott, 1999; Fox and Brown, 1998; Nelson, 1995.

28. Barrett and Frank, 1999.
29. Jönsson and Söderholm, 1996; Söderholm, 1997
30. Braithwaite and Drahos, 2000; Smythe, 2000.
31. Arts, 1998; Lipschutz and Mayer, 1996; Raustiala, 1997; Wapner, 1996.
32. Boli and Thomas, 1999a; Charnovitz, 1997; Clark *et al.*, 1998; Gordenker and Weiss, 1996; Higgott *et al.*, 2000; Keck and Sikkink, 1998; O'Brien *et al.*, 2000; Willetts, 1996.
33. Haufler, 2001; Spar, 1994; 1999; Dezalay and Garth, 1996; Ronit and Schneider, 2000; Salter, 1999; Webb, 1999.
34. Braithwaite and Drahos, 2000; Sell, 2000; Ruggie, 2003.
35. Verbeek, 1998.
36. Abbott and Snidal, 1998; Barnett and Finnemore, 1999
37. Hampson, 1995. See also Cox *et al.*, 1974; Ness and Brechin, 1988; Koenig-Archibugi, 1997; Reinalda and Verbeek, 1998; Gagné, 2000.
38. McGrew, 2000; 2002.
39. Grimm, 1995; Scharpf, 1999; Hirst and Thompson, 1999; Dahl, 1999; Kymlicka, 1999.
40. Falk, 1995; Archibugi, 2003; Held, 2003. See also Keohane (2003).

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19 The political economy of the third way: the relationship between globalisation and national economic policy

Simon Lee

Introduction

There have been few more important recent debates in the discipline of political economy than those relating to the relationship between globalisation and national economic policy. Three principal perspectives have been advanced (Held *et al.*, 2000). First, the 'hyperglobalisers' who have contended that globalisation has rendered national economic policy largely redundant (Ohmae, 1995). Second, the 'sceptics' for whom the notion of the powerless state has been exaggerated to the point of mythology (Weiss, 1998). Third, the 'transformationalists' for whom globalisation has unleashed an unprecedented period of social change upon states and societies (Giddens, 1998; Blair, 1996). These perspectives have been accompanied by a parallel discourse concerning the transition from government to governance in the relationship between the public and private, and the state and market, in the conduct of economic policy making at all levels from the local to the global (Pierre, 2000). The ideological context of these discourses has been a vigorous argument concerning the viability and legitimacy of the economic policy prescriptions of the neo-liberal orthodoxy of the 'Washington Consensus' (Williamson, 1993). On the one hand, the market fundamentalism of the 'Washington Consensus' has been vigorously promoted in the policies of the International Monetary Fund (IMF) (Lee, 2002), World Bank and World Trade Organisation. On the other hand, the likely dividend both for global growth and national economic development has been contested by academics (Gray, 1998; Hutton, 2002), market traders (Soros, 1998), Nobel Prize winning economists (Sen, 1999; Stiglitz, 2002) and the anti-capitalist movement (Bircham and Charlton, 2001).

This chapter analyses the relationship between national economic policy and globalisation by initially exploring the changing global environment for policy making during the 1990s. It then focuses upon the political economy of the third way as implemented by the Blair Governments in the United Kingdom (UK) since May 1997. The UK provides a particularly important case study for analysing the impact of globalisation upon national economic policy choices for three reasons. First, the era of globalisation has been much longer and more pronounced for the UK economy than for most of its major competitors (Hirst and Thompson, 2000). Second, the presence of the volatile markets of the City of London since long before the UK became the world's first industrialised economy has confronted successive UK governments with the challenge of attempting to implement and reconcile expansionist domestic modernisation strategies, designed to arrest the UK's longstanding relative economic decline, with the more orthodox and prudential economic policies required to maintain sufficient confidence among the City's investors to avoid undermining the value of the pound sterling. Third, the economic policies of the third way implemented by the Blair Governments have assumed that there is no insurmountable conflict between New Labour's domestic modernisation agenda and the exigencies of globalisation. Indeed, New Labour has been almost messianic in its advocacy of the opportunities provided by liberalised markets and globalisation, not only to remedy national decline but also to both improve the performance of the European Union's economies (HMT, 2001) and eliminate world poverty (DfID, 2000). However, the chapter concludes that the third way has overestimated the capacity of national governments to manage the economic, political and social consequences of the risk, volatility and contagion which is characteristic of liberalised global markets.

'One size fits all': the rise of the Washington Consensus

The global environment for national economic policy making has changed dramatically since the early 1970s. Liberalisation of markets for capital, goods and services, the spectacular growth of Foreign Direct Investment (FDI), the volatility of financial markets allied to the increasing incidence of financial crises, and the huge political and economic power exercised by transnational corporations (Hertz, 2001) have all served to constrain the autonomy of national monetary, fiscal and competitiveness policies. For example, FDI in global markets grew by 18 per cent in 2000 to reach a record $1.3 trillion, propelled by the more than 60 000 transnational corporations and their 800 000 overseas affiliates (UNCTAD, 2001: 1). At the same time, national governments now confront a context for economic policy making in which their policies and performance are regularly audited and benchmarked in a series of monitoring reports and scoreboards produced by public institutions, notably the regular economic outlooks and national surveys produced by the IMF and the Organisation for Economic Cooperation and Development (OECD), and by private market institutions, notably the annual World Competitiveness Scoreboard and Yearbook produced by the Institute for Management Development. In addition, some national governments, notably that of the UK, and the European Union now publish their own annual reports on national competitiveness.

Given this challenging global context for economic policy making, national governments have continued to search for the optimum model among rival national capitalisms. Following the collapse of communism, it was suggested that the 'Rhine model' (characteristic most notably of Germany and Japan) would triumph over the 'neo-American' model (characteristic of the US and UK) because of its economic and social superiority resulting from an interpenetration rather than a separation (as in the US and UK) of finance and industry (Albert, 1993). In the event, the 2001 World Competitiveness Scoreboard has ranked the US as the world's most competitive economy for the fifth consecutive year. By contrast, Japan has been ranked only 26th out of 49 major industrialised economies (IMD, 2001). Indeed, where once Japan's developmental state had been identified as the model for rival economies to emulate, including the US (Vogel, 1979), by the early 1990s Japan's status had changed to that of an economy facing imminent collapse (Reading, 1992; Wood, 1992). The growth of Japan's real GDP has declined from an annual average of 4.5 per cent from 1971–1980 to 4.0 per cent from 1981–1990 and only 1.4 per cent from 1991–2000 (World Bank, 2001: 234). This decline has led eminent commentators to question whether the Japanese economy can still compete in international markets and to advocate the competitive strategies of both the Japanese government and Japan's private corporations moving closer to the Anglo-American model of competitiveness (Porter et al., 2000).

In a departure from the capital controls and managed exchange rate regime of the post-war Bretton Woods international economic order, national governments have increasingly adopted the economic policy prescriptions of the dominant neo-liberal orthodoxy of the 'Washington Consensus' (Williamson, 1993). This American model for reconciling national economic policy choices with globalisation has prescribed the pursuit of monetary stability and fiscal prudence, with budget deficits small enough to be financed without extra taxation; the establishment of priorities in public expenditure through a transfer of resources from politically sensitive areas, such as welfare payments, towards neglected fields with high economic returns, such as investment in tangible and intangible infrastructure; and tax reforms to broaden the tax base and cut marginal tax rates to provide incentives. Despite the repeated promise of a dividend of macroeconomic stability and higher rates of economic growth, the 'Washington Consensus' has actually delivered slower growth. During the inflationary and recession-ridden 1970s, annual world output growth had increased by 4.4 per cent, but this duly declined to only 3.4 per cent during the 1980s in the era of Thatcherism and Reaganomics. Following the collapse of communism and the further rolling forward of the frontiers of the market, during the 1990s, world output growth has barely averaged 3.0 per cent (IMF, 1999: 2, 27).

Having grown by 4.7 per cent in 2000, world output growth has fallen back to only 2.5 per cent in 2001 and is predicted to reach only 2.8 per cent in 2002 (IMF, 2002: 6). Furthermore, as the IMF's own data have demonstrated, far from delivering increased stability, the 'Washington Consensus' has fostered greater volatility in global markets and an increasing incidence of recessions. Most of the Bretton Woods era (1950–1972) was characterised by recessions which averaged 1.1 years and led to an average 2.1 per cent decline in output. A total of 94.4 per cent of these recessions were only one year in length. In overall terms, only 5.6 per cent of the Bretton Woods era was spent in recession. By comparison, the IMF has shown that the post-Bretton Woods era (1973–2000) has witnessed recessions averaging 1.5 years and leading to a 2.5 per cent average decline in output. While 60 per cent of these recessions were one year in length, no fewer than 32.5 per cent were two years in length and the remainder three years or longer. There were no recessions of more than three years in length during the Bretton Woods era. In terms of expansions, Bretton Woods was characterised by a 102.9 per cent average increase in output compared to an average of only 26.9 per cent since 1973. Moreover Bretton Woods saw an average 5.3 per cent annual growth rate, arising from expansions averaging 10.3 years in length which occupied no fewer than 94.8 per cent of the years from 1950–1972. In sharp contrast, the post-Bretton Woods era has seen an average annual growth rate of only 2.6 per cent and expansions which have averaged only 6.9 per cent and occupied only 86.6 per cent of the period from 1973–2000 (IMF, 2002: 45).

The political economy of the third way

Confronted by a global context for national economic policy making characterised by increasing volatility, slower rates of economic growth, and greater external scrutiny of policy, some national governments have chosen to pursue a third way, claimed to lie beyond the post-war social democratic Keynesian consensus and the more recent neo-liberal political economy of the New Right. This third way has been defined by its leading academic proponent, Anthony Giddens, as 'the renewal of social democracy in contemporary social conditions'. Globalisation, the emergence of the knowledge economy, and the rise of individualism have been held to have transformed the landscape of politics. In response to this challenging context, Giddens has claimed that the third way is able to deliver a politics capable of reconstructing the public realm, renewing public institutions, and offering an integrated and robust political programme based upon the key insight that 'a strong civil society is necessary both for effective democratic government and for a well-functioning market system' (Giddens, 2000: 2–3, 29). Although not exclusively an Anglo-American project, the ideology and policies of the third way have been most widely promulgated in the US by the Clinton Administration and in the UK by the Blair Governments. Thus, it was Bill Clinton who proclaimed in his 1998 State of the Union Address that 'We have moved past the sterile debate between those who say government is the enemy and those who say government is the answer. My fellow Americans, we have found a third way' (Clinton, 1998: 1). For his part, Tony Blair has followed Giddens in defining the third way as a 'modernised social democracy', one which understands that 'Effective markets are a pre-condition for a successful modern economy' (Blair, 1998: 1).

Prior to any evaluation of its economic policies, it is important to acknowledge the strength of the critique of the broader ideology of the third way, especially from those on the Left of the political spectrum. Giddens has himself acknowledged the criticism that the third way is 'an amorphous political project, difficult to pin down and lacking direction', which has failed 'to sustain the proper outlook of the left and hence, whether deliberately or not, lapses into a form of conservatism' (Giddens, 2000: 22). The assertion that it is fundamentally a market-driven Anglo-American project, which has accepted the basic tenets of neo-liberalism, particularly with regard to global markets, had led some of the third way's most vehement critics to suggest that third way governments have merely 'embraced and in certain respects radicalised the neo-liberal policies of their predecessors' (Callinicos, 2001: 107). Moroever, the third way has been portrayed as 'the best ideological shell of neo-liberalism today' (Anderson, 2000: 11). Despite this critique, because it has claimed to be able to reconcile globalisation with national economic development, the third way has assumed particular importance in the political economy of the UK because successive British governments have found the implementation of their respective state-led modernisation programmes undermined by repeated currency crises and a loss of investor confidence in the City of London's financial markets. While raising interest rates and cutting public expenditure has enabled past UK governments to restore confidence and stabilise the value of the pound, such short-term austerity measures have been at the expense of long-term investment in the modernisation of Britain's infrastructure, frequently resulting in damaging strikes as public sector unions have sought to defend their members' pay and employment.

The third way of economic policy implemented by the New Labour Governments led by Tony Blair therefore constitutes both a reaction to and a critique of the perceived failure of the post-war economic policies of the first and second ways. For New Labour, the first way denotes the social democratic Keynesian welfare state political settlement implemented by Labour and Conservative governments between 1945 and 1979. The economic policies of this era have been criticised for both their 'exaggerated belief in demand management' and their failure to provide macroeconomic stability 'Even in the most successful years of the postwar period' (Blair, 1996: 77, 79). For New Labour, the election of the first Thatcher Government in 1979 marked the beginning of the second way or 'British Experiment' which lasted until the defeat of the Major Government at the 1997 General Election (Blair, 1996: 82). Blair has criticised the macroeconomic policy regime of the Thatcher and Major Governments for changing 'whenever it seemed convenient' and failing 'to respond to excessive imbalances in the economy even if they are produced by the private sector' (Blair, 1996: 82–3). As a consequence, the absence of a 'tough, credible and transparent' macroeconomic framework, allied to a failure to see macroeconomic and microeconomic policy as inseparable and complementary had destabilised domestic policy, especially given the UK's location 'in the middle of an active global market for capital – a market which is less subject to regulation today than it has been for several decades'. Given this context, controlling public expenditure would be a long and gruelling slog' for New Labour and the third way (Blair, 1996: 84–6).

A fixation with stability and prudence

To surmount the errors of the first and second ways, for the Blair Governments the implementation of national economic policy in an era of globalisation and open-deregulated markets has meant a fixation with stability and prudence in monetary and fiscal policy. The Blair Government's primary monetary policy objective for the Bank of England has been the maintenance of price stability. Indeed, the Bank should only support the Government's growth and employment objectives, subject to the maintenance of price stability. To demonstrate New Labour's commitment to low inflation and stability in monetary policy, one of Gordon Brown's first acts as Chancellor of the Exchequer in May 1997 was to grant the Monetary Policy Committee (MPC) of the Bank of England full operational independence. To achieve price stability, the MPC was charged with setting interest rates to an inflation target (the Retail Prices Index excluding mortgage interest payments) of 2.5 per cent. Like many elements of New Labour's economic policy, this constituted a refinement of the policies first adopted by the Major Government. In October 1992, the Conservative Chancellor Norman Lamont had set an explicit inflation target of 1–4 per cent, a target whose range was narrowed to 2.5 per cent by his successor, Kenneth Clarke. Inflation had averaged 2.8 per cent from 1993–1997 under the Conservatives' monetary policy framework. The accomplishment of an average inflation rate of 2.4 per cent during the Blair Government's first term of office, with inflation moving within the range of 1.8–3.2 per cent appears to have vindicated the third way's framework for monetary policy. The spectre of currency instability, devaluation crises and rising inflation, which had haunted the previous 'Old Labour' Callaghan

Government and seen inflation above 10 per cent in every year between 1974 and 1981, resulting in a tripling in prices (Richards, 2002: 9), appears to have been banished for good. However, this achievement of price stability has come at a very high price for the UK's manufacturing sector.

While the MPC's interest rate setting has neither damaged the growth of the UK's services sector nor dampened the rampant property market in London and the South East of England, the biggest shortcoming of New Labour's monetary policy has been its failure to create the conditions to redress either the process of deindustrialisation or the deterioration in the UK's balance of payments. Accounting for around 5 per cent of global trade, the UK remains the world's fifth largest exporter of goods and services. Exporting more per capita than either the US or Japan, in 2000 exports accounted for 27 per cent of the UK's GDP (ONS, 2002a: 383). However, under the Blair Governments, the UK's annual balances on its current account and overall balance of payments have continued to deteriorate, accentuating the trend established by the economic policies of the second way. During the 1990s, UK manufacturing had grown at an annual rate of only 0.5 per cent. Having recorded a surplus of £2.7 billion in 1980, the UK's trade balance in manufactured goods had fallen into deficit in 1984, a trend sustained throughout the remaining tenure of the Thatcher and Major Governments.

Under New Labour, there have been few signs of a reversal of deindustrialisation. In 1999, the UK's current account deficit was £9.9 billion, but this increased to £16.2 billion in 2000. The figure for 2001 witnessed a further deterioration to £20.5 billion, with a further deficit of £5.6 billion recorded for the first quarter of 2002 – compared with a deficit of £4.3 billion in the first quarter of 2001 (ONS, 2002b: 1). These figures have concealed an even worse performance on the UK's trade in manufactured goods. Although the services sector accounted for 3.8 times as much GDP and more than five times as much employment in 2000, manufacturing nevertheless accounted for 18.7 per cent of gross added value (at current basic prices) and 3.9 million jobs or 15.2 per cent of UK employment. Manufacturing productivity in the UK is also 25 per cent higher than in the other sectors of the UK economy. Moreover, manufacturing exports in 2000 of £187.1 billion vastly exceeded the £67.2 billion of UK exports of services. Imports of goods to the UK in 2000 were £215.9 billion, resulting in a then record trade in goods' deficit of £28.8 billion (ONS, 2002a: 468). Unfortunately, the UK's trade balance in goods has continued to deteriorate in 2000 and 2001 with record deficits being recorded of £30.4 billion and £33.6 billion respectively (ONS, 2002b: 1). The cumulative impact of successive deficits has been to move the UK's overall financial account and investment position from one of substantial surplus to one of substantial deficit. Indeed, at the end of 2000, despite a net balance on direct investment of £281 billion, UK external liabilities exceeded assets by £123 billion (ONS, 2002a: 415).

From negotiated discretion to centralised prescription

In the field of fiscal policy, the Blair Government's inheritance was an increase in taxation by the Major Government equivalent to around 1 per cent of GDP in 1994–5 and more than twice that in 1995–6 and 1996–7. Despite this fiscal conservatism, Gordon Brown signalled New Labour's own commitment to fiscal prudence and his own status as the 'Iron Chancellor' by adhering to the Major Government's very tight spending plans for 1997–8 and 1998–9, which meant that public expenditure would be £4 billion or 1.2 per cent lower in real terms (at 1999–2000 prices) in 1998–9 than in 1996–7. Indeed, public expenditure would fall from 41.2 per cent of GDP in 1996–7, the final year of the second way's economic policies, to 37.8 per cent of GDP in 1999–2000, a real terms decline in spending of £1.4 billion or 0.4 per cent (Dilnot *et al.*, 2001: 11–12). In this way, New Labour has chosen to 'lock in' fiscal prudence and stability through a rules-based approach to fiscal policy. A 1997 General Election manifesto pledge 'not to raise the basic or top rates of income tax throughout the next Parliament' was reinforced by the implementation of two further fiscal policy rules. First, the 'golden rule' of public expenditure, that is 'over the economic cycle, we will only borrow to invest and not to fund current expenditure'. Second, the 'sustainable investment rule', that is 'over the economic cycle, public debt as a proportion of national income is of a stable and prudent level' (Labour Party, 1997: 11–12). These rules were subsequently given greater coherence by their incorporation in March 1998 into the Code for Fiscal Stability, a measure which enshrined the Blair Government's five principles of fiscal management, transparency, stability, responsibility, fairness and efficiency.

Since most of the policies and principles incorporated in the Code for Fiscal Stability had already been put into practice by Gordon Brown, the Code constituted little more than a retrospective device for codifying and justifying fiscal policy choices to investors in the City of London's financial markets. Moreover, the 'golden rule' and 'sustainable investment rule' have been damned with faint praise by leading commentators who have depicted them as 'sensible rules of thumb, but they are no more than that'. Moreover, it has been asserted that 'There is nothing sacrosanct about these two rules, nor are they necessarily optimal' since, while adherence to these rules might maintain fiscal discipline, it might not necessarily meet New Labour's goal of spreading the burden of public expenditure across present and future generations. Indeed, 'slavish adherence to the golden rule may also be suboptimal' (Emmerson and Frayne, 2001: 2). Furthermore, eventual departure from these fiscal rules might not necessarily undermine the public finances because the

Blair Government had failed to provide any substantiation either for its selection of a target for net public debt of 40 per cent of GDP, or why it should remain constant over time, even if it was to prove to be the optimum level.

By far the most important fiscal policy innovation introduced by New Labour has been the implementation of biennial spending reviews in 1998, 2000 and 2002 because these have given the Treasury an unprecedented degree of control over the domestic policy agenda. However, this role has been consistent with Brown's own redefinition of the mission for the Treasury to act as 'the guardian of the public finances and the guarantor of monetary stability', so as to be 'not just a Ministry of Finance, but also a Ministry working with other departments to deliver long-term economic and social renewal' (Brown, 1999: 11). Under previous governments, the Treasury's capacity to control public expenditure and to intervene in domestic policy choices had been based upon 'the exercise of discretionary authority constrained by the exercise of countervailing discretionary power by each autonomous spending department in the particular circumstances of an expenditure proposal' (Thain and Wright, 1995: 537). New Labour's spending reviews, commencing with the year-long Comprehensive Spending Review (CSR), published in July 1998, have helped to accomplish a 'paradigm shift' in expenditure planning and control. This has threatened 'the permanent abandonment (not merely temporary relaxation) of the pre-existing paradigm of negotiated discretion' (Thain and Wright, 1995: 543) in favour of a Treasury-driven system of central prescription over expenditure and policy choices.

The Treasury's increasing control over domestic policy choices, especially in the English regions beyond London which have lacked the counterbalance of elected, devolved governments similar to those operating in the other constituent nations of the UK, has been entrenched further by the principle of 'money for modernisation'. Whitehall departments and other public spending bodies have been allocated additional resources by the Treasury, but only in accordance with Public Service Agreements (PSAs) and Service Delivery Agreements (SDAs) which have incorporated new objectives, defined by central government, and measurable efficiency targets, including measures of policy outputs, inputs and processes. The creation of the spending reviews, the PSAs and SDAs, and the role this has accorded the Treasury, has attracted a withering critique from the House of Commons' Treasury Select Committee (TSC). It has taken a malign view of the Treasury's greatly increased power over 'the strategic direction of the Government', claiming that 'The Treasury as an institution has recently begun to exert too much influence over policy areas which are properly the business of other departments and that it is not necessarily in the best interests of the Treasury or the Government as a whole' (TSC, 2000: paras 19, 21). Moreover, in exercising this undue influence, rather than practising transparency the Treasury's role has been portrayed as being 'opaque, hidden behind a curtain of Whitehall secrecy' (TSC, 2001: para 48).

The failure of the UK competition state

If its monetary and especially its fiscal policies have proven controversial, the third pillar of the Blair Government's third way approach to economic policy has been much more aligned with developments in policy elsewhere. Globalisation of markets has inspired a transformation in the role of the advanced industrialised state away from its previous incarnations as a social democratic welfare state or industrialisation-driven developmental state, and towards a competition state. Having previously served as a decommodifying hierarchy, attempting to withdraw certain economic activities from the realm of the market, the contemporary competition state has acted increasingly as 'a collective commodifying agent – that is, putting activities *into* the market – and even as *a market actor itself*' (Cerny, 1997: 267). This transformation has in turn been marked by a movement from industrial policy through competitiveness policy to enterprise policy, that is a shift in public policy 'away from policies that constrain the freedom of firms to contract and towards policies enabling the start-up and viability of knowledge-based entrepreneurial firms', not least because 'the comparative advantage of the high-cost countries in the OECD is increasingly based on knowledge-driven innovative activity' (Audretsch and Thurik, 2001: 5, 29).

One of the most conspicuous trends in competitiveness policy has been the emphasis, both rhetorically and in the substance of policy, placed upon the importance of the quality of the institutional and policy environment for fostering an entrepreneur-driven enterprise culture capable of generating new sources of innovation, employment and prosperity. The Blair Government has been at the forefront of these trends in economic policy. Drawing upon the insight that 'The only meaningful concept of competitiveness at the national level is national productivity', and that certain characteristics of a nation can create and sustain competitive advantage through a highly localised process (Porter, 1990: 6–13), Gordon Brown has defined the objective for the UK economy for the forthcoming decade as achievement of 'the fastest rise in productivity of competitor economies' so as to create 'a wider and deeper enterprise culture that promotes investment and entrepreneurship and rewards success' (Brown, 2001a: 2–3). However, despite its attempts to bridge the productivity gap, the Blair Government's own most recent evaluation of the UK's competitiveness has concluded that the UK's 'overall performance in terms of GDP per head and productivity is disappointing' (DTI, 2001: 80). While the UK's GDP per head remains near to the EU average, it is nevertheless 21 per cent below the G7 average. More importantly, whether in terms of output per worker or output per hour worked, the UK remains far behind the US, France and Germany, with the gap widening (in terms of output per worker) between the UK and the US during the first three years of the Blair Government. This poor performance has been attributed by New Labour to some of the poorest levels of basic literacy and numeracy in the OECD countries, an R&D performance which is falling further behind the UK's principal competitors, a failure to develop attitudes to risk-taking characteristic of a genuine enterprise society, and 'decades of underinvestment, both public and private' (DTI, 2001: 80). None of these weaknesses are likely to be redressed in the short to medium term by the economic policies of the third way.

Conclusion

In implementing its third way of economic policy making, in an attempt to reconcile domestic policy choices in the UK with globalisation, New Labour has claimed not only to have stabilised both monetary and fiscal policy but also to have broken 'decisively with the short-termist secretive and unstable record of macroeconomic policy-making of the past two decades' (Brown, 1999: 10). Indeed, prior to the 2001 General Election, the Blair Government was able to claim 'A new and hard won stability', manifested in 'the lowest inflation for 30 years; the lowest long term interest rates for 35 years; mortgages now averaging £1200 a year lower than under the last Government; more people in work than ever before; and the lowest unemployment since 1975' (Brown, 2001b: 1). However, if the UK has enjoyed low inflation and stability in monetary policy, this has been as much a consequence of generally low global commodity prices, especially for oil, a scenario which could rapidly change should the US opt for further military action against Iraq. If prudence has been attained in fiscal policy, with the national debt falling from 44 per cent of GDP in 1997 to 31.8 per cent in 2001, it has owed as much to an initial austerity in public expenditure which has served only to further delay long overdue modernisation of the UK's deteriorating physical and human infrastructure, and to a rise in government revenues from 37.6 per cent of GDP in 1997 to 40.5 per cent of GDP in 2001 – rises in indirect taxation more than compensating for cuts in direct taxation on both individuals and businesses. Furthermore, the Blair Government's competitiveness policies have singularly failed to bridge the productivity gap with the UK's principal competitors.

The third way has not reconciled UK domestic economic policy choices with globalisation in a manner that has been able to insulate domestic modernisation from the consequences of increasing volatility and contagion in global financial markets. Thus, in the year to June 2002, UK manufacturing output had fallen by 5.3 per cent, the largest fall since January 1979 (*The*

Guardian, 6 August 2002). Long-term stability in monetary and fiscal policy cannot be guaranteed in a world of liberalised financial markets and volatile short-term capital flows. When the sources of imprudence, debt, risk and instability can emanate from the private sector and liberalised markets overseas rather than solely from the public sector or domestic markets, the provision of a prudent framework for national macroeconomic policy may not be sufficient to guarantee economic stability. This is especially true for a national economy like the UK's, whose unusual degree of international integration and openness to international market forces may be 'both exposing itself to externally generated economic shocks to a greater degree than its competitors and hollowing out domestic control of manufacturing industry to the point where it falls below the critical mass necessary to sustain a distinctive national system' (Hirst and Thompson, 2000: 352).

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PART VII

INTERNATIONAL ECONOMIC INSTITUTIONS

20 The WTO and its GATS

Scott Sinclair

Introduction

The General Agreement on Trade in Services (GATS) has been described as 'perhaps the most important single development in the multilateral trading system since the GATT itself came into effect in 1948.'[1] Despite its importance, the GATS was hardly known when the Uruguay Round of international trade negotiations concluded in 1994. It has only recently begun to attract deserved public scrutiny. This broadly worded treaty to enhance the rights of international commercial service providers has potentially far-reaching public policy impacts that merit serious attention and debate.

From the GATT to the WTO

The GATS came into being when the World Trade Organization (WTO) was created on 1 January 1995, after eight years of complex and difficult negotiations. The WTO Agreements subsumed and ranged far beyond the General Agreement on Tariffs and Trade (GATT) which had regulated international trade since 1948. While the GATT system had gradually been amended and elaborated throughout the post-war period, the advent of the WTO suddenly and profoundly transformed the multilateral trading regime in several fundamental respects.

Some of the most important of these fundamental changes include:

- While the GATT was simply an international agreement among 'contracting parties', the WTO is a fully-fledged multilateral institution with 'member governments'. It now takes a place alongside the International Monetary Fund, the World Bank and other elite international economic institutions.
- While GATT rules primarily covered tariffs and trade in goods, the WTO rules cover not only trade in goods, but agriculture, standards-setting, intellectual property and services.
- While the GATT focused primarily on reducing tariffs and other 'at-the-border' trade restrictions, the far broader scope of the WTO means that it intrudes into many 'behind-the-border' regulatory matters.
- While the GATT was concerned primarily with challenging discriminatory policies, many of the new WTO agreements (SPS, TRIPS, TBT and the GATS) aim to discipline explicitly non-discriminatory measures,

either by stipulating substantive norms,[2] procedural norms,[3] or by putting the WTO dispute settlement machinery in a position to impugn explicitly non-discriminatory public standards or measures if they are deemed to be more burdensome than necessary on foreign commercial interests.[4]

- While the GATT agreements had gradually expanded to cover new matters such as procurement or standards-setting, adhering to such 'side codes' was optional. By contrast, the WTO agreements are a 'single undertaking', meaning that member governments have no choice but to be bound by all WTO agreements.
- Perhaps most significantly, while the GATT dispute settlement system was essentially 'diplomatic' (panel rulings had to be adopted by consensus, including the agreement of the defendant government), the WTO dispute system is 'legally binding' (the adoption of panel rulings can only be blocked by consensus, including the agreement of the complaining government).

These changes qualitatively transformed not only the GATT regime, but the entire multilateral system. Taken together, they amount to a constitutional shift: a fundamental reworking of the basic legal precepts of the multilateral trading regime and of its role in the international system. There is now a huge asymmetry between multilateral rules – and particularly enforcement – to protect broadly defined commercial trading interests and multilateral rule-making and enforcement in vital areas such as environmental protection, human rights, public health and cultural diversity. These changes, relatively unnoticed and undebated at the conclusion of the Uruguay round, are now proving both controversial and destabilising.

This constitutional shift has resulted in serious tension and instability in the multilateral system. These strains are evident along at least three axes. There has been north–south conflict over the development impacts of the Uruguay round agreements. Developing countries charge that implementing the WTO Agreements has been arduous and costly and that the promised development benefits have generally not materialised. Meanwhile, there have been serious East–West disputes between the major trading powers. The US and the EU, for example, have clashed over approaches to regulating food safety and environmental protection (especially regarding the role of the precaution).[5] Finally, there has been a growing critique of the WTO's 'democratic deficit' and commercial biases from within civil society. Non-governmental organisations (NGOs) have criticised the WTO rules on an array of important issues ranging from decreased access to essential medicines, increased food insecurity, and the institution's closed decision-making and dispute settlement processes. Increasingly, NGOs have begun to direct attention to the GATS and its far-reaching policy implications.

The GATS debate

There is now a lively – and sometimes caustic – international public debate on the GATS.[6] The main protagonists have been a range of non-governmental analysts and activists on the one side, whose GATS critiques have provoked an angry and defensive backlash from Quad trade negotiators, and the WTO secretariat and OECD trade officials on the other. More recently, certain developing country representatives have articulated some similar concerns to those raised by NGOs and other distinct, offensive negotiating interests with respect to the GATS.[7]

The GATS imposes, for the first time, multilateral trade law restrictions on trade and investment in the vast services sector. It has become a political flashpoint because it intensifies already existing pressures to commercialise and commodify services that have traditionally been provided through non-market means – including social services such as health and education and basic services such as water, electricity and postal services. It is doubly controversial because, as we will see, it also aims to restrict public interest regulation in the universally acknowledged 'regulation-intensive' service sectors (OECD, 2001). It is an imperfect, but potentially powerful, tool for transnational services corporations to 'break out of the boundaries that close non-market spheres to commodification and profit-making' (Leys, 2001: 4).

Fathoming the GATS legal complexities is challenging. The best place to turn for enlightenment is to the GATS text itself, but this is unusually complicated – even for a trade treaty. The purpose of this chapter is to assist the discerning reader to understand the legal text of GATS itself and the emerging debate about its role and significance. It argues that the GATS seriously overreaches, intruding into vital areas of public policy making that are only indirectly related to conventional international trade matters. It contends that the GATS unacceptably restricts democratic policy-making, by privileging international commercial interests over other legitimate societal interests. And it asserts that, contrary to the sometimes strident denials of many proponents, the GATS does, in fact, threaten serious harm to public services and public interest regulation.[8]

The scope of the GATS

First, a few basic facts. As previously noted, the GATS was concluded in 1994 as part of the Uruguay Round. It took effect on 1 January 1995. It is part of the WTO's single undertaking and therefore binds all WTO member governments. It is subject to a legally binding dispute settlement. The GATS consists of a 'top-down' framework of rules that cover all services, measures, and ways (or 'modes') of supplying services internationally. This framework is combined with more intrusive rules that apply only to services that governments explicitly agree to cover. Further negotiations to expand GATS rules and to increase its coverage are built in to the agreement. The first of these successive rounds to broaden and deepen the GATS is currently underway in Geneva.

GATS critics and proponents agree on at least one critical point. The scope of the GATS is very broad: far broader than traditional rules governing trade in goods. Indeed, the subject matter of the GATS – services – is immense. These range from birth (midwifery) to death (burial); the trivial (shoe-shining) to the critical (heart surgery); the personal (haircutting) to the social (primary education); low-tech (household help) to high-tech (satellite communications); and from our wants (retail sales of toys) to our needs (water distribution).

Moreover, the GATS applies to all measures affecting services taken by any level of government, including central, regional and local governments. Therefore, no government action, whatever its purpose, is, in principle, beyond GATS scrutiny and potential challenge. As noted, all service sectors are also on the table in ongoing, continuous negotiations.

For the critics, this breadth and the GATS' novel restrictions set off alarms. As a former director general of the WTO has admitted, the GATS extends 'into areas never before recognized as trade policy'.[9] Not limited to cross-border trade, it extends to every possible means of providing a service internationally, including investment. While this broad application does not, of course, mean that all services-related measures violate the treaty, it does mean that any regulatory or legislative initiative in any WTO-member country must now be vetted for GATS consistency, or risk possible challenge.

How flexible is the GATS?

The proponents, however, while acknowledging the treaty's universal scope, stress its 'remarkable flexibility'.[10] They also point to its controversial exclusion for governmental services and the range of exceptions available to protect otherwise non-conforming measures from successful challenge.

Proponents sometimes refer to the GATS as a 'bottom-up' agreement. This refers to a treaty that applies only to those specific government measures and sectors that individual governments explicitly agree to cover. By contrast, 'top-down' treaties automatically apply to all measures and sectors unless governments explicitly exclude them by negotiating them off the table. The GATS, however, is not a purely bottom-up agreement. It is, in fact, a hybrid agreement that combines both bottom-up and top-down approaches.

Certain GATS obligations, notably the most-favoured-nation treatment (MFN) rule, already apply unconditionally across all service sectors. And while it is true that the most forceful GATS obligations only apply to sectors that governments explicitly agree to cover, there are serious limits to this flexibility:

- Most governments have already given up much flexibility by not making full use of their one-time chance to specify limitations to their initial GATS commitments.
- Members remain under intense pressure to cede flexibility in successive rounds of negotiations to expand GATS coverage.
- The GATS requires governments that withdraw previously-made commitments to compensate other governments whose service suppliers are allegedly adversely affected.
- Protective country-specific limitations will endure only if all future governments are committed to maintaining them.

The GATS' vaunted flexibility is therefore considerably less than is often claimed by its proponents. Indeed, much of what passes for flexibility in the GATS is temporary and deliberately designed to disappear over time.[11]

The GATS governmental services exclusion

The GATS covers all services, except those 'supplied in the exercise of governmental authority'. At first glance, this controversial exclusion is a potentially broad one. But it is highly qualified. GATS Art. I:3 excludes services provided 'in the exercise of governmental authority', but it goes on to define these as services provided neither on commercial nor a competitive basis. These terms are not further defined and, if left to the dispute settlement process, will most likely be, according to the rules of treaty interpretation, interpreted narrowly.

'Public services' are rarely delivered exclusively by government. They are complex, mixed systems that combine a continually shifting mix of public and private funding, and public, private not-for-profit and private for-profit delivery. A truly effective exclusion for public services should safeguard governments' ability to shift this mix and to regulate all aspects of these mixed systems. When the GATS exclusion is most needed – when governments want to expand or restore the public, not-for-profit character of the system – it is least effective. This controversial exclusion is therefore ambiguous at best and ineffective at worst.

The GATS preamble and the 'right to regulate'

A common refrain in every official rejoinder to GATS critics is that the GATS specifically recognises governments' right to regulate. Regrettably, it is terribly misleading to suggest that the mere affirmation of the right to regulate, contained in the treaty preamble, fully protects the right to regulate. It does not. While the preamble does contain a clause that 'recognizes the right of Members to regulate', this language has strictly limited legal effect. It would have some interpretive value in a dispute but should not be construed as providing legal cover for regulations that would otherwise be inconsistent with the substantive provisions of the treaty. In short, governments retain their freedom to regulate only to the extent that the regulations they adopt are compatible with the GATS.

The MFN rule

The GATS most-favoured nation treatment rule, which applies to all service sectors, has proven to be a surprisingly powerful obligation in two recent GATS-related disputes.[12] This rule (GATS Article II) is best understood as a most-favoured-foreign *company* rule, as it requires that any regulatory or funding advantage gained by a single foreign commercial provider must be extended, immediately and unconditionally, to all. The MFN obligation has the practical effect of consolidating commercialisation wherever it occurs. While not legally precluding a new policy direction, this rule makes it far more difficult for governments to reverse failed privatisation and commercialisation.

The national treatment and market access rules

The hard core of the GATS is comprised of restrictions that apply only to the sectors, or sub-sectors, where governments have made specific commitments. These commitments, together with any country-specific limitations, are listed in each government's GATS schedule.

The GATS national treatment rule (GATS Article XVII) requires governments to extend the best treatment given to domestic services (or service providers) to like foreign services (or service providers). In the GATS, this rule is quite intrusive, as it explicitly requires government measures to pass a very tough test of *de facto* non-discrimination. That is, measures that at face value are impartial can still be found inconsistent if they modify the conditions of competition in favour of domestic services or service providers. This gives dispute panels wide latitude to find measures 'GATS-illegal' even when they seem to be non-discriminatory or when such measures alter the conditions of competition merely as an unintended consequence in the legitimate pursuit of other vital policy goals. The GATS' stiff national treatment requirement thus opens the doors for non-discriminatory public policy to be frustrated for reasons that are unrelated to international trade.

The GATS Market Access rule (GATS Article XVI) is one of the treaty's most novel, and troublesome, provisions. There is nothing quite like this rule in other international commercial treaties. Framed in absolute rather than relative terms, it precludes certain types of policies whether they are discriminatory or not. A government intent on maintaining otherwise inconsistent measures is forced to inscribe them in its country schedules when it makes its specific commitments. This rule prohibits governments from placing restrictions on: the number of service suppliers or operations; the value of service transactions; the number of persons that may be employed in a sector; and, significantly, the types of legal entities through which suppliers may supply a service.

Such prohibitions call into question, for example, the GATS-consistency of government-set limits to conserve resources or protect the environment. To take another example, many governments restrict the private delivery of certain social services such as childcare to legally constituted non-profit agencies. Many also confine certain basic services such as rail transportation, water distribution, or energy transmission to private, not-for-profit providers. Such public policies certainly restrict the market access of commercial providers, whether domestic or foreign. But they have never before been subject to binding international treaty obligations. Now, these vital policies are exposed to the GATS challenge.

GATS restrictions on monopolies and exclusive service suppliers

The GATS restrictions on monopolies and exclusive service suppliers (GATS Article VIII) impose new restrictions on monopolies and exclusive service supplier arrangements. In fact, monopolies and exclusive service suppliers are GATS-inconsistent and must be listed as country-specific exceptions in committed sectors. Any government wishing to designate a new monopoly in a listed sector is required to negotiate compensation with other member governments or face retaliation.

Monopolies, while not as prevalent as formerly, are still relied upon to provide basic services in many countries. Postal services, the distribution and sale of alcoholic beverages, electrical generation and transmission, rail transportation, health insurance, water distribution, and waste disposal are just some of the more widespread examples. Exclusive supplier arrangements are commonplace in post-secondary education, health care and other social services. The consequences of these GATS rules, which so far have gone largely unexamined, are likely to be significant in all of these important areas.

GATS restrictions on domestic regulation

If proposed GATS restrictions on domestic regulation (GATS Article VI.4), now being negotiated in Geneva, were ever agreed to, they would constitute an extraordinary intrusion into democratic policy-making. At issue is the development of 'disciplines' on a member country's domestic regulation – explicitly non-discriminatory regulations that treat local and foreign services and service providers evenhandedly. The subject matter of these proposed restrictions is very broad, covering measures relating to qualification requirements and procedures, technical standards and licensing procedures – a wide swathe of vital government regulatory measures.

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Critically, these proposed restrictions are intended to apply some form of 'necessity test', that is, that regulations must not be more trade restrictive than necessary and that measures must be necessary to achieve a specified legitimate objective. Perversely, the proposed GATS restrictions would turn the logic of the long-established GATT necessity test on its head. They would transform it from a shield to save clearly discriminatory measures from challenge into a sword to attack clearly non-discriminatory measures.[13] The proposed GATS restrictions on domestic regulation are a recipe for regulatory chill; they are among the most excessive restrictions ever contemplated in a binding international commercial treaty. This excess is concrete evidence of the hazards of leaving the ambitions of commercial ministries, and the corporate lobbyists driving them on, unchecked by broader public scrutiny and debate.

Conclusions

The GATS is a deservedly controversial agreement. Its broadly worded provisions give too much weight to commercial interests, constraining legitimate public interest regulation and democratic decision-making.

As GATS proponents frequently insist, the treaty does not *force* governments to privatise public services. But, nevertheless, as previously discussed:

- Through continuous negotiations it exerts constant pressure to open services to foreign commercial providers.
- The GATS MFN rule helps consolidate commercialisation.
- The GATS monopoly provisions make it more difficult for governments to maintain public services by hamstringing their ability to compete.
- Where GATS commitments are made, the GATS restricts the ability of governments to restore, revitalise or expand public services, and
- In such cases, compensation must be negotiated or retaliatory sanctions faced.

Similarly, the GATS does not *eliminate* governments' ability to regulate, but

- The recognition of the right to regulate in the preamble has little legal effect.
- The GATS clearly applies to government regulatory measures, whatever their form or purpose.
- The GATS applies a very tough test of non-discrimination when considering the possible adverse effects of domestic governmental measures on foreigners.
- The GATS prohibits certain types of measures, whether they are discriminatory or not, and

- Negotiations to apply a necessity test to non-discriminatory domestic regulation pose a very serious threat to crucial regulatory instruments.

Many of the pronouncements by trade policy elites based in Geneva, Paris and Quad capitals are carefully worded to obscure these basic points about the agreement. But they are unlikely to succeed in this. The negotiations to broaden and deepen GATS coverage will make services one of the centre-pieces of the new round of WTO negotiations launched recently in Doha.[14] The existing GATS and the negotiations to expand it raise such serious challenges to democratic governance and social cohesion that they are certain to stimulate even greater public interest and controversy.

List of Acronyms

EC	European Communities
EU	European Union
GATT	General Agreement on Tariffs and Trade
GATS	General Agreement on Trade in Services
MFN	Most Favoured Nation
NAFTA	North American Free Trade Agreement
NGOs	Non-Governmental Organizations
OECD	Organization for Economic Cooperation and Development
SPS	Agreement on the Application of Sanitary and Phytosanitary Measures
TBT	Agreement on Technical Barriers to Trade
TRIPS	Agreement on Trade-Related Aspects of Intellectual Property Rights
WPDR	Working Party on Domestic Regulation
WTO	World Trade Organization

Notes

1. World Trade Organization (1999) p. 1.
2. Such as the minimum 20-year term of patent protection in TRIPS.
3. Such as risk assessment in the SPS Agreement.
4. For example, under Article VI of the GATS.
5. The successful North American challenge of the European ban on hormone-treated beef may foreshadow an even more contentious WTO dispute over Europe's approach to regulating genetically modified foods.
6. A valuable collection of NGO critiques of the GATS can be found on the GATS Watch website at http://www.xs4all.nl/~ceo/gatswatch/factfict. Both the WTO and the OECD have responded directly to GATS critics. World Trade Organization (2001a), available on the WTO website at www.wto.org. OECD (2001).
7. Communication from Cuba, Senegal, Tanzania, Uganda, Zimbabwe and Zambia, 'Assessment of Trade in Services', 6 December, 2001, S/CSS/W/132, para. 8.
8. These themes are developed more fully in Sinclair and Grieshaber-Otto (2002).
9. Renato Ruggiero, former WTO Director, 2 June 1998.
10. See WTO (2001a), p. 6 and OECD (2001), p. 10 para. 12.
11. The public policy and development impacts of an international treaty should not be judged

against the ability of the countries to opt out of particular GATS provisions or to limit their application. It is fair rather, to judge its impacts assuming, as is intended over time, that its provisions are fully applicable (cf. Luff, 2002).

12. The two cases are: 'Canada: certain measures affecting the automotive industry', WTO (2002) and 'European communities – regime for the importation, sale and distribution of bananas', WTO (1997). For summaries and analysis of these cases see Sinclair (2000), chapter 3
13. Under GATT Article XX, a government can, as a last resort, try to save an otherwise GATT-inconsistent measure from successful challenge by arguing that it is necessary to achieve a GATT-sanctioned legitimate objective. But this general exception has been interpreted very restrictively. Indeed, under GATT jurisprudence, 'a measure cannot be deemed necessary if satisfactory and effective alternative means to achieve the same objective are reasonably available to the Member enacting it'. World Trade Organization, Council for Trade in Services, 'Article VI.4 of the GATS: Disciplines on Domestic Regulation Applicable to all Services', Note by the Secretariat, March 1, 1999, para. 27 (S/C/W/96).
14. WTO (2001b).

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21 The International Monetary Fund (IMF) and the World Bank (WB)

John Toye

The fund's original aims and its modalities

The IMF was established in 1947, as an international institution to manage international payments, in the chaotic economic conditions that obtained at the end of World War II. The Fund's objectives, stated in its Charter, were to restore a system of multilateral payments for current transactions between its members; to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members; to promote exchange stability; and (the one most usually forgotten) 'to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income'.

In promoting all of these objectives, the Fund acted as an enforcer of a set of rules of international monetary behaviour. The IMF was originally designed to manage a system of fixed, but adjustable, exchange rates against the US dollar, which itself was pegged to gold. In order to keep exchange rate fluctuations within set limits, each member country – and the membership then (59) was much smaller than it is now (over 180) – paid into the Fund a capital sum, determined according to its importance in world trade, and was given a borrowing 'quota' related to its capital. Voting power in the organisation is related to the size of this capital.

If a balance of payments deficit began to threaten the stability of their exchange rate, member countries were permitted to borrow from the Fund and repay over the following two or three years. In facilitating deficit country borrowing and repayment, the Fund acted as a bank, but the scale of the 'banking' operation was initially small. Between 1947–55, 14/59 members made drawings, at an annual rate of $46m. This equalled 0.06 per cent of world imports. In 1990–98, when 78/182 members made drawings, the rate was $13.4bn, or 0.29 per cent of world imports.

The gold exchange standard devised at Bretton Woods succeeded in re-establishing current account convertibility in the industrialised nations, while permitting countries to maintain capital account controls. Controversy was related to the IMF's role as a banker, particularly about its success in shortening and reducing the severity of balance of payments disequilibria (Killick, 1985). Nevertheless, under this system, international trade did grow rapidly, and employment and real income also grew at faster rates than subsequently, so that the period 1946–71 has been called 'the Golden Age'.

The anchor of the whole system was the fixed parity between the official price of gold and the US dollar, at $35 an ounce. In 1968, this price became unsustainable, as confidence in the dollar–gold convertibility guarantee began to evaporate. It was partly to forestall this outcome that Special Drawing Rights (SDRs) in the IMF were created in 1967: this was the First Amendment of the Fund's Articles of Agreement, but it was already too late. The ratio of US gold reserves to its liquid liabilities had fallen from 2.73 in 1950 to 0.41 by 1968. Once the private market gold price rose above the official gold price, dollar–gold convertibility was suspended *de facto*. Revaluation of gold to $38 an ounce was no lasting solution, as it simply strengthened the forces of speculation against the dollar, and the US commitment to buy and sell gold at a fixed dollar price was officially abandoned in 1971. The collapse of the gold exchange system was thus due to an inherent design flaw, and not to particular failures of its umpire and manager, the IMF.

The IMF in the post Bretton Woods world

The end of the system of fixed parities was also the end of the Fund's role as banker to the OECD countries (with the exception of its loans to the UK and Italy in 1976). This was important for two reasons. The Fund as an organisation began to cast around for a new role for itself, and it looked increasingly to find new clients in the developing countries. However, as this happened, a divorce occurred between the countries whose entrenched voting power still directed the Fund, the industrial countries, and the users of the Fund, the developing countries. The Fund thus changed from an institution of collective action into an instrument to discipline others.

At first, the move towards floating exchange rates was thought to be temporary, but none of the various grand designs for a new international monetary system commanded general agreement (Williamson, 1977). Instead, the industrial countries learned to live with a non-system. The Second Amendment to the IMF Articles in 1978 allowed all forms of national exchange rate mechanism, except pegging to gold. Many of the larger economies chose to float their currency, for example the US, UK, Japan and those in the European Union. Many of the smaller economies chose to peg their exchange rate to other currencies or baskets of currencies. The role of the IMF was thus reduced to surveillance and reporting on the exchange rate arrangements chosen by members, plus advocating 'principles of guidance' which it had no power to enforce.

Freely floating exchange rates produced rate fluctuations among major currencies greatly in excess of changes in macroeconomic fundamentals of the real economies, measured in terms of departures from purchasing power parity. The first half of the 1980s saw a 40 per cent real appreciation of the dollar, followed by an equal depreciation in the second half. The uncertainties created by currency speculation have acted to magnify the exchange rate effects on real income and employment. Yet international economic coordination was abandoned in favour of periodic communiqués from G7 meetings that tried to 'talk down' or 'talk up' particular key currencies.

Under the gold exchange standard, developing countries were of little interest to the IMF. Many had never been properly integrated into the gold exchange system at all, apart from certain Latin American countries (Peru, Paraguay) that had been the arena in which the Fund pioneered the use of policy conditionality to its lending. From the early 1960s onwards, largely under pressure from the United Nations, the Fund did develop additional 'banking' facilities relevant to the needs of developing countries, characterised by concessional interest rates compared with commercial sources of finance. The Compensatory Financing Facility, established in 1963, made limited credit available to countries experiencing a temporary fall in their export revenues. More significant was the Extended Fund Facility (EFF) of 1974, which provided medium-term finance, beyond the limits of normal lending, to support agreed stabilisation programmes requiring structural adjustments. The EFF was backed up in 1976 and 1977 by a new Trust Fund to provide balance of payments loans on highly concessional terms to low-income countries, and a new Supplementary Facility to assist countries that might otherwise be liable to debt default, subject to adoption of policies to restore the external position of the borrowing country.

The Fund and the debt crisis of the 1980s

In the wake of the oil price rises of the 1970s, private commercial banks were left to undertake the task of recycling the savings of the oil-producing countries to the non-oil-producing developing countries. The election of Reagan, Thatcher and Kohl at the turn of the 1980s began a process of severe disinflation in the industrialised world, which sparked off a deep debt crisis in Latin America. The Mexican debt crisis (1982) was a turning point in the history of the Fund and the World Bank. Following the Baker Plan of 1985, the US Administration recruited the Fund, along with the Bank, to be its managers at one remove of the prolonged debt crisis which for some years threatened the survival of major Western banks. The capital available to both institutions was increased. Building on the EFF, new longer-term lending facilities were created to channel credit to indebted developing countries. The Structural Adjustment Facility (SAF) was set up in 1986, followed by the Extended Structural Adjustment Facility (ESAF) in 1987.

SAF/ESAF resources are provided as loans to low-income countries suffering protracted balance of payments problems. Interest is very low at 0.5

per cent and repayment is made in five and a half to ten years. Policy conditionality is strong under ESAF loans, specified in the annual Policy Framework Papers (PFPs) drawn up jointly with the Bank. (At the end of the 1990s, these were re-titled Poverty Reduction Strategy Papers – PRSPs.) SAF and ESAF allowed the Fund to adopt a mediating role between debtors and creditors. IMF stabilisation programmes were intended to restore macroeconomic balance in the countries that adopted them, so that they would be able to pay their debt service obligations (re-scheduled if necessary) to their creditors in an orderly manner. Participation in an IMF programme was therefore expected to be a 'seal of approval' that would encourage private creditors to roll over existing loans and supply new loans to the debtors. Thus IMF money was expected to 'leverage' or 'catalyse' private flows.

In the event, matters did not work out quite so well. On the one hand, the stabilisation programmes did not always have the intended effect of rendering the borrowing country creditworthy. They frequently broke down before completion. Between 1979 and 1993, 53 per cent of 305 Fund programmes were uncompleted. This was for a variety of different reasons, but was often connected with inadequate financing (Killick, 1995: 58–65). Estimates of the impact of IMF programmes showed that they improved the current account and the overall balance of payments, and slowed inflation, but that there was also a short-term reduction in the growth rate. On the other hand, the IMF seal of approval was not effective in catalysing new private lending. The overall balance of payments rarely improved by more than the improvement on the current account, as would have happened if the catalytic effect had been positive. Although private markets (and aid donors) valued a government's commitment to sound economic policies, they might doubt that the Fund would prescribe the best policies, or that Fund conditionality would ensure that prescribed policies were pursued. They might also judge the amount of IMF financing to be inadequate (Bird and Rowlands, 2000).

The IMF, along with the World Bank, found a second new area of influence after the fall of the Berlin Wall in 1989 and the collapse of the Soviet Union. Both had to absorb many new members and to attempt to provide them with appropriate financial assistance, to help them to undergo the transition from socialist to proto-capitalist economies. The Fund established a *Systemic Transformation Facility* under pressure from OECD countries in 1993. Nevertheless, the transition countries did not displace developing countries as the main users of IMF funds. Over the period 1988/93, developing countries borrowed four times as much as transition countries. Lending in transition countries was highly political, and heavily influenced by the policies of the US Treasury. The Fund policies of liberalisation, stabilisation and privatisation were controversial. Whether the economic failures that followed in Russia should be attributed to the Fund policies or the way they were implemented continues to be debated. Reform in Russia was made even more difficult by the outbreak of the Asian financial crisis (1997–99).

The Asian financial crisis and criticism of the fund

The outbreak of the Asian financial crisis, in Thailand in July 1997, took the Fund unawares, and led to dramatic falls in the exchange rates of Asian countries, losses of income and employment and rises in poverty. This was followed outside the region by debt repudiation in Russia and a fiscally driven economic crisis in Brazil in 1998. There was a knock-on effect in Africa, as the pre-existing recovery of primary commodity prices was reversed. At the time, this was the worst global recession since 1945, although it hardly touched the US or European economies. As a result, there was strong criticism of the Fund. Critics claimed that the Fund should have been aware of, and warned about, the fragility of the economies of East Asia; that the Fund should have been able to prevent the crisis from happening; and that the Fund's remedies, especially its insistence on higher interest rates, were counter-productive, deflating the economy in the face of GDP contraction (Stiglitz, 2002). Finally, critics saw moral hazard in the fact that the costs of the crisis were borne wholly by the public taxpayer, while Western bankers who had made unwise loans were repaid in full.

Those who call for an effective early warning system for financial crises will probably be disappointed. Financial crises are products of complex nonlinear causes. Government policy preferences, investors' expectations and herd behaviour all enter the equation, as well as measurable economic quantities such as the assets and liabilities of the banking system, the balance of payments deficit and the size of the foreign exchange reserves. This makes forecasting crises extremely difficult. Moreover, the Fund's surveillance faces a problem to the extent that countries do not insist on publication of information that might reveal fragility. Limited disclosure is not the whole story, however. Much vital macroeconomic and financial information was in the public domain in July 1997. What was lacking was its adequate evaluation both by the Fund and the Bank, and by the markets.

The Fund published a *Special Data Dissemination Standard* (SDDS) for macroeconomic variables in April 1996. This was broadened in 1998 to include net reserves and private debt. The Fund is encouraging the definition and promulgation of appropriate accounting standards for firms and banks, and insisting that its members adopt such standards for the information provided to the Fund. In 1999 new transparency guidelines were agreed for authorities conducting monetary policy, financial regulation and the overseeing of payments systems. The Fund, until recently the most secretive of public organisations, has improved the transparency of its own operations.

putting the onus on a member government to embargo the disclosure of any information supplied to the Fund.

The fundamental defect of floating exchange rates is the large and frequent misalignment of the three key world currencies – the dollar, the euro and the yen. The solution would be to specify exchange rate targets for these currencies, and find instruments to move them towards the specified targets. The US and the rest of the G8 countries are wholly unwilling even to contemplate this. The financial systems of developing countries are relatively small, and often fragile. Poor credit evaluation and poor control of banks' foreign currency exposure are typical aspects of fragility. These weaknesses become much more dangerous after liberalisation of the capital account. A crisis develops when foreign transactions, induced by interest rates in combination with investors' expectations of exchange rate movements, are large in relation to the system, though small in relation to the foreign investor's portfolio. Moreover, the quality of bank assets changes with changes in economic conditions, and no amount of Fund surveillance can prevent this kind of 'contagion'. This is a new danger which developing countries face in a more financially integrated world.

The Fund faces a genuine problem when it suspects that a crisis is about to happen. By giving a public warning, or giving exceptional assistance to a country, it may provoke an earlier or worse crisis than would otherwise have occurred. It may not be able to provide sufficient help to prevent a crisis, without at the same time signalling that a crisis is imminent. Similarly, while the improvement of domestic banking supervision would clearly help to prevent crises, it is doubtful whether the time to try to begin to improve standards is in a period of banking fragility, or whether doing so is consistent with moving to full disclosure of all relevant information: either could trigger the collapse of already weakened banks.

As an aid to crisis prevention, the Fund introduced in 1999 a *Contingency Credit Line*. Countries who want to be eligible for such assistance have to agree to six-monthly macroeconomic reviews, although the IMF will not impose its preferred macroeconomic policies in advance. A large proportion of the funding will now be made available immediately on demand. If the IMF later concludes that national policies were a cause of the crisis, the remainder will be conditioned on macroeconomic reforms. The interest on CCL loans will be at a concessional rate. Few countries have shown an interest in this facility, and its efficacy remains to be tested.

The Fund's defence against the accusation that the conditions of its lending to the Asian crisis countries were misconceived was that, in a short-term crisis, the resources at its disposal are fixed, and they cannot fully substitute for the private outflow (and indeed should not, given the moral hazard). Thus, private capital outflow has to be balanced by loss of foreign exchange reserves, by a depreciation of the exchange rate or, failing these, interest rate rises to make the adjustment via loss of output, and/or to reverse the outflow of private capital. Practically, it appeals to the outcome from the IMF conditions, pointing to the speed of recovery of the countries, like Korea, that complied with them most fully, compared with the slowness of recovery of those, like Indonesia, that resisted most. Critics maintain that looser monetary and fiscal policy, combined with rapid corporate re-structuring, would have restored confidence and reversed the capital outflow with less damage to the real economy.

More radical ideas for fund reform

The G8 governments, who effectively direct the Fund, like to keep it on a short leash. So its main handicaps in discharging its tasks are (1) its limited resources and (2) political interference in its handling of particular situations. Should its resources therefore be increased? With greater resources at its disposal, the Fund could possibly in future act as a lender of last resort to countries facing the possibility of destabilising private capital outflows. A lender of last resort must lend in unlimited amounts, and with no conditions apart from a penalty interest rate. Even if the IMF were put in the position to do this, it could create moral hazard, encouraging imprudent lending by foreign banks, and/or imprudent borrowing by public agencies.

An alternative to an international lender of last resort would be a scheme to manage international bankruptcies when they occur. Orderly debt work-outs would be an international equivalent to domestic bankruptcy proceedings, which apply to public authorities as well as private enterprises. They involve (a) an automatic debt standstill or moratorium (b) access to working capital on a preferred creditor basis (c) financial and managerial reorganisation to restore viability and then pay off pre-standstill creditors on an equal basis. There are many detailed problems of legality, timing and the prevention of abuse that are involved in deciding how such arrangements could be effectively brought into force for cross-border transactions. Clearly they would involve private sector burden sharing, and it is in this policy area where least progress has been made in building an international consensus. The US in particular argues that any form of private sector burden sharing will kill off foreign investors' interest in emerging markets. However, a scheme is now under consideration that would require debt contracts to include a clause providing in advance for collective action agreements in the event of debt crises. The adoption of such clauses would probably render debt crises much more manageable (Akyuz, 2002).

The World Bank's original mandate and its early years

The International Bank for Reconstruction and Development (IBRD) was established in 1946 in order to provide medium-term, lower than commercial interest rate loans to governments for (post-war) reconstruction and for the development of capital-poor areas. Since then other parts of what is now called the World Bank Group have been added. There are three organisations that deal with the private sector, the International Finance Corporation (IFC) set up for lending to the private sector in 1956, the International Centre for the Settlement of Investment Disputes (1966) and the Multilateral Investment Guarantee Agency (MIGA) of 1988. However, the most significant addition was the International Development Agency (IDA), which was added in 1960 to provide long-term, highly concessional loans to the poorest countries. This was a response to a long campaign in the UN for a new source of development capital for poor countries. Initially, the Bank opposed the idea, but was finally persuaded by the US government to agree to it, as a way of preventing this facility being set up under UN auspices.

The IBRD played a minimal role in the reconstruction of Europe, because the US decided not to channel their Marshall Aid through the Bank. Marshall Plan aid amounted to $12.7bn in 1948–51, while IBRD loans to Europe were less than $1bn during this period. Having largely missed out on reconstruction lending, the Bank began to focus on project lending for economic development. The procedure chosen was to borrow on the developed country capital markets and re-lend (plus a small margin) for specific investment projects in developing countries. In the early years, this was a slow process, explained by Bank officials in terms of the low absorptive capacity of developing countries, and their failure to prepare a sufficient number of sound projects.

The initial mode of operation, as a public sector development bank, was justified on the grounds of private capital market imperfections. Engineers and engineering dominated the early operations. The project portfolio of the Bank was originally concerned with large physical infrastructure schemes, such as dams and electricity generation. After the 1960s, the composition of Bank investments began to change, gradually including agricultural and urban redevelopment projects. The lending vehicle remained the project, however. The evaluation of project success was with reference to calculations of the *ex post* rate of return on each project. A semi-independent Operations Evaluation Department was established for this purpose.

In its first 30 years, the Bank provided both project finance and technical assistance in formulating and executing projects, and in developing associated pricing and maintenance policies. The Bank's participation in these projects almost certainly produced a better quality of project than would have occurred in its absence. However, the force of the argument of the fungibility of funds was increasingly recognised. In the presence of fungibility, the economic effect of the investment cannot be measured by its *ex post* rate of return. If the government would have undertaken the project that the Bank financed even in the absence of the loan, then the loan actually financed some other project – the one that would not otherwise have been undertaken. In that case, the economic effect of the loan was to fund the (unidentified) marginal investment project, whose rate of return might be much less satisfactory than that of the Bank-financed project. Although fungibility need not concern a development bank, whose chief aim is to recover its loans, it should worry a multilateral aid agency funded by public capital, whose main objective is to promote the sound development of the borrower's economy. To ensure that, projects need to be part of a comprehensive development plan, precisely in order to avoid the fungibility problem.

The move to policy-based lending after 1979

In the 1970s, the economies of developing countries were disturbed by substantial economic shocks, favourable and unfavourable, arising from oil price increases, and the recycling of petro-dollars by commercial banks. The World Bank came to the view that the success of their individual loan projects, as measured by their *ex post* rates of return, was being affected negatively by the broader economic environment in which they had to operate (rising oil price, high inflation, fixed nominal exchange rates, import restrictions, and so on). In 1979, after a number of previously unsuccessful forays, the Bank initiated a new type of lending, called programme lending. This had previously been regarded as unsound banking, but the need for additional balance of payment finance was very pressing, and programme loans could be justified on the grounds that, if successful, they would render themselves redundant in future. The new types of loans, structural (SAL) and sectoral (SECAL) adjustment lending, provided rapidly disbursing foreign exchange on condition that the borrowing government undertook economic policy changes, either economy-wide or sectorally. This form of lending rose to be one third of new lending, the other two-thirds remaining as project finance.

Programme lending with policy conditions attached provided the instrument that the Bank could bring to the task of co-managing the 1980s debt crisis with the Fund. At the same time it blurred the previous functional boundaries of the two organisations. The Bank took up economy-wide policy issues just as, through SAF and ESAF, the Fund moved into adjustment lending. This brought them into potential conflict. Various coordination problems arose from their overlap of functions, notably the incident in 1988 when the Bank (under US pressure) made a loan to Argentina, while the Fund refused its support. A Fund–Bank 'concordat' (1989) established effective (though not formal) cross-conditionality of Fund and Bank loans. Bank adjustment lending became conditional on a pre-existing Fund programme, and a statement of economic policy for the borrowing country had to be agreed by both institutions. In usual practice, they jointly drafted the Policy Framework Paper, and the country's government agreed to it.

Evaluation of bank lending

The Bank, through its Operations Evaluation Department, evaluates the outcome of its projects. This is done on the simplifying assumption of *ceteris paribus* – nothing changes outside the project. Overall, the *ex post* rate of return on Bank projects has been 10 per cent, although this has been lower in recent years (despite the Bank's efforts to reform the overall economic environment!). This is certainly a good performance, given that developing countries provide a relatively risky environment for most forms of investment. Nevertheless, the need to continue Bank lending of the IBRD type has been questioned, both by appeal to the fungibility argument, and on the grounds that private flows to developing countries can do the job instead (Krueger, 1998). In 1970, IBRD net lending was about 10 per cent of net private flows. In 1996, this share had fallen to 0.7 per cent. In 25 years, private flows had increased forty-fold, while IBRD flows had increased three-fold in nominal terms. The original justification of IBRD loans in terms of imperfect private capital markets seems weak in the light of these figures, although private finance is very concentrated geographically and the Asian crisis showed how short-term and volatile private money can be.

The evaluation of the effects of programme lending is more difficult and controversial. Governments of developing countries have been reluctant to comply with some of the conditions for policy change laid down in the loan agreements. This is often described as a result of their lack of ownership of the economic reform process. The Bank itself faces incentives that make it unlikely that it will react to non-compliance consistently with a discontinuation of funding (Mosley *et al.*, 1995). Thus the evidence suggests that the Bank's loan conditionality is a weak instrument for inducing policy change. At the start of the twenty-first century, the Bank was moving towards a lending strategy of selectivity, in which future loans are directed increasingly to countries that have already demonstrated their zeal for reform.

The Bank's contribution to the development dialogue

Apart from project and programme lending, the Bank undertakes many other activities. It conducts what is probably the largest single publication programme on development issues in the world. This includes its own research across the field of development problems, published in two house journals, flagship reports like the annual *World Development Report*, a host of monographs and a multitude of Working Papers. The Bank has also become a major provider of statistical data, including regular published series and data from household and firm surveys.

Complementing its publications are its other methods of disseminating its views on development. At the Economic Development Institute, the Bank maintains an in-house training facility for developing country economics professionals, many of whom return to work at the Bank. Policy advice is also provided separately from loan operations, something that the strategy of more selective lending is likely to increase

The Bank's justification for undertaking research and its dissemination in-house is that this gives it better control over the topics of research, and makes it more likely that the results will be used in its operations. Critics note that in-house research is less independent of management's desire to promulgate a particular perspective, which became compelling in the early 1980s, and that top-level editorial control will have the inevitable effect of dampening in-house intellectual creativity. Attempts to evaluate the quality of the Bank's research and publication activities have noted that their extensive influence on policy makers and educators has not been matched by the extent of their intellectual comprehensiveness or innovation.

Lines of criticism and possible reforms for the Bank

The Bank has faced powerful criticism in the last 20 years as it has increased both its policy salience and its research dissemination capacity. A major focus of criticism has been on the effect of Bank-financed projects on the environment, both physical and human. Large dam projects, in which the Bank has seemed to breach its own guidelines on resettlement of existing inhabitants, have been at the centre of fierce conflict with NGOs. New measures of accountability have since been put in place, but the power of NGOs to lobby the US Congress has brought a more widespread change of political stance at the Bank. Under President James Wolfensohn, the Bank has been more pro-active in reaching out to these powerful critics, and shaping its policies to reflect their concerns.

Wolfensohn has pursued this political approach by promoting the use of his Comprehensive Development Framework, which is a coordinating matrix for all development activities. This allows the Bank to adopt a central position in the development process, providing a diverse range of services to the entire development community. The Bank is able to identify itself as a development partner and facilitator, instead of as a banker insisting on loan conditionality. Conditionality is being phased out, and selectivity is being phased in. Meanwhile, Bank lending has been increasingly diversified to support a new development agenda that would find favour with the US NGOs – gender equality, participation, the environment, civil society and good governance.

Although the Bank has managed to distance itself from the wave of criticism that surrounded the Fund's handling of the Asian financial crisis, the present populist approach is not without its dangers. Critics complain of a consequent loss of focus and comparative advantage in the Bank, an over-extension of staff capacities to areas where they have little competence and potential loss of political support among governments of developing countries, not to mention among the G8 if the political wind should change direction.

A more radical strategy has also been discussed – the transformation of the Bank into a 'university of development', specialising in non-lending educational activities that can be justified as public goods, and subsidising their provision with income from the Bank's subscribed capital and accumulated reserves. Lending would continue in a selective mode to safe borrowers, but would cease to be the Bank's major function. The prospects for re-inventing itself as a 'knowledge bank' depend on the extent to which its research and publication activities could continue in the same way if its lending were scaled down, and on the feasibility of introducing greater selectivity in lending, which as yet remains under-explored.

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22 A new Bretton Woods?

Mića Panić

The idea of a new Bretton Woods raises three important questions. Is it really necessary? What would be its objectives? And how would they be achieved?

The first question is relatively easy to answer. The world has changed almost beyond recognition since that famous conference at Bretton Woods, New Hampshire in July 1944. The need for the international community to observe certain rules of behaviour, essential if economically interdependent countries are to achieve their domestic policy objectives, has become even greater as a result of the profound changes that have taken place since the Second World War – many of them as a result of decisions made in 1944. That, in turn, has increased the need for supranational organisations that would promote international harmony of interests by acting for the benefit of *all* their members.

These changes mean that, for reasons explored briefly in the next two sections, 'a new Bretton Woods' might have to differ significantly from the 'old' one both in its concept and practice.

The spirit of 'Bretton Woods'

It is impossible even to think of a comprehensive reappraisal of the 1944 initiatives without a clear notion of what the concept 'Bretton Woods' stands for. This is essential because, as I show elsewhere (Panić, 2003, chapter 10), there was a significant difference between the Bretton Woods System as conceived by its architects and the way that it actually operated. This section highlights some of the key concerns and aims that inspired what is still the only successful attempt by a large number of countries to construct a new global economic order.

The process of industrialisation involves continuous specialisation – national and international – and, consequently, a progressive reduction in national economic self-sufficiency. This is true of all countries, though the reduction is normally more extensive in small than in large economies. As a result, the higher the level of industrialisation, the greater the dependence of national economies on the performance and policies of other nations, especially those with which they have close economic links. The willingness of the international community to pursue similar economic and social objectives and to collaborate in achieving them is, therefore, of critical importance.

This was demonstrated in the 1930s at an exceptionally high cost in social welfare to all countries. It was that experience that led to the 1944 Conference and shaped the blueprint for a new world economic order that is associated with 'Bretton Woods'.

There was a significant increase between 1870 and 1913 in the proportion of exports in GDP in virtually all the countries for which we have relevant data (cf. Maddison, 2001, p. 363; Panić and Vacić, 1995, p. 4). Increases in international capital flows were even greater (Bloomfield, 1963 and 1968).

The growth of the international economy and optimism about the existing economic order that it generated were reversed dramatically during the Great Depression in the 1930s, as all countries resorted to a variety of protective measures in order to minimise the economic and social cost of the Depression. That, as they were to discover, made it even more difficult to stage the strong, sustainable economic recovery required to lift them out of the slump.

Between 1929 and 1932 the volume of world exports declined by 27 per cent (Maddison, 1995, pp. 238–9). To make matters worse, the flow of international capital dried up in the 1930s and international immigration was reduced to less than 20 per cent of the average annual level between 1911 and 1930 (Panić, 1988, p. 172). In many industrial countries GDP did not recover to the level reached in 1929 until after the Second World War; and it was only in the early 1950s that peacetime unemployment in most industrialised countries fell back to the 1929 level (Maddison, 1991).

Those who lived through these events were convinced that the economic failure, social divisions and the rise of political extremism that led eventually to World War II were avoidable. What the world needed was a combination of national policies that would maximise social welfare, and an effective international institutional framework for dealing collectively with economic problems that affected all countries.

The result was a unique consensus that included countries at different levels of development and with different economic and political systems (see US Department of State, 1948a, b). A radically new global economic order had to be created after the war to preserve world peace by preventing losses in economic welfare, social friction and political instability within countries; and that was possible only through active international cooperation spearheaded and supervised by supranational organisations. The cooperation was essential because 'world prosperity, like world peace, is indivisible …' (US Department of State, 1948b, p. 1600).

It is this recognition by governments as diverse as those represented at the 1944 Conference that, in the words of the US Secretary of the Treasury Morgenthau, 'the wisest and the most effective way to protect our national interests is through international co-operation' (*ibid.*, p. 1226), which has come to symbolise 'Bretton Woods'. Even more remarkably, they translated their conversion to internationalism into something that the world has failed to achieve before or since: an agreement in principle concerning the ends, the means, the policy instruments and the institutional framework that the new global economic order would require.

The ends were defined in strictly national terms. Those attending the Bretton Woods Conference never pretended that they were doing anything other than, as Morgenthau told them approvingly, act 'in the particular national interests' that they were 'sent ... to represent' (US Department of State, 1948b, p. 1225). The 'interests' are reflected in the national objectives that they set out to achieve: a high level of employment and income, balanced economic development and sustainable external balance. Together with price stability and an equitable distribution of income, they became the social welfare goals pursued by many governments, especially in industrial countries, after World War II. (See Panić, 2003; Goodin *et al.*, 1999.)

However, the inter-war period taught them an important lesson: to realise these goals they had to re-establish the old trading links. The main task of the two institutions set up at Bretton Woods was, therefore, to help restore *multilateral* international trade so that individual countries could achieve their national objectives (cf. US Department of State, 1948a, pp. 942 and 1016).

At the same time, it was recognised that there was a great difference in the ability of countries to reconcile internal and external balances. The degree of trade liberalisation and the period over which it was to be achieved would have to vary, therefore, if all of them were to benefit significantly from a more open international economic system. Consequently, there was no attempt at Bretton Woods, in the General Agreement on Tariffs and Trade (GATT) or in the policies pursued by the United States after 1948, to impose uniform institutional arrangements and an identical package of policies on all countries.

The IMF Articles of Agreement permitted countries to introduce 'restrictions on payments and transfers for current international transactions' if they could not balance their external account without such restrictions (Article XIV). For the same reason, GATT allowed member states to resort to restrictions on imports (General Agreement, Article XII). It also recognised the importance of infant industries and gave a wide measure of discretion to developing countries to employ tariffs and quantitative controls: (a) to make it possible for them to establish such industries and (b) to enable them to balance their current account (Article XVIII). The United States adopted a similar attitude when providing external assistance to Western Europe in the early post-war period (Panić, 1991).

There was, however, one 'impediment to trade' that they agreed to remove as soon as possible: exchange rate protection through the competitive currency devaluation. All the countries that signed the IMF Articles of Agreement undertook to adhere strictly to a regime of fixed exchange rates. But, as in the case of trade policy, this arrangement contained an important element of discretion: the rates were to be fixed but adjustable (see IMF Articles of Agreement in US Department of State, 1948a, pp. 942–84). A country experiencing 'fundamental disequilibrium' was permitted to devalue its currency. The concept was never defined officially, although, given the primacy of the domestic objectives that they had adopted, this could mean only one thing: that the country was incapable of balancing its external balance 'in the long term at socially acceptable levels of unemployment and inflation' (Panić, 1988, p. 66). Countries that could reconcile internal and external balances risked provoking costly retaliation if they devalued their currency.

The advantage of a regime of fixed parities was that it would facilitate the revival of multilateral trade by removing exchange rate protection as well as exchange rate risks. That could be achieved only, experience had taught them, by maintaining exchange controls, because a regime of fixed exchange rates was incompatible with free flows of capital between countries. IMF Article VI.3 states, therefore, that: 'Members may exercise such controls as are necessary to regulate international capital movements ...'. In other words, it was left to individual countries to decide whether the pursuit of domestic objectives made it necessary for them to maintain/impose controls on capital flows.

The need to continue with exchange controls (on capital movements other than those connected with current account transactions) meant that they had to find an alternative way of ensuring adequate provisions of short-term finance to enable individual countries to deal with temporary, unforeseen external disequilibria *without* resorting to deflationary policies and/or devaluation. This was essential if they were to avoid a return to the economic stagnation and 'beggar-my-neighbour' policies of the 1930s, destroying the new global order and spirit of internationalism that the Bretton Woods Conference was trying to create.

The same reasoning made it also essential to secure adequate international provisions of long-term capital to finance the reconstruction of advanced economies and the development of low-income countries. That would make it unnecessary for them to impose restrictions on trade in order to economise on their limited holdings of foreign exchange, needed to finance domestic investment and development (see Panić, 1988, Part II).

The result was that most visible and enduring of Bretton Woods initiatives: the creation of supranational financial institutions to manage the new international order instead of relying, as in the past, on the dominant economy to perform this role. There were important reasons for this, all based on what actually happened towards the end of the Classical Gold Standard and, even more so, during the inter-war period (cf. Panić, 1992 and 2003, chapter 10; and Kindleberger, 1973).

First, a dominant economy will pursue policies that are in *its* interest. There is no guarantee that the same policies will be in the interest of other countries. Second, the proportion of external trade in its total output may be so small that it will lack financial institutions with the experience to perform a global role. Third, even if this is not the case, the country's authorities may not be willing, unlike the British Government and the Bank of England in the inter-war period, to sacrifice its economic welfare in the hope of sustaining the existing international financial system and their role within it. Finally, in a dynamic world economy no country is likely to retain its economic dominance for more than a relatively short period. Hence, the creation of a viable, lasting international trading and financial system requires a different, supranational solution.

The proposals tabled at the Bretton Woods Conference dealt, therefore, specifically with the establishment of supranational financial institutions (see US Department of State, 1948a, b). The International Monetary Fund was created to provide short-term finance and to supervise the maintenance of fixed exchange rates. The International Bank for Reconstruction and Development (World Bank) was given the responsibility of providing the long-term capital that could not be raised from other sources.

There were also plans to set up a third supranational institution, the International Trade Organisation (ITO), to facilitate and supervise extensive trade liberalisation. However, national concerns about its responsibilities and potential power ensured that the plans were soon abandoned (see MacBean and Snowden, 1981). Instead, the General Agreement on Trade and Tariffs (GATT) was created in 1948. Although it was given much more limited responsibilities than those planned for the ITO, it provided a useful forum for tariff bargaining. It was superseded in 1995 by the World Trade Organization (WTO).

The old spirit in a new century

The Bretton Woods System may never have operated as planned, but the spirit that made it possible had a lasting influence on the institutions created and the policies pursued by national governments after World War II. Hence, it is the spirit – and US adherence to it while it managed the System – rather than the supranational institutional blueprint that made it possible to realise many of its objectives to an extent that Keynes and his contemporaries could never have expected. In the process, new conditions have been created and new problems have emerged. Is the spirit still strong enough for the international community to translate it into the institutions and policies appropriate to the international environment at the beginning of the twenty-first century?

To answer this question, even in the very brief and sketchy form that the space allows here, it is necessary to take into account the extent to which the

Bretton Woods aims have been realised, whether they are still relevant, and how the existing framework of international organisations might be reformed to reflect the far-reaching changes that have taken place since the 1940s.

The starting point now, as in 1944, would have to be the ends – 'the primary objectives' – of national economic policy. They determine the nature of economic institutions, national and international, and the policies that individual organisations pursue. Furthermore, the capacity of individual countries to implement successfully the policies needed to achieve their desired ends will influence the nature and extent of international cooperation.

The improvements in economic welfare achieved over the last 50 years in many countries are without historical parallel (cf. Maddison, 2001). But progress has been unequal, increasingly so since the 1980s (Milanović, 2002). Poverty, homelessness and deprivation have not been eliminated, even in the most advanced economies. They are widespread in large parts of the developing world, where over a billion people live in conditions of extreme poverty (World Bank, 2000). Moreover, there is a good deal of dissatisfaction with existing economic performance even in countries where levels of prosperity are rising. Persistently high unemployment, job insecurity and growing inequalities are among the main reasons for this. In addition, aspirations tend to grow with income, for reasons that I discuss elsewhere (Panić, 2003).

Not surprisingly, surveys of social attitudes show remarkable agreement between countries in the importance which people attach to the Bretton Woods economic objectives of high levels of employment, economic development and rising income equally distributed (Goodin *et al.*, 1999).

To help satisfy these aspirations a new Bretton Woods would have to solve two difficult, interrelated *political* problems.

First, the prevalence of autarky and extensive wartime controls made it possible in 1944 to assume that governments would be able to apply successfully whatever policies were needed to achieve national economic objectives. The unprecedented increase in international interdependence over the last 40 years has diminished national economic sovereignty even of the largest economies to such an extent that it would be impossible to build a new global order starting from such a premise. That would require a completely new, much more complex approach to international economic cooperation (see Panić, 2003).

The second problem stems directly from the first, and raises questions of fundamental importance for the optimum level of economic openness and interdependence. As recognised explicitly at the 1944 Conference, countries at different levels of development, or with different institutions, can realise the same objectives only if they follow *different*, but compatible, policies – appropriate to their particular circumstances, problems and priorities. To impose the same policy package on *all* of them in these conditions – rather than to let them develop their own programme of action – is to condemn, as the recent African experience demonstrates (Devarajan *et al.*, 2001), a large proportion of the world's population to unacceptable, sub-optimal outcomes. The inter-war experience shows that an integrated international system is unsustainable under these conditions.

Trade liberalisation since the 1970s illustrates the danger inherent in such a system. Restoration of multilateral international trade, intended by the Bretton Woods blueprint to be one of the means to a general improvement in social welfare of *all* nations, has become a major obstacle to economic progress in developing countries.

GATT negotiations over the years have reduced tariffs and quotas to, probably, their lowest level since the beginning of the Industrial Revolution. The task of the WTO is to oversee and accelerate this process further (see Trebilcock and Howse, 1995; Hoekman and Kostecki, 1995; Krueger, 1998). The extent of trade liberalisation achieved so far might have been a remarkable realisation of one of the key Bretton Woods intentions. However, contrary to the intention, the quest for *freer* trade has degenerated over the last three decades into a rapid, indiscriminate, across-the-board pursuit of 'free trade' in those industries in which OECD countries, especially the United States, dominate.

Even the classical economists warned of welfare losses that could result from premature trade liberalisation (Panić, 1988, chapter 7). The pace of liberalisation, both Adam Smith and Ricardo cautioned, should reflect the ability of a country to adjust. *Ceteris paribus*, this depends, for reasons given by John Stuart Mill, on its relative level of development – which is particularly relevant now. Oligopolistic competition, economies of scale, capital intensity of production, unequal endowment in human capital and capacity for technical change give the established firms in advanced economies an advantage that few developing countries can challenge without protecting their 'infant' industries (Panić, 2003; Krugman, 1986). Yet, far from becoming more prominent, available evidence suggests that the *inverse* relationship between levels of economic development and protection broke down in the closing decades of the twentieth century (Panić, 2003, chapter 5).

This breakdown makes it difficult for developing countries to pursue an outward-looking growth strategy (as urged by international donors) based on exports of primary commodities and labour-intensive manufactures in which they have comparative advantage. The reason is that agriculture and labour-intensive products, such as textiles and clothing, are precisely the sectors that industrial countries are allowed to protect under the various GATT agreements (see McGovern, 1986). In addition, they have often used anti-dumping rules to make it difficult for developing countries to exploit the one advantage that they have in trade in manufactures: low costs and prices.

A new Bretton Woods would, clearly, have to reform the existing international trade rules and policies. That would require the constitution, *modus operandi* and governance of the WTO to be changed radically. Trade policies and 'transition periods' would differ according to a country's level of development and capacity for adjustment. Trade negotiations would have to take fully into account the welfare, health, safety and environmental consequences of trade liberalisation. To ensure that these decisions are carried out, the WTO would have to monitor the actions not only of governments but also of transnational enterprises, the driving force behind the process of globalisation (see Panić, 2003). Many past decisions might, therefore, have to be reversed because, as Samuelson (1939, p. 203) concluded after examining possible gains from trade: 'If self-sufficiency is not an end in itself ... trade is always preferable to no trade, although it is not necessarily true that *free* trade is the best policy'. Despite claims to the contrary, it cannot be demonstrated 'rigorously that *free* trade is better (in some sense) for a country than *all* other kinds of trade ...' (*ibid.*, p.195).

Compared to trade, a new Bretton Woods would have to adopt a completely different approach to exchange rate protection and international capital movements from the one in 1944.

A regime of fixed exchange rates is impossible to resurrect in the conditions of massive capital flows common since the 1970s; and a return to extensive exchange controls would be impractical. The choice is, therefore, between managed flexibility of currencies and the creation of a global monetary union with a single currency. As the latter belongs to a distant future, a continuation of the regime of managed floating is unavoidable. Moreover, it is also less of a threat to multilateral trade now than it was in 1944. One of the lessons of the 1970s and 1980s is that competitive devaluations or depreciations are ineffective, even counterproductive, in conditions of economic interdependence (IMF, 1984; Goldstein and Kahn, 1985; and Panić 2003, chapter 6). This means that, unlike in 1944, it is now the scale of global capital movements and the crises that they generate which would require special attention. Strict capital controls cannot be implemented effectively for long in dynamic capitalist economies, especially when they are dominated by *transnational* enterprises (Panić, 2003). The result is financial crises (Kindleberger, 1978; Goldstein, 1997) – too serious to be prevented by measures like the Tobin tax (Tobin, 1982; Haq *et al.*, 1996; Davidson, 1997).

An effective system of regulation and supervision becomes, therefore, essential (Goodhart, 1998; Goodhart *et al.*, 1998). As no regulatory framework can eliminate the crises completely, the main purpose of such a system is to reduce their scale and frequency. However, even this more modest aim can succeed only if there is active control and cooperation at the three levels: within financial institutions, national and international (Panić, 2003, chapter 9).

The main concern of a new Bretton Woods would be the last of these. There would have to be an international organisation within which the international community would set the standards for dealing with common problems, monitor that all its members observe them, and organise technical assistance to enable developing countries to implement effective regulatory frameworks. Equally important, the institution would not be allowed to pursue a dogmatic policy towards financial deregulation and liberalisation. The sterling crisis in 1947 and the Asian Crisis in 1997 demonstrated how highly destabilising the two could be if a country is forced to adopt them before it is ready. Hence, as in 1944, no country would be required to introduce such policy changes if they threatened its social welfare. Given its experience in this field (cf. Basle Committee on Banking Supervision, 1991; 1997; 1999), a reconstituted Bank for International Settlements (BIS) would be the obvious institution to coordinate international regulation and supervision of financial institutions.

However, it is those two flagships of the 1944 system, the IMF and the World Bank, that would present a new Bretton Woods with its greatest challenge.

Their role has changed in many ways since the 1940s (see James, 1996; Nayyar, 2002). The problem is that these changes are widely seen as betraying the principles of Bretton Woods. Both are accused of acting in the interest of powerful financial and commercial interests in industrial countries by promoting dogmatically the ideology of neo-liberalism to the detriment of social welfare in developing countries (Payer, 1974 and 1982). The high economic and social cost of the policies imposed by the two organisations on many developing and transition economies and, more recently, on countries at the centre of the Asian Financial Crisis – also raises serious doubts about their ability to contribute to global public goods (Nayyar, 2002; Stiglitz, 2002; Lavigne, 1999). The letter written at the beginning of July 2002 by 100 members of the Indonesian Parliament to the Heads of the IMF and World Bank is a devastating criticism of their contribution to the collapse of the country's economy and its social consequences. It also adds a question of fundamental importance to those already raised: are these organisations supposed to be the servants of the international community or its masters? (The letter is reported in *Bretton Woods Update* July/August 2002.)

The need for Bretton Woods-type institutions to help achieve global public goods is as great now as it was half a century ago (see Kaul *et al.*, 1999 for a discussion of global public goods). The growth of transnationals and the liberalisation of international capital flows have removed the risk, which concerned Keynes and his contemporaries, that a shortage of international liquidity could plunge the world into another round of protectionism, depression and war. The problem is that all countries do not have equal access to the private funds available on international financial markets. Most developing countries still rely heavily on the kind of assistance that the IMF and World Bank were created to provide. A new Bretton Woods would have to ensure that they receive it on conditions consistent with the Bretton Woods intentions.

This would require specific measures to prevent the potential misuse of authority and resources at the disposal of the two organisations. These could range from avoiding overlap in their responsibilities to changes in their accountability, governance and restrictions on 'Conditionality' to ensure that it is not a threat to global public goods. Each would be required to establish branches in different parts of the world, making it better informed about local conditions, needs and resources. Neither would be allowed to impose the neoclassical or any other ideology on the borrowing countries. Given that resources are limited, strict auditing would be needed to prevent them from lending to corrupt governments as an inducement to support the policies of the US or other major industrial countries (see Barro and Lee, 2002; Devarajan *et al.*, 2001; Alesina and Dollar, 1998).

Finally, it is clear even from the sketchy analysis in this section that a new Bretton Woods would have to broaden the original institutional framework. Bringing a revamped BIS within it would help the stabilisation effort. Even more urgent now is the need for a global environmental agency – something along the lines of the World Environment and Development Organisation suggested by Simonis (2002). Given the effect of industrialisation on the environment so far, a long-term global development strategy that does not take into account its impact on the environment is unlikely to be sustainable in the twenty-first century (cf. IPCC, 2001).

To avoid costly duplications of effort or conflicts of interest, the international community would have to define clearly the interrelationship between the five core economic organisations (that is those covered in this section) and their relations with other important international institutions whose responsibilities may overlap with theirs.

Conclusion

Whatever the original intentions, the performance of supranational or any other institutions depends on those who exercise effective control over them. Hence, in the absence of a global government, the failure of the Bretton Woods institutions to act in accordance with the principles that led to their creation lies not so much with the institutions themselves as with the attitude and policies of the governments of their dominant members. Members of the Indonesian Parliament should, therefore, have addressed their letter to the heads of these governments rather than to those of the IMF and World Bank!

Given the extent of global economic interdependence, the need for a new Bretton Woods is obvious. The objective of achieving global public goods through improvements in national social welfare is as relevant now as it was in the 1940s. However, without the spirit of Bretton Woods – the absence of which is equally obvious at present – it would be impossible to convene such a conference, let alone to agree on a common course of action and implement it. Much more likely, the realities of interdependence may force an increasing number of countries to organise regional 'Bretton Woods' or, following the example of Western Europe, create economic and monetary unions.

Globally, however, the most that one can hope for is an improvement in the work of the existing institutions along *some* of the lines suggested in this chapter. Unfortunately, the present (2003) US Administration in Washington makes even the objective of such modest improvements look positively utopian.

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PART VIII

POLICY IMPLICATIONS AND RESPONSES

23 Kicking away the ladder – globalisation and economic development in historical perspective[1]

Ha-Joon Chang

1. Introduction

To most of those who govern the global economy today – the developed country policy-makers, international business leaders, and the international economic organisations (the IMF, the World Bank, and the WTO) – the solution to the problem of economic development is obvious. What the developing countries need, they argue, is the 'good' economic policies and institutions that the developed countries themselves used in order to develop – such as liberalisation of trade and investment and strong patent law. Their belief in their own recommendation is so absolute that in their view it has to be imposed on the developing countries at all costs, through strong bilateral and multilateral external pressures.

As is well known, there have been heated debates on whether these policies and institutions are suitable to the developing countries. However, the curious thing is that even those who are sceptical of their suitability rarely question whether these are the policies and the institutions that the developed countries actually used in order to become rich.

The historical fact is, though, that the rich countries did not develop on the basis of the policies and the institutions that they now recommend to, and often force upon, the developing countries. In this chapter, I will establish this fact and draw from it some implications for today's debates on globalisation and economic development. But before doing so, let me first critically examine what I call the 'official history of capitalism' which informs these debates.

2. The official history of capitalism

According to the 'official history of capitalism', the world economy has developed in the following way over the last few centuries.

From the eighteenth century, Britain proved the superiority of free-market and free-trade policies by beating interventionist France, its main competitor at the time, and establishing itself as the supreme world economic power. In particular, once it had abandoned its deplorable agricultural protection (the Corn Law) and other remnants of old mercantilist protectionist measures in

1846, it was able to play the role of the architect and the hegemon of a new 'liberal' world economic order. This liberal world order, perfected around 1870, was based on: *laissez faire* industrial policies at home; low barriers to the international flows of goods, capital and labour; and macroeconomic stability, both nationally and internationally, guaranteed by the Gold Standard and the principle of balanced budgets. A period of unprecedented prosperity followed.

Unfortunately, according to this story, things started to go wrong with World War I. In response to the ensuing instability of the world economic and political system, countries started to erect trade barriers again. In 1930, the USA abandoned free trade and raised tariffs with the infamous Smoot–Hawley tariff, which the famous free-trade economist Jagdish Bhagwati called 'the most visible and dramatic act of anti-trade folly' (Bhagwati, 1985, p. 22, fn. 10). The world free trade system finally ended in 1932, when Britain, hitherto the champion of free trade, succumbed to the temptation and re-introduced tariffs. The resulting contraction and instability in the world economy and then finally World War II destroyed the last remnants of the first liberal world order.

After World War II, so the story goes, some significant progress was made in trade liberalisation through the early GATT (General Agreement on Trade and Tariffs) talks. However, unfortunately, *dirigiste* approaches to economic management dominated the policy-making scene until the 1970s in the developed world, and until the early 1980s in the developing world (and the Communist world until its collapse in 1989).

Fortunately, it is said, interventionist policies have been largely abandoned across the world since the 1980s with the rise of neo-liberalism, which emphasises the virtues of small government, *laissez faire* policies, and international openness. Especially in the developing world, by the late 1970s economic growth had begun to falter in most countries outside East and South-east Asia, which were already pursuing 'good' policies (of free market and free trade). This growth failure, which often manifested itself in economic crises of the early 1980s, exposed the limitations of old-style interventionism and protectionism. As a result, most developing countries have come to embrace 'policy reform' in a neo-liberal direction.

When combined with the establishment of new global governance institutions represented by the WTO, these policy changes at the national level have created a new global economic system, comparable in its (at least potential) prosperity only to the earlier 'golden age' of liberalism (1870–1914).

As we shall see later, this story paints a fundamentally misleading picture, but a no less powerful one for it. And it should be accepted that there are also some senses in which the late nineteenth century can indeed be described as an era of *laissez faire*.

To begin with, there was a period in the late-nineteenth century, albeit a brief one, when liberal trade regimes prevailed in large parts of the world economy. Between 1860 and 1880, many European countries reduced tariff protection substantially. At the same time, most of the rest of the world was forced to practise free trade through colonialism and through unequal treaties in the cases of a few nominally 'independent' countries – such as the Latin American countries, China, Thailand (then Siam), Iran (then Persia), and Turkey (then the Ottoman Empire), and even Japan (until 1911). Of course, the obvious exception to this was the USA, which maintained a very high tariff barrier even during this period (see below). However, given that the USA was still a relatively small part of the world economy, it may not be totally unreasonable to say that this is as close to free trade as the world has ever got (or probably ever will).

More importantly, the scope of state intervention before World War II (or at least before World War I) was quite limited by modern standards mainly for institutional reasons – such as the absence of income tax, the absence of the central bank, and the Gold Standard.

Despite these limitations, as we shall see in the next section, virtually all now-developed countries (NDCs) actively used interventionist industrial, trade and technology (ITT) policies which are aimed at promoting infant industries during their catch-up periods.

3. History of industrial, trade and technology policies: widespread use of tariffs and subsidies

Almost all of today's rich countries used tariffs and subsidies to develop their industries in the earlier stage of their development. It is particularly important to note that Britain and the USA, the two countries that are supposed to have reached the summit of the world economy through free-market, free-trade policy, are actually the ones that most aggressively used protection and subsidies.

Contrary to the popular myth, Britain was an aggressive user, and in certain areas a pioneer, of activist policies intended to promote its industries. Such policies, although limited in scope, date back from the fourteenth century (Edward III) and the fifteenth century (Henry VII) in relation to woollen manufacturing, the leading industry of the time. At the time, England was an exporter of raw wool to the Low Countries, and various English monarchs tried to change this by protecting domestic woollen textile producers, taxing raw wool exports, and poaching skilled workers from the Low Countries.

Particularly between the trade policy reform of its first Prime Minister Robert Walpole in 1721 and its adoption of free trade around 1860, Britain used very *dirigiste* trade and industrial policies, involving measures very similar to those that countries like Japan and Korea later used in order to develop their economies. During this period, it protected its industries a lot more heavily than did France, the supposed *dirigiste* counterpoint to its free-trade, free-market system (Nye, 1991). Germany, another country frequently associated with state interventionism, had much lower tariffs than Britain during this period, although the German states tended to use other means of economic intervention more actively.

Given this history, argued Friedrich List, the leading German economist of the mid-nineteenth century, Britain preaching free trade to less advanced countries like Germany and the USA was like someone trying to 'kick away the ladder' with which he had climbed to the top. He is worth quoting at length on this point.

> It is a very common clever device that when anyone has attained the summit of greatness, he *kicks away the ladder* by which he has climbed up, in order to deprive others of the means of climbing up after him. In this lies the secret of the cosmopolitical doctrine of Adam Smith, and of the cosmopolitical tendencies of his great contemporary William Pitt, and of all his successors in the British Government administrations.
>
> Any nation which by means of protective duties and restrictions on navigation has raised her manufacturing power and her navigation to such a degree of development that no other nation can sustain free competition with her, can do nothing wiser than *to throw away these ladders* of her greatness, to preach to other nations the benefits of free trade, and to declare in penitent tones that she has hitherto wandered in the paths of error, and has now for the first time succeeded in discovering the truth (List, 1885, pp. 295–6, italics added).

The USA, today's supposed champion of free trade, was even more protectionist than Britain throughout most of its history before World War II. According to the authoritative study by Paul Bairoch (1993), between the Civil War and World War II, it was literally the most heavily protected economy in the world. Indeed, even the Smoot–Hawley Tariff of 1930, which Bhagwati in the above quote portrays as a radical departure from its free-trade tradition, only marginally (if at all) increased the degree of protectionism in the US economy. The average tariff rate for manufactured goods that resulted from this bill was 48 per cent, and it still falls within the range of the average rates that had prevailed in the USA since the Civil War (40–50 per cent), albeit in the upper region of this range.

In this context, it is also important to note that the American Civil War was fought on the issue of tariffs as much as, if not more than, on the issue of slavery. Of the two major issues that divided the North and the South, the South had actually more to fear on the tariff front than on the slavery front. Abraham Lincoln was a well-known protectionist who had cut his political teeth under the charismatic politician Henry Clay in the Whig Party, which advocated the 'American System' based on infrastructural development and protectionism (thus named on recognition that free trade was in 'British' interests). On the other hand, Lincoln thought the blacks were racially inferior and slave emancipation was an idealistic proposal with no prospect of immediate implementation – he is said to have emancipated the slaves in 1862 as a strategic move to win the War rather than out of some moral conviction.

The USA was also the intellectual home of protectionism throughout the nineteenth century. It was in fact American thinkers like Alexander Hamilton, the first Treasury Secretary of the USA, and the now-forgotten economist Daniel Raymond, who first systematically developed the so-called 'infant industry' argument which justifies the protection of manufacturing industries in the less developed economies. Indeed, List, who is commonly known as the father of the infant industry argument, started out as a free-trader and learnt about the Hamiltonian infant industry argument during his exile in the USA during the 1820s.

In heavily protecting their industries, the Americans were going directly against the advice of such prominent economists as Adam Smith and Jean Baptiste Say, who saw their country's future in agriculture. However, they knew exactly what the game was. They knew that Britain had reached the top through protection and subsidies and therefore that they needed to do the same if they were going to get anywhere. Criticising the British preaching of free trade to his country, Ulysses Grant, the Civil War hero and the US President between 1868–1876, retorted that 'within 200 years, when America has gotten out of protection all that it can offer, it too will adopt free trade'. When his country later reached the top after World War II, it too started 'kicking away the ladder' by preaching and forcing free trade on the less-developed countries.

The UK and the USA may be the more extreme examples, but almost all the rest of today's developed countries used tariffs, subsidies and other means to promote their industries in the earlier stages of their development. Cases like Germany, Japan and Korea are well known in this respect. But even countries like Sweden, which later came to represent the 'small open economy' to many economists, also strategically used tariffs, subsidies, cartels and state support for R&D to develop key industries, especially textile, steel and engineering.

There were some exceptions like the Netherlands and Switzerland that have maintained free trade since the late eighteenth century. However, these were countries that were already on the frontier of technological development by the eighteenth century and therefore did not need much protection. Also, it should be noted that the Netherlands had deployed an impressive range of interventionist measures up till the seventeenth century in order to build up its maritime and commercial supremacy. Moreover, Switzerland did not have a patent law until 1907. More interestingly, the Netherlands abolished its 1817 patent law in 1869 on the grounds that patents were politically-created monopolies inconsistent with its free-market principles – a position that seems to elude most of today's free-market economists – and did not introduce a patent law again until 1912.

4. History of institutional development: the long and winding road

The story is similar in relation to institutional development. Contrary to what is assumed by today's development orthodoxy, most of the institutions that are regarded as prerequisites for economic development emerged after, and not before, a significant degree of economic development in the now-developed countries. Without claiming to be exhaustive, let us examine the six categories of institutions that are widely believed to be prerequisites of development: democracy, bureaucracy, intellectual property rights, institutions of corporate governance, financial institutions (including public finance institutions), and welfare and labour institutions.

Whatever one's position is on the relationship between democracy and economic growth in today's world, it is indisputable that today's developed countries did not develop under democracy. Until the 1920s even universal male suffrage was a rarity. It was not until the late twentieth century that all developed countries became truly democratic. Spain and Portugal were dictatorships until the 1970s, votes were given to all ethnic minorities in Australia and the USA only in 1962 and 1965 respectively, and women in many countries were given the suffrage only after World War II, and in Switzerland as late as 1971. Until World War II, even when democracy formally existed, its quality was extremely poor. Secret balloting was introduced only in the early twentieth century even in France and Germany, and corrupt electoral practices, such as vote buying, electoral fraud and legislative corruption, lasted in most of today's developed countries well into the twentieth century.

In terms of bureaucracy, sales of offices, spoils system and nepotism abounded in most countries until the early twentieth century. Modern professional bureaucracy first emerged in Prussia in the early nineteenth century, but much later in other countries – even Britain got a modern bureaucracy only in the mid-nineteenth century. Until the Pendleton Act in 1883, none of the US federal bureaucrats were competitively recruited, and even at the end of the nineteenth century, less than half of them were competitively recruited.

A similar story emerges in terms of intellectual property rights institutions, which have become a key issue following the recent controversy surrounding the TRIPS (trade-related intellectual property rights) agreement in the WTO. Until the late nineteenth century, many countries allowed patenting of imported inventions. As mentioned earlier, Switzerland and the Netherlands refused to protect patents until the early twentieth century. The US did not recognise foreign citizens' copyrights until 1891. And throughout the nineteenth century, there was a widespread violation of British trademark laws by the German firms producing fake 'Made in England' goods.

Even in the most developed countries (the UK and the US), many key institutions of what is these days regarded as a 'modern corporate governance' system emerged after, rather than before, their industrial development. Until the 1870s, in most countries limited liability, without which there would be no modern corporations based on joint stock ownership, was something that was granted as a privilege to high-risk projects with good government connections (for example, the British East India Company), and not as a standard provision. Until the 1930s, there was virtually no regulation on company audit and information disclosure. Until the late nineteenth century, bankruptcy laws were geared towards punishing the bankrupt businessmen (with debtors' prison being a key element in this) rather than giving them a second chance. Competition law did not really exist in any country until the 1914 Clayton Act in the USA.

As for financial institutions, it would be fair to say that modern financial systems with widespread and well-supervised banking, a central bank, and a well-regulated securities market did not come into being even in the most developed countries until the mid-twentieth century (Kindleberger, 1984). In particular, until the early twentieth century, countries such as Sweden, Germany, Italy, Switzerland and the US lacked a central bank.

A similar story applies to public finance. The fiscal capacity of the state remained highly inadequate in most now-developed countries until the mid-twentieth century, when most of them did not have income tax. Even in Britain, which introduced the first permanent income tax in 1842, William Gladstone was fighting his 1874 election campaign with a pledge to abolish income tax. With limited taxation capability, local government finance in particular was in a mess. A most telling example is an episode documented in Cochran and Miller (1942, p. 48), where the British financiers put pressure in vain on the US federal government to assume the liabilities of a number of US state governments after their defaults on British loans in 1842 – a story that reminds us of the events in Brazil following the default of the state of Minas Gerais in 1999.

Social welfare institutions (for example, industrial accident insurance, health insurance, state pensions, unemployment insurance) did not emerge until the last few decades of the nineteenth century, although once introduced they diffused quite quickly. Germany was a pioneer in this respect. Child labour regulations started emerging in the late eighteenth century, but until the early twentieth century, most of these regulations were extremely mild and poorly enforced. Until the early twentieth century, in most countries regulation of working hours or working conditions for adult male workers was considered unthinkable. For example, in 1905 the US Supreme Court declared in a famous case that an Act introduced by the New York state restricting bakers to a 10-hour working day was unconstitutional because 'it deprived the baker of the liberty of working as long as he wished' (Garraty and Carnes, 2000, p. 607).

One important conclusion that emerges from historical examination is that it took the developed countries a long time to construct institutions in the earlier days of their development. Institutions typically took decades, and sometimes generations, to develop. Just to give one example, the need for central banking was perceived, at least in some circles, from as long ago as the seventeenth century, but the first 'real' central bank, the Bank of England (founded in 1694), was instituted only by the Bank Charter Act of 1844, some two centuries later.

Another important point emerges from historical comparison of the levels of institutional sophistication in today's developed countries in the earlier period with those in today's developing countries.

For example, measured by the (admittedly highly imperfect) per capita national income level, in 1820, the UK was at a somewhat higher level of development than that of India today, but it did not even have many of the most 'basic' institutions that India has today. It did not have universal suffrage (it did not even have universal *male* suffrage), a central bank, income tax, generalised limited liability, a generalised bankruptcy law, a professional bureaucracy, meaningful securities regulations, and even basic labour regulations (except for a couple of minimal and hardly-enforced regulations on child labour).

This kind of comparison can go on, but the point is that the developed countries in earlier times were institutionally *less* advanced compared to today's developing countries at similar stages of development. Needless to say, the quality of their institutions fell well short of the 'global standards' institutions that today's developing countries are expected to install.

5. Concluding remarks

If the policies and institutions that the rich countries are recommending to the poor countries are not the ones that they themselves used when they were developing, what is going on? We can only conclude that, whether intentionally or not, the rich countries are effectively 'kicking away the ladder' that allowed them to climb to where they are now.

It is no coincidence that economic development has become more difficult during the last two decades, when the developed countries have been turning up the pressure on the developing countries to adopt the so-called 'good' policies and institutions. Their average annual per capita income growth rate has been halved (from 3 per cent to 1.5 per cent) between the 1960–80 period and the 1980–2000 period. And even this disappointing growth rate would not have been achieved except for rapid growths in large countries like China and India, which have not followed the orthodox strategy but have reformed and opened up their economies at their own pace. During this period, Latin America has virtually stopped growing, while sub-Saharan Africa and most ex-Communist countries have experienced a fall in absolute income. Economic instability has increased markedly, as manifested in the dozens of financial crises we have witnessed over the last decade alone. Income inequality has been growing in many developing countries and poverty has increased, rather than decreased, in a significant number of them.

What can be done to change this situation?

First, the facts about the historical experiences of the developed countries should be more widely publicised. This is not just a matter of 'getting history right', but also of allowing the developing countries to make more informed choices about their strategies of economic development and global integration.

Second, the conditions attached to bilateral and multilateral financial assistance to developing countries should be radically changed. It should be accepted that the orthodox recipe is not working, and also that there can be no single 'best practice' policies that everyone should use. More specifically, the 'bad policies' that most of today's developed countries used with so much effectiveness when they were developing countries themselves should be at least allowed, if not actively encouraged, by the developed countries and the international financial institutions that they control. While it is true that activist trade and industrial policies can sometimes degenerate into a web of red tape and corruption, this should not mean that these policies should never be used.

Third, the WTO rules should be re-written so that the developing countries can more actively use tariffs and subsidies for industrial development. They should also be allowed to have less stringent patent laws and other intellectual property rights laws.

Fourth, improvements in institutions should be encouraged, but this should not be equated with imposing a fixed set of (in practice, today's – not even yesterday's – Anglo-American) institutions on all countries. There need to be more serious attempts, both at the academic and the practical levels, to explore exactly which institutions are necessary, or at least beneficial, for what types of countries, given their stages of development and their economic, political, social and even cultural conditions. Special care has to be taken in order not to demand excessively rapid upgrading of institutions by the developing countries, especially given that they already have quite sophisticated institutions when compared to today's developed countries at comparable stages of development, and given that establishing and running new institutions is costly.

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By having the freedom to choose policies and institutions that are more suitable to their conditions, the developing countries will be able to develop faster. This will also benefit the developed countries in the long run, as it will increase their trade and investment opportunities. That the developed countries cannot see this is the tragedy of our time.

Note

1. This chapter summarises the arguments presented in Ha-Joon Chang (2002), *Kicking Away the Ladder – Development Strategy in Historical Perspective*, London: Anthem Press. References and notes have been kept to a minimum in this chapter: further references can be found in the book.

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24 Time to replace globalisation with localisation

Colin Hines

Corporate globalisation v. Internationalism

It is crucial to make a clear distinction between for example a global flow of technology, ideas and information to rebuild sustainable local communities – that is a supportive 'internationalism' – and the process of globalisation. In essence, the latter is the systematic reduction of protective barriers to the flow of goods and money by international trade rules shaped by and for big business. It pits country against country, community against community and workers against workers. That is the point of it, because such a structure and process is the route to maximising profits. Internationalism can be thought of as the flow of ideas, technologies, information, culture, money and goods with the end goal of protecting and rebuilding local economies worldwide. Its emphasis is not on competition for the cheapest, but on cooperation for the best.

Linguistic clarity is vital since the advocates and beneficiaries of globalisation misuse the indisputable benefits that can accrue from such constructive international flows to justify the destructive process of globalisation. In tandem with this misleading approach is invariably a promise that some day the growth resulting from globalisation will somehow trickle down to benefit the majority.

Corporate globalisation

Corporate globalisation: the ever-increasing integration of national economies into the global economy through trade and investment rules and privatisation, aided by technological advances. These reduce barriers to trade and investment and in the process reduce democratic controls by nation states and their communities over their economic affairs. The process is driven by the widespread lobbying of large corporations who use the theory of comparative advantage, the goal of international competitiveness and the growth model to achieve the maximisation of their profits. It is occurring increasingly at the expense of social, environmental and labour improvements and rising inequality for most of the world.

Or more bluntly, Globalisation: (1) the process by which governments sign away the rights of their citizens in favour of speculative investors and transnational corporations. (2) the erosion of wages, social welfare standards and environmental regulations for the sake of international trade. (3) the imposition worldwide of a consumer monoculture. Widely but falsely believed to be irreversible. See also financial meltdown, casino economy, Third World debt and race to the bottom. (16th century: from colonialism, via development).[1]

An alternative: localisation

Localisation: a process which reverses the trend of globalisation by discriminating in favour of the local. Depending on the context, the 'local' is predominantly defined as part of the nation state, although it can on occasions be the nation state itself or even occasionally a regional grouping of nation states. The policies bringing about localisation are ones which increase control of the economy by communities and nation states. The result should be an increase in community cohesion, a reduction in poverty and inequality and an improvement in livelihoods, social infrastructure and environmental protection, and hence an increase in the all-important sense of security.

Localisation is not about restricting the flow of information, technology, trade and investment, management and legal structures – which further localisation, indeed these are encouraged by the new localist emphasis in global aid and trade rules. Such transfers also play a crucial role in the successful transition from globalisation to localisation. It is not a return to overpowering state control, merely governments' provision of a policy and economic framework that allows people, community groups and businesses to rediversify their own local economies.

The route to localisation consists of seven interrelated and self-reinforcing policy areas. The basic steps are:

i. reintroduction of protective safeguards for domestic economies;
ii. a site-here-to-sell-here policy for manufacturing and services domestically or regionally;
iii. localising money such that the majority stays within its place of origin;
iv. local competition policy to eliminate monopolies from the more protected economies;
v. introduction of resource taxes to increase environmental improvements and help fund the transition to the 'Protect the Local, Globally' approach;
vi. increased democratic involvement both politically and economically to ensure the effectiveness and equity of the movement to more diverse local economies;
vii. reorientation of the end goals of aid and trade rules such that they contribute to the rebuilding of local economies and local control.

Under these circumstances, beggar-your-neighbour globalisation gives way to the potentially more cooperative better-your-neighbour localisation.

A wake-up call for the politically active – globalisation can't be tinkered with

What we have at present is an array of largely futile efforts by political activists from trades unionists to development NGOs, to tame globalisation. Campaigns for 'labour standards' or 'fair trade' or 'voluntary ethical codes' fundamentally mistake the nature of the trade liberalisation beast. These attempts are like trying to lasso a tiger with cotton. It is now time to return this tiger to its original habitat. Trade was initially a search for the novel; Europeans went to India for spices and other exotics, not coal. That is precisely the 'localisation' approach, but without the former's disastrous social effects. Long-distance trade is only for acquiring what cannot be provided within the region where people live. The rules for this diminished international sector then become those of the 'fair trade' movement, where preference is given to goods supplied in a way that benefits workers, the local community and the environment.

The politically active need to demand a new direction and end goal for trade rules. The latter must contribute to the rebuilding and protection of local sustainable economies. In the process, the myriad goals of movements for social and animal welfare, development, human and labour rights and environmental protection have much more potential to be met.

Bringing about the change in direction

To bring about this change it is crucial to play the globalisers at their own game. They have a clear end goal: maximum trade and money flows for maximum profit. From this end goal comes a clear set of policies and trade rules supporting this approach. Those seeking a more just, secure, environmentally sustainable future need to have their own clear end goal and policies for achieving it. This will require the 'mindwrench' mentioned above, away from mostly concentrating on opposing globalisation towards considering the detailed policy route to its alternative – localisation.

A programme for localisation

To achieve such a dramatic turnaround I have drawn from many people's ideas and detailed in my book (Hines, 2002)[2] a 'Protect the Local, Globally' set of interactive and self-reinforcing policies that can bring about localisation.

Protecting the local economy

The first step must be a 'mind-wrench' away from the passive acceptance that globalisation is as inevitable as gravity and towards support for a set of self-reinforcing measures that will bring about a 'Protect the Local, Globally' end goal internationally. Protective safeguards, such as import and export controls, quotas, subsidies and so on, will need to be introduced over a clearly agreed transition period to all continents. This will not be old style protectionism which seeks to protect a home market whilst expecting others to remain open. The emphasis will be on local trade. Any residual long-distance trade will be geared to funding the diversification of local economies. Such a dramatic, radical change will need to overcome TNC opposition and so will need to take place at the level of regional groupings of countries, especially the most powerful – in Europe and North America.

Localising production and controlling TNCs
Industry and services will be localised by site-here-to-sell-here policies to ensure localised production. Threats by TNCs to relocate thus become less plausible, as the market is lost to existing, or government encouraged, new local competitors. Once TNCs are thus grounded, then their domestic activities and the levels of taxation paid are back under democratic control. Campaigners' demands for social, labour and environmental standards also become feasible. Adequate company taxation can help compensate the poor for any increases in prices.

Localising money
The disastrous effects of the unfettered international flow of money have led to global calls for some controls to be reintroduced. What is required is a regrounding of money to remain predominantly in the locality or country of origin to fund the rebuilding of diverse, sustainable local economies. Measures include controls on capital flows, Tobin-type taxes, control of tax evasion, including off-shore banking centres, the floating of civic bonds and the rejuvenation of locally orientated banks, credit unions, Local Exchange and Trading Schemes (LETS) and so on. Public and private flows of money to other countries must also be directed to strengthen the local economies of the countries concerned.

A localist competition policy
Local competition policies will ensure that high quality goods and services are provided by ensuring a more level, but more local, playing field. Free of the 'race to the bottom' competitive pressures from foreign competition, business can be carried out within the framework of ever-improving labour, social and environmental regulations, enhanced by the best ideas and technologies from around the world. Government competition policy will cover the structure and market share of businesses, plus regulate the behaviour of firms.

Taxes for localisation

To pay for the transition to localisation and to improve the environment the majority of taxation will come from gradually increasing resource taxes, such as on non-renewable energy use and pollution. To promote a more equitable society, the removal of the option of relocation or the availability of foreign tax havens will make it possible to tax companies and individuals according to their wealth, their income, their spending through value added tax and their land. Part of this taxation will be used to compensate the poorer sections of society for any price rises and by shifting taxes away from employment to encourage more jobs.

Democratic localism

A diverse local economy requires the active democracy of everyday involvement in producing the maximum range of goods and services close to the point of consumption. To ensure the broadest distribution of the ensuing benefits will simultaneously require wider, political, democratic and economic control at a local level. A Citizen's Income will allow involvement in the economy as a matter of right. Political funding will be strictly constrained and power will pass from the corporations to the citizens. This will involve the encouragement of maximum participation in defining priorities and planning local economic, social and environmental initiatives. This will require a balance of involvement of the state, community networks and organisations and citizen's movements.

Trade and aid for localisation

The GATT rules at present administered by the WTO should be revised fundamentally to become a General Agreement for Sustainable Trade (GAST), administered by a democratic World Localisation Organisation (WLO). Their remit would be to ensure that regional trade and international aid policies and flows, information and technological transfer, as well as the residual international investment and trade, should incorporate rules geared to the building up of sustainable local economies. The goal should be to foster maximum employment through a substantial increase in sustainable, regional self-reliance.

Localising food security

Globalisation is increasing control of the world's food system by transnational companies (TNCs) and big farmers. There is a backlash from both consumers and farmers to this process that provides less safe food, environmental threats and rural impoverishment. Localisation can reverse this trend. Food security both for rich and poor countries requires an increase in the level of self-sufficiency. Also needed is a dramatic reduction in international trade in foodstuffs until the commerce left becomes a useful adjunct to increased self-reliance. This should be governed by fair trade rules benefiting small farmers and food producers, animal welfare and the environment. Land reform and the rebuilding of rural economies is an integral part of such food localisation.

Finally, 'localisation' is not about trying to put the clock back. Globalisation is doing that as it reduces the security, basic needs provision and employment prospects for billions for whom things had been improving since World War II. The 'Protect the Local, Globally' policies of 'localisation' could return us to a path that advances the majority and doesn't mire them in cruel insecurity. It is not against trade, it just wants trade, where possible, to be local. The shorter the gap between producer and consumer, the better the chance for the latter to control the former. Adverse environmental effects are more likely to be experienced through long-distance trade and lack of consumer control over distant producers. Local trade should significantly lessen these problems and make possible the tighter regulation required.

Why should this radical change come about?

The widespread resistance to globalisation can be built upon to help fashion a viable localist alternative. There are already countless people and groups strengthening their local economies from the grass roots up. The greatest spur to consideration of such radical local alternatives at the governmental level will be the need to respond to global economic upheavals and the deflation, the job losses and inadequate consumer demand that will come in its wake. Equally crucial in shaping a different localist imperative amongst politicians will be the pressure that the politically active can bring to bear. This must shift from just fighting separate issue-specific aspects of globalisation to realising that their individual successes can only be secured as part of an overarching change to localisation, but in an internationally supportive manner.

Development professionals' calls for a 'fairer' liberalised trading system ignore the reality of what the rules of trade liberalisation have done to the poor in the South. Development NGOs also adhere to the flawed paradigm that exports from the South to the North are a major route for the poor's development. Southern critics of this approach point to the inevitability of adverse competition between poor exporting countries, its hijacking of national priorities to the provision of the cheapest exports, the adverse working conditions and country-hopping demanded by the companies involved and instead propose the alternative of a localist development policy.

Development NGOs must recognise these facts and make their campaigns more effective by putting them within an overarching and internationalist 'localisation' context. Thus campaigns against the World Bank, IMF, Debt, WTO and so on must recognise that it is not the actual institutions or the people working in them that are the problem. Rather it is the end goal of their activities and policies. What must be challenged up-front is the fact that they are geared to the continued contortion and distortion of every country's economy in order to prioritise international competitiveness and obey the diktats of globalisation.

Were trade and aid rules and debt forgiveness geared to the radically different end goal of protecting and rebuilding local communities globally then such dramatically altered institutions could play a useful part in the necessary transition of saving the world from globalisation by shifting it to localisation.

Just as the last century saw the battle between the left and the right, what needs to become the big battle of this century must be an alliance of localists, red-greens and small 'c' conservatives pushing a localist agenda, defeating the doomed globalists of the political centre. So, with apologies to Karl Marx and Margaret Thatcher, the rallying cry should be: 'Localists of the World Unite – There is an Alternative'.

Notes

1. International Society for Ecology and Culture (1999). *From Global to Local – resisting monoculture, rebuilding community*. ISEC, Devon.
2. Hines, Colin (2002). *Localization – A Global Manifesto*. London: Earthscan.

25 Free trade or social tariffs?

George DeMartino

Introduction

The last quarter of the twentieth century was marked by dramatic steps toward the achievement of global neo-liberalism. This is a policy regime in which largely unregulated market forces override the state in directing international trade and investment flows. It therefore comprises 'free' trade, the liberalisation of international financial markets, the global protection of property rights, and so forth. It has been constructed through a series of important international agreements, including notably the North American Free Trade Agreement, the GATT agreement that established the World Trade Organization, and through other explicit policy choices taken at the national and multilateral levels.

The history of economic integration since the late nineteenth century suggests that global neo-liberalism will prove to be unsustainable. As in the past, (cf. Polanyi, 1944), the dislocations and instability that are associated with today's increasingly market-driven international trade and financial flows are instigating political reaction in the form of demands on national governments for economic protection and security. But global neo-liberalism has made it difficult for national governments to provide these protections, not least since this regime creates ample opportunity for private investors and firms to escape taxation by relocating their assets internationally. At just the time that workers and other vulnerable groups need greater state assistance, then, the burden of taxation required to fund social programmes has shifted onto the shoulders of these very same groups. While free trade promises economic growth which might be expected to offset the effects of growing instability, recent estimates find that trade has a larger effect on inequality than it does on growth (cf. Rodrik, 1997).

Facing these difficulties, states will be pressed by diverse constituencies to establish protective barriers to insulate their domestic economies from global economic forces. Not least, they will be pressed to renege on their commitment to free trade. The important question that arises in this context is what will come next, after the current experiment with free trade has been abandoned.

Many heterodox economists and social movements across the globe have begun to advocate new trade and investment regimes that can reap the potential benefits of international economic integration, while protecting vulnerable groups from the most damaging tendencies of neo-liberalism. Many worry that if the campaign for a new, just trade and investment regime fails, we risk the prospect of a return to the antagonistic, nativist and neo-mercantilist trade policies of the past that have proven so destructive. Indeed, the impulse to pursue nationalist trade policy is in evidence today even in the US (some would say especially in the US), which has arguably done more to advance the cause of global neo-liberalism than has any other country. Like all his recent predecessors, President Bush has been more than willing to resort to protectionist measures (most recently in the case of steel imports) whenever domestic political circumstances dictate. As opposition to free trade mounts, so will the pressure on political actors to install belligerent, nationalist trade measures.

In this context, neo-classical trade theorists have retained their commitment to free trade, and indeed have advocated further liberalisation. Unfortunately, they have been equally hostile to progressive, egalitarian trade initiatives – initiatives that promise to retain an internationally open regime – as they have been to patently nationalist, reactionary measures.

In this chapter I explore one important aspect of the trade controversy – it concerns the proposal by labour and human rights advocates to incorporate labour standards into trade agreements. Neoclassical economists have argued that such measures would subvert the project to establish free trade. Making this argument has required them to re-theorise the concept of comparative advantage that is at the heart of trade theory. Many critics find this re-theorisation to be deeply objectionable. In what follows, I will examine this theoretical innovation, argue that it is flawed, and then conclude with a very brief survey of new trade (and investment) proposals that seek genuine global equality and economic security.

Rescuing free trade

The neoclassical case for free trade based on the existence of comparative advantages is appealing. Since countries differ amongst themselves in critical ways, they will exhibit different levels of competence in the various industries in which they engage. A country that is well endowed with fertile soil is likely to be relatively efficient (and therefore have a comparative advantage) in agricultural production, while a country that enjoys a large supply of skilled workers will have a comparative advantage in manufacturing. Given these differences, each country can improve its situation by specialising in what it does best (relative to other countries), and then trading with other nations to secure those goods for which it is not so well suited. It can be shown that with each country specialising in this way, even those countries that are deficient relative to their neighbours in all industries can gain through trade.

This account begs an important question: just why do nations differ among themselves in industrial performance? Why might one country be better suited to agriculture, and another to industry? The example given above suggests one part of the answer: countries enjoy different resource endowments, such as fertile soil or supply of skilled labour. Countries also exhibit different levels of technology; moreover, their inhabitants might hold distinct preferences. For instance, workers in one country might prefer agriculture to manufacturing, while workers in another might prefer the opposite. These three categories of differences – in *endowments, technology and preferences* – will yield different levels of economic efficiency and costs of production. It must be emphasised that these differences, which give rise to distinct comparative advantages, are taken to be entirely natural and, partly on that account, unobjectionable. The determinants of comparative advantage are not right or wrong in this account, they just *are*. A country should not complain about the endowments or technology of its neighbour – it should instead trade freely to reap the benefits of its neighbour's greater competencies.

So far, this account of comparative advantage has ignored the matter of labour standards, which are now at the heart of the controversy over free trade. Critics of neo-liberalism have begun to demand that trade and investment agreements include labour standards that will ensure basic worker rights across trading partners. They claim that without such protections, free trade will put undue pressure on workers to accept deficient working conditions in order to save their jobs in the face of foreign competition and threats of capital flight.

Re-theorising comparative advantage

Neoclassical defenders of free trade have resisted the momentum building for labour standards in trade agreements by extending the concept of comparative advantage. As the demand for labour standards strengthened over the past decade, they began to argue that cross-national differences in labour standards simply represent another *natural* and therefore *legitimate* determinant of comparative advantage. This argument is crucially important: it places governments' policy choices on an equal normative footing with nations' natural resources in driving trade flows. It therefore inoculates a nation's labour standards from outside inspection or complaint by those who seek to establish global economic policies that will ensure equality and justice.

How do neoclassical theorists sustain this claim? Consistent with the thorough reductionism of neoclassical thought,[1] these economists now claim that a nation's labour standards are the direct result of its endowments, technology and preferences. One country may be wealthy enough (owing to favourable endowments and technology) to be able to afford strong labour standards. Moreover, its citizens might prefer to allocate substantial funds to ensure such labour protections. In such a nation, strong standards are perfectly natural and legitimate since they reflect its particular endowments, technology and preferences. But another country, with fewer resources and relatively impoverished workers who are willing to sacrifice safety in order to find employment, is warranted in establishing much weaker standards – in keeping with its particular endowments, technology and preferences. The key point is this: when we encounter differences between countries in labour standards, we should treat them as entirely natural and legitimate determinants of comparative advantage since they result from natural differences between countries. Rather than complain about lower standards abroad, then, we should recognise that everyone benefits when a higher-standard country imports goods now produced more cheaply in a low-standard country. The importing country gains access to inexpensive goods, while workers in the low-standard country get jobs and income that would otherwise be unavailable to them. To complain about the weaker labour standards abroad that generate this mutually beneficial trade would be as nonsensical as complaining about the fertility of its soil or the quality of its other natural resources. From the neoclassical perspective, far better that we should all enjoy the growth and prosperity that trade allows, irrespective of the basis of the comparative advantages that induce this trade.

The campaign to write labour standards into trade agreements is therefore unwise, since it will necessarily undermine economic welfare (Krugman, 1997). But it is also unfair. Neoclassical theory treats a nation's labour standards (and other policies) as a consequence of the preferences of its citizens in the context of the endowments and technology they face, as we have just seen. Since these agents are assumed to be rational, they are taken to know what is in their own best interests. Hence, it is inappropriate for the economist (and by extension, people in other countries) to assess their choices. This refusal to judge agents' preferences stems equally from the neoclassical pursuit of objective science. Assessing agents' choices would require the economist to impose an explicit set of value judgements – something that would disqualify neoclassical thought as an objective account of social affairs.

The treatment of national policy as the outcome of simple choice, combined with an antipathy to judging the preferences that induce those choices, generates in neoclassical thought a strident commitment to what is called cultural relativism. Speaking simply, this is the idea that each society should be allowed to choose for itself how to live, in accordance with its own cultural norms (or preferences), free of unwarranted intervention by outsiders. Given this commitment, neoclassical theorists argue that it is unfair for activists in one country to try to impose their own preferences and ensuing policies on those in other countries with different preferences and policy choices. In this view, the campaign to write labour standards into trade agreements amounts to cultural imperialism, even when those advocating universal labour standards claim that they are advancing the interests of workers worldwide.

To sum up: neoclassical theorists have corralled and domesticated the new challenge to free trade emanating from labour rights activists by expanding the concept of comparative advantage to comprise international differences in labour standards. Just as countries exhibit different bundles of endowments, technology and preferences, so do they exhibit different levels of labour standards. Indeed, since the latter is a direct consequence of the former, we must take differences in standards to be entirely natural and legitimate determinants of comparative advantage. Rather than complain about weak standards abroad, we should celebrate the difference – not just because it is right to do so, but because it will also make us rich!

Contesting free trade

Labour rights advocates object to the extension of comparative advantage to include countries' labour standards (and other policies) on multiple grounds. In what follows, I will examine several of their most important arguments.

First, labour rights advocates view the neoclassical claim that a country's labour standards reflect a simple national choice as an extraordinarily naïve and, indeed, dangerous fiction. On important policy matters, members of a society typically differ among themselves about the right course of action. This implies that any policy will reflect the views of some groups and conflict with the views of others. But this also implies that when evaluating the legitimacy of nations' standards we must always attend to the matter of power – to the institutional arrangements under which policies are devised and enacted, and ultimately to the ability of the relatively powerless to achieve political voice and effective representation.

This simple insight leads us to what ought to be a rather obvious point, but which eludes most free traders: *citizens in countries lacking basic worker protections and rights do not typically choose weak standards*. Instead, oppressive standards are imposed on them by autocratic regimes. Weak standards are routinely enforced across the globe through the liberal use of the military to break strikes, through harassment, imprisonment and even execution of labour activists, and through the concerted denial of basic political rights (cf. Dorman, 1988). Given the obvious record of coercion across the globe, the economist's claim that weak standards represent a simple national choice, based on aggregated preferences, strikes labour advocates as not just wrong but disingenuous.

A focus on political arrangements and power leads to the view that a country's labour standards at any given moment are an indicator of the balance of political forces in that country. In the view of its critics, global neo-liberalism is now weakening labour's power, certainly in the US where the labour movement has withered over the past 40 years but even in those countries that have historically featured stronger labour movements. Labour advocates contend that it is far more accurate to interpret this trend toward weaker labour standards as an effect of the coercive force of global neoliberalism, than as an unproblematic choice reflecting national preferences.

It must be said that neoclassical economists typically reject the argument that neo-liberalism has in fact undermined labour standards. They claim that the evidence on this point is at best inconclusive, not least since too few firms migrate to low-standard countries to affect workers' bargaining power (Bhagwati and Srinivasan, 1996). But in researching this matter they have missed the mark on two counts: they have focused on explicit revisions to standards, when the more prevalent danger is *lax enforcement* of existing standards; and they have focused narrowly on actual corporate relocations, when the broader danger lies in *threats* of relocation. These two matters are related. The effective enforcement of labour standards depends on labour's political and economic power. When labour's power is eroded, existing standards provide weaker protection. And under neo-liberalism, the mere threat of corporate relocation often succeeds in undermining workers' power and rights.

The situation facing labour in the United States today exemplifies the connections between neo-liberalism, the erosion of labour's effective power, and the diminution of labour rights. In the United States, workers seeking unionisation must petition the National Labor Relations Board to secure a government-supervised election. Under NLRB rules, the union must secure a majority of the vote in order to secure bargaining rights. In the months leading up to the election, employers do whatever they can to dissuade their workers from voting for the union.

In the 1950s, about one third of all eligible workers in the US were represented by unions. Today, about 13 per cent enjoy union representation. To what degree is global neo-liberalism culpable in this trend? The evidence on this is instructive. A series of recent studies by Bronfenbrenner (1996; 2000) found that during the late 1990s, following the passage of the North American Free Trade Agreement (NAFTA), 70 per cent of firms in mobile industries such as manufacturing threatened to relocate abroad when facing unionisation drives. These threats were found to be effective in dissuading workers from voting for unions. In firms in which workers actually voted to unionise despite these threats, the rate at which firms made good on their threats and actually relocated abroad tripled as compared with the 1980s. In short, US workers are effectively losing their ability to form unions, in part as a consequence of global neo-liberalism. But because there has been no formal change in US labour law – indeed, on paper US workers enjoy the same rights to unionise today that they have for decades – this erosion has occurred below the radar screen of those economists who refute the connection between neo-liberalism and worker rights. They infer from union defeats a *preference* on the part of workers to remain union-free. In this way, they shield neo-liberalism from any culpability for de-unionisation in the US.

In short, the idea that a nation's standards simply reflect the preferences of its citizens is naïve, dangerous and even disingenuous. It overlooks the obvious ways in which weak standards are imposed on relatively powerless members of society; and it also overlooks the more subtle ways in which neo-liberalism undermines the efforts of workers to secure basic rights. In the view of labour rights advocates, weak labour standards therefore distort the trade patterns that would otherwise occur, and disrupt the benefits from trade that would otherwise flow to vulnerable workers.

Labour advocates also reject the cultural relativism that underlies the neoclassical antipathy to universal labour standards. I pursue this matter at length elsewhere (DeMartino, 2000); here, I want to make just one argument against neoclassical theory's romantic view of culture. As many theorists have by now argued, culture is never unequivocally benign. All cultures affect the rights and freedoms of societies' members. People contest culture all the time, precisely because there is so much at stake in this domain. We rightly contest our own; and for those of us who are concerned about global justice, we must also contest cultures abroad. But we must also be prepared to welcome the complaints voiced abroad against our own, especially when it can be shown that the way we live undermines the well-being of those who are worse off in other societies.

The main problem with neoclassical theory's refusal to judge culture is this: in any society in which oppression is rife, we can be certain that its culture will obscure and/or defend the legitimacy of that oppression. In very few societies do oppressors rely merely on the threat of force. Even slave societies typically produce elaborate accounts of the justness of that kind of social order. Justifications for slavery typically draw in equal measure on biology and religion for sustenance; they posit the slaves as biologically and morally deficient, and in need of the kinds of control and spiritual enhancement that slavery affords them.

For better or worse, it appears that those who are oppressed often come to accept their situation; Jon Elster (1982) calls this a case of 'adaptive preferences'. The idea is that those who are denied vital rights and freedoms may lose the aspiration to achieve them as a way of coping with their predicament. Some may even come to embrace the very cultural norms that oppress them. In the words of Amartya Sen, 'acute inequalities often survive precisely by making allies out of the deprived. The underdog comes to accept the legitimacy of the unequal order and becomes an implicit accomplice' (Sen, 1990, cited in Crocker, 1992). But this suggests that the stronger is the regime that secures the oppression, the more likely it is that those who are oppressed will resign themselves to their plight. Hence, we may find less rather than more cultural contest in those societies where oppression is most egregious.

The problem with the stridency of the neoclassical embrace of cultural relativism, then, is that it strips from us any normative foundation to indict practices beyond our own borders that perpetuate even egregious exploitation. It romanticises culture, treating it as the natural compilation of a society's preferences, rather than seeing it as the outcome of a struggle among different groups in society to order their lives and their communities. It fails to appreciate that preferences are shaped (for better or worse) by the social circumstances in which people find themselves. It then validates whatever labour standards emerge as simple national choices that can and should form the basis of beneficial trade.

After free trade: in pursuit of international egalitarianism

The controversy over free trade runs even deeper than all this, however. It derives from a fundamental conflict between normative perspectives. Neoclassical theory is rooted in a normative commitment to what is called 'welfarism', a perspective that judges social arrangements by exclusive reference to the preferences of the people affected by those arrangements, whatever those preferences might be (or how they were formed). This perspective yields the famous Kaldor–Hicks 'compensation' criterion, under which one social outcome is deemed better than another if the winners under the former can fully compensate the losers and still enjoy net benefit.

Labour rights advocates, along with political theorists and philosophers and most heterodox economists, typically reject this normative perspective. In the first place, as Elster's emphasis on adaptive preferences reminds us, preferences are an inadequate indicator of people's well-being. Second, welfarism pays scant attention to the matter of inequality, and so has little to say about the legitimacy of measures that would redistribute from the wealthy to the poor.[2] It seeks social arrangements in which people are 'formally' free – that is, where each is able to choose the best course of action, given her opportunity set. But this perspective has little to say about whether people should all enjoy the same opportunity set. It can therefore be taken to justify even egregious levels of inequality.

In contrast, those advancing universal labour standards in trade agreements generally advance internationalist egalitarianism as the appropriate normative foundation for assessing global social arrangements. This perspective holds that just social arrangements are those that ensure that people enjoy equal 'substantive' freedom – that they face the same opportunity sets.[3] To the degree practicable, global policy regimes must seek to achieve this outcome. A just policy regime would be one that seeks to expand the substantive freedom of the relatively impoverished – by increasing their access to resources and consumption goods, to be sure, but also by enhancing their political and economic power so that they can achieve more effective representation and secure the rights to which they are formally entitled.

Labour rights advocates have offered several policy measures to advance the cause of global justice. These include (for instance) the incorporation of labour standards directly into trade agreements, just as these agreements presently comprise strong property rights protections; the adoption of a social charter of labour rights as a precondition for trade; the adoption of corporate codes of conduct that would require a corporation that invests in a country with lower standards to live by the higher standards that obtain in its home country;[4] and the imposition by a high standard country of 'social tariffs' on imports from countries with lower standards, to offset the cost advantage gained on the basis of these lower standards (Dorman, 1992). In my own work (2000) and in joint work with Stephen Cullenberg (1994) I have advanced a new multilateral approach to trade policy, called the Social Index Tariff Structure (SITS) regime, which would penalise countries for pursuing advantage based on weak standards through social tariffs, while substantially rewarding those countries that take steps to promote worker rights (and human development more generally) through subsidies funded by the social tariffs. The SITS regime advances international equality by inverting the incentive structure that exists under neo-liberalism to erode worker rights. Under SITS, countries achieve open access for their exports in global markets by enhancing worker rights, while the burden for subsidising these measures falls on wealthier countries and on those poorer countries that refuse to promote the substantive freedom of their citizens. On balance, the SITS regime would induce a substantial net flow of resources from the North to the South, with the largest beneficiaries in the South being those countries that most aggressively promote the rights of workers and the dispossessed.

Conclusion

Contrary to the view of most neoclassical economists, global neo-liberalism is not the best imaginable economic system. It is inducing extraordinary inequality, and it threatens to deepen that inequality in the future. It is likely to prove to be unsustainable, owing to the insecurity, crises, political backlash and ecological degradation that it is inducing. But even if it does prove to be sustainable, it ought not to be sustained.

Fortunately, those who oppose global neo-liberalism have begun to examine and propose just policy regimes that can and should be built to replace it. I have offered SITS as one possibility, though it surely must be coupled with a range of complementary policy regimes that speak to other facets of global economic integration – such as short-term capital flows (see Grabel, 2003), labour mobility (see Sutcliffe, 1998), and corporate taxation, subsidies and codes of conduct (DeMartino, 2000, ch. 7; Rodrik, 1997). The immediate challenge is to make substantial progress toward realizing these initiatives since, if history is any guide, the most likely alternatives to neoliberalism are apt to be neither internationalist nor egalitarian.

Notes

1. Space precludes an extended examination of neoclassical reductionism here, but I treat this matter at length in DeMartino (2000). See also Wolff and Resnick (1987).
2. See DeMartino (2000, chs. 2 and 3) for an explication of welfarism and a survey of its chief defects.
3. See Sen (1992) for a thorough explication of the 'capabilities' approach to equality, which focuses on substantive freedom. DeMartino (2000 chs. 5–7) examines the global policy implications of capabilities equality.
4. This proposal is reminiscent of the Sullivan Principles which governed the behaviour of corporations that invested in South Africa during the apartheid era; see Bhagwati (1993), who endorses this approach reluctantly, in order to ameliorate the concerns of labour rights advocates.

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