Globalization and the New Politics of Embedded Liberalism

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Economic Globalization and Domestic Politics in the Developed Democracies

Around the world there is growing political opposition to the liberalization of trade, the rising levels of foreign investment, and increased inflows of foreign workers. This backlash against economic globalization is beginning to have an impact on public policy, particularly in the developed democracies. In Europe over the last few years, we have witnessed EU "enlargement fatigue," the rejection of a European constitution by French and Dutch voters, and, more recently, governmental attempts to limit cross-border mergers and acquisitions in a number of "strategic" sectors of the economy, such as the banking, steel, and energy sectors. On the other side of the Atlantic we see similar political developments. President George W. Bush had to fight an intense political battle early in his administration to win Trade Promotion Authority from Congress. During the 2004 campaign, presidential candidate John Kerry referred to CEOs who outsource production as traitors. The Central American Free Trade Agreement passed the U.S. House of Representatives by a single vote in the summer of 2005. Dozens of anti-China trade bills have been introduced in Congress in recent years. The collapse of the World Trade Organization's Doha round of multilateral trade negotiations is yet another manifestation of swelling discontent with globalization. Why do we observe this backlash, and where will it have the most significant and lasting policy consequences? What are the implications for the global economy and international relations more generally?

International and comparative political economists have argued that the domestic political foundation of the current liberal international economy rests on an implicit bargain between governments and their citizens called the bargain of embedded liberalism. According to this compact, governments are expected to protect their citizens from the vagaries of the global economy, primarily through the provision of social insurance and, more recently, with active labor market programs in return for political support for policies like free trade that drive economic globalization. Without this support, democratically elected politicians find it hard to endorse policies of economic openness.

Some believe that new revenue constraints arising from the globalization of production and finance are making it increasingly difficult for governments to live up to their end of the bargain, which, in turn, puts the future of the international economy in doubt. International bond markets "discipline" governments that borrow excessively, and multinational corporations shift production across borders to avoid taxation. This is troubling on economic grounds as expanding trade has been a source of growth and prosperity in core countries for many years and promises the same for countries in the developing periphery. There are potentially serious consequences for international peace and security as well. When globalization was reversed in the 1930s, political disintegration and world war followed closely behind. Hence, it is imperative that we better our understanding of these issues.

In this book, I argue that the combination of majoritarian democracy and decentralized labor markets exacerbates the political problems that governments committed to economic openness face, and that the countries with these institutions are the most susceptible to a backlash against globalization. Unfortunately, this list of countries includes the United States and United Kingdom, two pillars of the international economy, Australia, a country that plays a special role in multilateral trade talks because of its membership in the Cairns Group—a coalition of agricultural exporting nations that was organized to promote free trade in agricultural products—and Canada, also a member of the Cairns group as well as the G8. Moreover, Germany and Japan are undergoing market reforms that, if successful, will make their political economies much more similar to the American and British systems. I engage and occasionally challenge some of the most influential research on globalization in political science, which has focused almost exclusively on the small corporatist European economies with large welfare states, downplayed the policy constraints arising from increased international capital mobility, and ignored public attitudes toward the international economy. In the end, I conclude that a new bargain of embedded liberalism must be forged, particularly within the world's most powerful nations, to sustain economic globalization. This will require carefully crafted compensatory programs that are designed with an eye to their politically sustainability.

ALTERNATIVE VIEWS OF GLOBALIZATION AND DOMESTIC POLITICS

Political economists have studied the reciprocal relationship between economic globalization and domestic politics in the developed democracies for many years now.[1] Does the internationalization of financial markets lead to welfare state retrenchment? Is the international economy vulnerable to a political backlash against globalization? Can corporatist systems of industrial relations survive the multinationalization of economic production? These are just a few of the important topics debated in the globalization literature today. Based on the answers they provide to these and related questions, it is possible to separate most globalization scholars into one of two groups—those who view the relationship between domestic politics and economic globalization optimistically or, in other words, largely compatible; and those who take a more pessimistic outlook, emphasizing the tension between democratic politics at the national level and the growth of international markets.[2] I do not take sides in the debate between globalization optimists and pessimists.[3] Instead, I draw on the relative analytical strengths of both camps in an attempt to bridge the divide that separates them. I begin by outlining their respective positions.

Pessimists believe that the internationalization of markets presents national governments with a number of serious challenges. They emphasize the constraints that come with economic openness. Dani Rodrik (1997), for example, has argued in an influential monograph that globalization increases the political demands on governments to provide social insurance and other public goods at the same time that it undermines their ability to finance additional spending. According to this argument, which I refer to throughout the book as Rodrik's "globalization dilemma," the political and economic forces of globalization pull governments from different directions. Pessimists point to welfare state retrenchment and declining capital taxes as evidence of this dilemma.

The concern is that ultimately one of these opposing forces will win out—either we will see an erosion of popular sovereignty over the domestic economy and democracy will be severely vitiated, or a political backlash against globalization will cause governments to rethink their commitment to policies of economic openness. The latter fear has become more prevalent recently, particularly among economic historians. These scholars worry that a public backlash against international economic openness might lead to a repeat of the policies of the 1930s that ended the first great period of globalization (e.g., Kapstein 1996; Rodrik 1997; O'Rourke and Williamson 1999; Gilpin 2000; James 2001; Bordo, Taylor, and Williamson 2003). By contrast, much of the early research on globalization in political science argued that the internationalization of markets would force all countries to converge onto a single neoliberal political economic model (e.g., Freeman 1990; Kurzer 1993; Moses 1994; Steinmo 1994).[4] In other words, this work emphasized the domestic political consequences of economic globalization rather than the effects of politics on the international economy.[5]

The more optimistic view of globalization developed partly as a response to the convergence thesis, which was, and to some extent remains, ubiquitous in both academic journals and the popular press. The group of globalization optimists includes many of the scholars who contribute to the "varieties of capitalism" literature.[6] Optimists downplay globalization's constraints and emphasize democratic choice instead.[7] Most do not deny that globalization has important effects on domestic politics, but they see the relationship between the global economy and domestic politics as mutually reinforcing and supportive. Societies that prefer regulated economies, interventionist governments, and income equality will only see their preferences strengthened by economic globalization. Moreover, cross-national differences in domestic political and economic institutions create space for leftist governments to choose distinct policies in response to globalization. Therefore, significant variation in the forms of democratic capitalism will continue into the indefinite future and may even increase. Countries will pursue "divergent paths" in response to globalization. Kitschelt and colleagues (1999, 444) put it simply:

> The more organized market economies remain organized, interventionist, regulatory, and socially supportive, and they continue to seek to manage adaptation through cooperation and concertation among collective organizations and governments. The liberal market economies are becoming even more liberal, with a weakening of social supports and an increased emphasis on individual merit and markets.

Garrett (1998a, chapter 4) also concludes on the basis of careful empirical analysis that globalization increases the policy differences between governments in corporatist and liberal market economies: the former are spending more while the latter are spending less. The quantitative evidence in Swank (2002a, chapter 3, table 3.5) supports the divergent paths thesis as well. Increasing international capital mobility is associated with lower levels of social welfare effort in countries with liberal market economies and exclusive electoral systems (i.e., polities in which the interests of political "losers" are not represented in the policy-making process) and higher levels of social welfare effort in countries with corporatist economies and inclusive electoral systems that encourage accommodation between political "winners" and "losers."[8]

Because they argue that the constraints associated with globalization are exaggerated, some optimists believe the threat of a backlash is overstated as well. If globalization does not lead to neoliberal convergence, there is no reason for a backlash to emerge. Countries that have competitive markets and minimalist welfare states have freely chosen this path, so compensating market losers is politically unnecessary. These societies have elected right-wing and center-left governments that have pushed both economic openness and welfare state retrenchment. According to the optimists, these choices tell us something about societal preferences in the countries with liberal market

economies: they prefer free markets, trade, small government, and economic growth.[9] Again, globalization will only reinforce the existing societal preferences. This position is implicit, if not explicit, in much of the "varieties of capitalism" research.[10]

For some purposes this division (optimists vs. pessimists) is a fruitful way to organize and think about the research on globalization, but it also obscures the fact that there are really two important and largely separate issues being debated. The first debate is about convergence. More specifically, does globalization cause a race-to-the-neoliberal-bottom? The second is about the likelihood of a political backlash against economic openness and the reversibility of globalization. Once we disconnect these debates, it is easier to see why globalization optimists and pessimists occasionally talk past each other, and the limitations of both camps become more apparent.

One problem with the standard "divergent paths" argument is that its assumptions about societal preferences in the liberal market economies are largely inconsistent with the public opinion research on globalization.[11] Consider the United States, everyone's exemplar of a liberal market economy.[12] The survey evidence from the United States is clear. Americans are worried about globalization, seemingly growing more so over time, and they expect their government to help them adjust to international competition. For example, here is a question from a recent (January 2004) PIPA/ Knowledge Networks Poll about government support for trade that was also asked in 1999.

> Overall, with regard to international trade, do you think that it should be a goal of the US to: try to actively promote it, simply allow it to continue, try to slow it down, or try to stop or reverse it?

From 1999 to 2004, the number of American respondents who said the United States should actively promote international trade dropped by 9% from 32% to 23%. The number who said the United States should either allow it to continue without promoting it or actively try to slow it down (67%) increased by 10%.[13] The numbers are similar when the question asks more generally about globalization. Moreover, the response to the following question suggests that Americans are not unconditional proponents of free trade.

> Which of the following three positions comes closest to your point of view? I favor free trade, and I believe that it is necessary for the government to have programs to help workers who lose their jobs. I favor free trade, and I believe that it is not necessary for the government to have programs to help workers who lose their jobs. I do not favor free trade.

A significant majority of respondents say their support for trade is conditional on the government providing programs to help displaced workers. In 2004, 60% of respondents agreed with the statement expressing conditional support for trade. This is 6% below the level of support in 1999. The number of respondents expressing unconditional support for trade also declined 5% from 18% to 13%. There was a large increase in the number of respondents who said they opposed free trade unconditionally (14% to 22%). Of those surveyed, 63% said that government efforts to retrain workers who have lost their jobs as a result of trade were inadequate, up from 57% in 1999 (PIPA 2004).[14]

These concerns have had some effect on policy. In the summer of 2002, the U.S. Congress ended an eight-year stalemate by granting trade promotion authority to President Bush. The authorizing legislation included an important concession made to free trade opponents—an increase in trade adjustment assistance to those who lose their jobs as a result of more intense international competition and an experimental wage insurance program for older workers.[15] More recently, in his nomination address at the 2008 Republican National Convention, presidential candidate John McCain embraced retraining programs and wage insurance as part of a comprehensive strategy for economic adjustment to trade-related job loss. In short, there seems to be little reason to dismiss the role of compensating losers when it comes to the politics of economic openness in the U.S. and other liberal market economies.[16]

Globalization optimists and other proponents of the "divergent paths" argument correctly point out that the liberal and coordinated (or corporatist) economies have responded differently to globalization. The problem is that there is almost no evidence that confirms the underlying assumptions about public attitudes in the liberal market economies. This suggests that it may be problematic to infer social preferences from observed policy choices. At the same time, the pessimists have largely ignored domestic institutions and therefore failed to show why the liberal market economies are uniquely vulnerable to globalization pressures or why the growing discontentment with economic openness might have future policy implications. This book addresses these important yet relatively neglected issues.

To sum, surprisingly little progress has been made in reconciling the views of globalization pessimists and optimists. The divide remains wide. Most importantly, for my purposes, they give two different explanations for why the liberal market economies are heading down a policy path that combines greater economic openness and smaller social safety nets. The "divergent paths" viewpoint is that the liberal market economies have freely chosen their course, which implies it is a politically sustainable trajectory (see figure 1.1). Others see this trend as evidence of a "globalization dilemma." Governments must provide social protection in order to maintain public support for economic openness, but the policy constraints that come with increased international capital mobility are pushing these countries off a stable equilibrium path (see figure 1.2). To restore political equilibrium, governments must

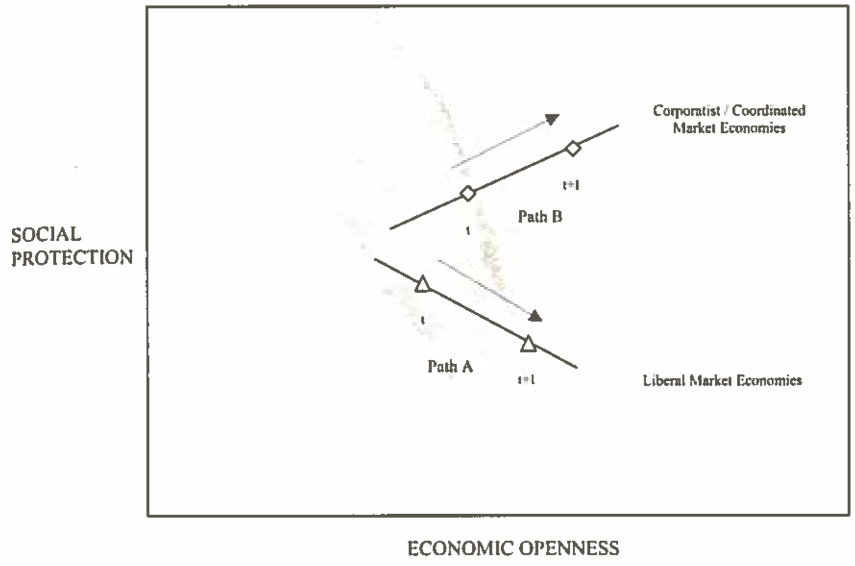

Figure 1.1 Divergent Paths Thesis

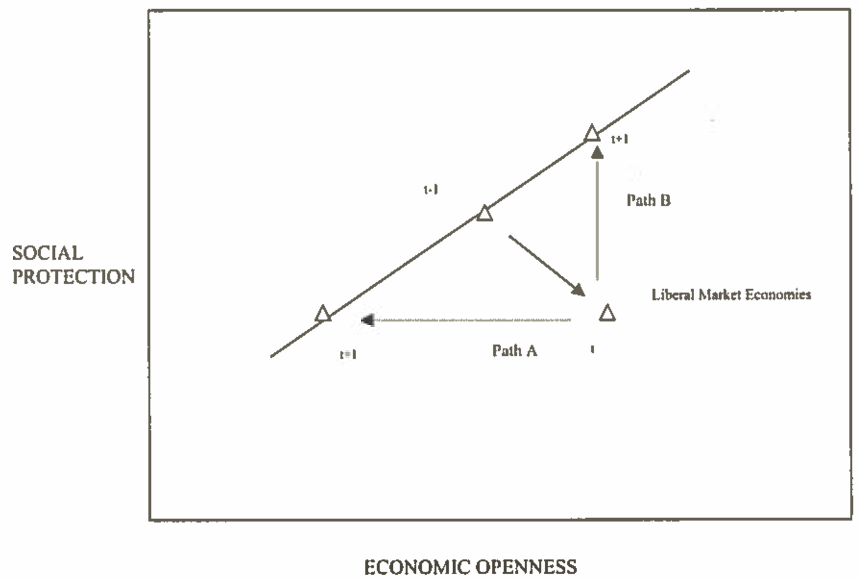

Figure 1.2 The Globalization Dilemma

either reduce levels of exposure to the international economy (Path A) or find new ways to provide effective social protection (Path B).

It is worth noting that there is a group of scholars who argue that the internationalization of markets has little, if any, effect on domestic politics and policymaking (e.g., Iversen and Wren 1998; Iversen and Cusack 2000; Pierson 2001). I refer to this group as the globalization *skeptics*. If pessimists believe that globalization creates both pressures and constraints on governments, and optimists accept the former but not the latter (countries must adjust to globalization pressures but they are not constrained to a single neoliberal response), skeptics argue that globalization produces neither. Iversen and Cusack, for example, contend that globalization pressures are unrelated to overtime and cross-national patterns in government spending. This position differs from arguments like Garrett's and other "divergent path" proponents who believe, not that globalization is causally irrelevant when it comes to variables like government spending, but rather, that globalization's effects are filtered through domestic political structures and institutions. I address the skeptics' case throughout the book.

In what remains of this introductory chapter, I briefly outline my theoretical argument for why the majoritarian democracies with liberal market economies are vulnerable to a political backlash against globalization and discuss the empirical evidence that supports this argument. Some would say my concerns about a globalization backlash are overly dire because (1) there are positive trends in the international economy that make openness less risky for workers than in the past, (2) globalization is largely irreversible, and (3) globalization's losers can be effectively compensated. I conclude the chapter by addressing each of these issues.

THE ARGUMENT

My argument does not fit neatly into any of the categories described above. I agree with the optimists (and disagree with many pessimists) that globalization does not lead to neoliberal convergence. I do not believe, at any time in the near future, the economies of Austria and Sweden will resemble that of the United States. Nor do I believe that these countries are vulnerable to a globalization backlash that could have adverse consequences for the international economy. Thus, I accept the divergent paths thesis as an accurate description of what we are observing empirically. Nevertheless, I argue that globalization creates new political pressures on governments in countries where trade is directly linked to levels of unemployment and associated with more labor market risk, and I argue that globalization constrains governments that are dependent on capital taxation. For these reasons, I contend

that the political and economic conditions are ripe for a backlash against globalization in a particular subset of the developed democracies: the majoritarian democracies with liberal market economies. These countries are the ones that face Rodrik's globalization dilemma. Therefore, I share a concern held by some pessimists. I do not believe that the policy trajectory of these countries is politically sustainable over the long term. I am particularly troubled because this subset includes some of the most important countries when it comes to governing the international economy (e.g., Canada, Britain, and the United States). If the leaders of any of these countries abandon their commitment to maintaining openness in the international economy, it would have grave consequences. My argument, which has three parts, begins with the connection between Ruggie's notion of embedded liberalism and Rodrik's globalization dilemma.

Globalization and the Crisis of Embedded Liberalism (Part I)

Building on the classic work of Polanyi (1944), John Ruggie (1982) introduced the concept of embedded liberalism into the political science mainstream with his seminal article on hegemony and international economic orders.[17] According to Ruggie, the international community learned two important lessons from the collapse of the gold standard and interwar global economy. First, the international economy would break down if states pursued unilateral, beggar-thy-neighbor trade policies. As a result, postwar governments around the Organisation for Economic Co-operation and Development (OECD), by and large, have committed themselves to pursuing free trade through multilateralism. Second, governments could not ignore the internal costs of adjusting to external economic shocks. Because trade causes economic dislocations and exposes workers to greater risk, it generates political opposition that democratically elected leaders ignore at their peril. Thus, one important implication of the commitment to free trade is that political leaders have had to be aware of and actively manage public support for economic openness. To do this, governments have exchanged welfare state policies that cushion their citizens from the vagaries of the international economy in return for public support for openness.

Embedded liberalism is the domestic social compact on which the post-World War II international economy was built. It recognized the importance of maintaining a liberal international economic order based on free trade and multilateral cooperation, but this commitment to liberalism was embedded within a more important obligation of governments to protect domestic social welfare. According to this story of postwar reconstruction, a link between trade and welfare state spending was established soon after World War II ended.

Ruggie's argument recognizes there is both a *demand* and *supply side* associated with the politics of international economic openness.[18] Workers exposed to fierce international competition *demand* protection. Governments, in turn, *supply* protection, which can come in a number of different forms—for example, tariffs, insurance, and adjustment assistance, to name a few of the most important kinds. Governments committed to economic openness prefer, if possible, to supply policies like insurance and adjustment assistance (rather than tariffs) in return for public support for trade. In chapter 2, I argue that the underlying factors that gave rise to the bargain of embedded liberalism are still in place, even in the liberal market economies: governments remain committed to free trade; workers in sectors of the economy exposed to foreign competition are still the strongest opponents; insurance and compensation programs remain the most effective means for governments to increase support for trade among those who are inclined to oppose it.

Starting with Ruggie's ideas, Rodrik (1997) identifies a significant globalization dilemma. He argues that growing international economic integration increases the *demand* on governments for protection at the same time it undermines their ability to *supply* policies that require significant government spending.[19] More workers are exposed to international competition through trade, and increased international capital mobility makes it difficult for governments to finance spending. This dilemma makes countries politically vulnerable to a backlash against globalization. The unfortunate possibility is that constrained governments will abandon their commitment to economic openness by adopting restrictions on international trade and capital flows. In this way, Rodrik's globalization dilemma can be viewed as a crisis of embedded liberalism (Keohane 1984; Garrett 1998b).

I argue that, because of important cross-national differences in domestic political and economic institutions, Rodrik's globalization dilemma is not equally severe for all countries. First, the degree to which globalization increases demands for protection depends on how, and the extent to which, shocks in international commercial markets are transmitted to domestic labor markets. This depends greatly on a country's labor market institutions. The strength of the political demand for protection also depends on how exposed the aggregate (national) labor market is to trade and the size of the shocks in international commercial markets. I argue that, *ceteris paribus*, trade generates more uncertainty and insecurity for workers who operate in competitive labor markets, and this leads them to pressure their governments for protection. Second, the constraints arising from international capital mobility primarily affect countries dependent on capital taxes to finance government spending. This dependence is a function of how majoritarian a country's polity is. Majoritarian democracies rely more heavily on capital taxes to finance public spending. Therefore, Rodrik's globalization dilemma applies most forcefully to countries that combine competitive labor markets with majoritarian political institutions, a combination found in the Anglo-American democracies.

Competitive Labor Markets and the Demand for Protection (Part II)

I argue in chapter 3 that governments in countries with relatively competitive labor markets will face stronger demands for protection from international competition.[20] The logic is mainly conventional and twofold. First, as Hall and Soskice (2001) have argued, firms in countries with liberal market economies are quick to hire and fire in response to changing prices. Therefore, in these countries, trade-related shocks to the economy (e.g., shocks to foreign demand or the competitiveness of foreign firms) are passed to workers in terms of employment levels. This is not true in the corporatist economies where the labor market institutions were designed in part to sustain full employment despite volatile conditions in the international economy. One of the strategies used in the corporatist economies to achieve this end is real wage moderation (Lange 1984; Garrett 1998a, 32). Given their dependence on trade, it is critical to keep wages low in order to maintain international competitiveness. In fact, Katzenstein has argued that terms-of-trade and balance-of-payments problems—or, more generally, the deterioration of a country's trade performance—are the key signals to labor unions that it is time to hold wages down.[21]

Second, trade increases the elasticity of the demand for labor in competitive market economies, exposing workers to greater risk (Rodrik 1997).[22] To the extent that it facilitates the multinationalization of production, either through outsourcing or foreign direct investment, trade flattens the labor demand curve by making it easier for firms to substitute foreign labor for domestic.[23] Exogenous shocks (domestic or international in origin) to a flat labor demand curve lead to greater changes in equilibrium levels of employment than shocks to a steep labor demand curve do.[24] Therefore, in countries with competitive labor markets, increased trade should be associated with more stochastic volatility in employment—that is, random, unpredictable changes in employment from year to year. Again, we would not expect this to be the case in corporatist economies where the labor market institutions were designed to stabilize employment and insulate workers from the risks associated with economic openness. However, the relative certainty under corporatism comes at a cost: there is less labor mobility across sectors of the economy, which can lead to long-term unemployment for a small group of workers. I argue that this is a trade-off many workers, particularly the politically powerful labor "insiders" who face very little if any risk of unemployment in corporatist systems, are willing to make. Even in a growing economy with opportunities for reemployment at high wages, losing one's job generates more risk and insecurity than real wage cuts. Thus, workers in non-corporatist economies are more likely to suffer trade-induced anxieties than their counterparts employed in corporatist systems.

Majoritarian Democracy and the Supply of Protection (Part III)

In chapter 4, I argue that countries with majoritarian political institutions face the strongest revenue constraints as a result of globalization because they are more dependent on capital taxes than countries with consensual polities. This makes it difficult for them to respond with increased spending to new globalization pressures without experiencing significant deterioration in their budget balances. To understand my argument, it is helpful to think about the tax policy preferences of the median voter (most likely a wage earner) and the influence of the median voter in different political contexts. The policy preferences of the median voter are important in majoritarian democracies because these policies will have majority support among the electorate. With respect to capital taxation, the median voter will prefer revenue-maximizing rates, and therefore, in majoritarian democracies, the capital tax rate will be set close to this level. In consensus democracies, where the polity is more inclusive in its representation of political minorities, the preferences of individuals with significant capital income are more likely to be incorporated into tax policy, and, importantly, parties that represent wage earners are able to make credible commitments to tax rates below their revenue-maximizing levels. To the extent that globalization reduces the cost of international capital mobility, it will shift the revenue-maximizing tax rate downward, and this will pressure governments in majoritarian countries to lower their capital taxes. It they do not lower tax rates, capital will flow out of the country, the tax base will shrink, and the revenue losses will be even greater.

THE EVIDENCE

In chapter 2, I provide micro-level evidence that connects exposure to trade, government spending, and individual support for tariff protection. The data set I use comes from two International Social Survey Programme (ISSP) surveys on national identity conducted in 1995 and 2003. It includes respondents from Australia, Austria, Canada, Germany, New Zealand, Norway, Spain, Sweden, the United Kingdom, and the United States. The results are consistent with the embedded liberalism thesis. The strongest opposition to trade comes from individuals employed in sectors of the economy that have

the highest levels of imports. Yet, the results demonstrate that politicians can, in fact, build support for trade, even among these sectors. Politically feasible policy reforms can offset declines caused by increased exposure to international competition. Interestingly, I find that raising net replacement rates for unemployment insurance increases support for trade among those employed in tradable sectors of the economy while spending on active labor market programs does not.

At the macro-level, I show that aggregate exposure to import competition correlates strongly with levels of government spending across the OECD. As imports rise, so do levels of government spending, and the magnitude of this effect depends on the percentage of workers employed in tradable industries and, to a lesser extent, the average duration of unemployment spells. The macro-panel data set analyzed in chapter 2 (and later chapters) includes twenty OECD countries: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom, and the United States. The sample period is 1960–2000. Taken together, the micro and macro findings suggest that the bargain of embedded liberalism is an important part of the contemporary politics of international economic openness, even in countries with strong right-wing parties and liberal market economies like the United States.

The empirical analyses in chapters 3 and 4 also utilize the macro-panel dataset. In chapter 3, I examine the relationship between wage and trade-related shocks, levels of trade openness, and employment. The results are more or less consistent with the conventional wisdom from comparative political economy. First, there is more evidence that shocks, in non-corporatist countries, are passed to workers in terms of employment levels; second, trade openness increases the elasticity of the demand for labor in the liberal market economies; and finally, trade generates more employment volatility in countries with competitive labor markets than it does in the corporatist economies.

The empirical evidence presented in chapter 4 shows that the tax policies of majoritarian democracies, richly endowed ones in particular, are most constrained by increasing levels of international capital mobility. These countries are the most dependent on capital taxes, and they have seen the largest declines in tax rates. A comparison of tax reform in Britain and the Netherlands beginning in the 1980s largely supports the theoretical argument. Britain, a majoritarian democracy, was at (or possibly above) its revenue-maximizing capital tax rate at the beginning of the 1980s. European economic integration, which made these tax rates very costly in terms of revenue generation, was a major impetus for reform. The British government could either lower its capital tax rate or see the tax base shrink to the point at which the capital taxes would generate very little revenue anyway. The Netherlands, a consensus democracy, also reformed its tax system, but the Dutch if anything increased their average effective capital tax rate. The Dutch tax system was less dependent on capital taxes than the British system for revenue generation, and therefore European economic integration did not present the same set of challenges for the Netherlands. In chapter 5, I examine the empirical consequences of the demand and supply sides of my argument jointly. The econometric evidence suggests that countries that have relied heavily on capital taxes to finance spending face substantial budgetary pressures when they experience an increase in employment volatility.

IS THERE A SILVER LINING?

There are at least three reasons that my concerns about a political backlash against globalization may be too pessimistic. First, because of structural changes in the economies of the developed democracies, primarily deindustrialization, workers are becoming less exposed to foreign competition and externally generated risk despite rising trade flows. A similar argument is that there is more price stability in international markets today than in previous decades. Second, it could be that globalization is more or less irreversible. The most sophisticated and persuasive version of this argument is that a coherent ideological alternative to globalism is a necessary and currently missing condition for globalization to be reversed, particularly in the liberal market economies. Finally, it is possible that a new bargain of embedded liberalism can be established, one that will allow governments in the Anglo-American democracies to rebuild popular support for economic openness.

I address these arguments in turn below. I am doubtful that the first two conditions make the probability of a political backlash significantly less likely, but I am hopeful that a new social compact with this effect can be established.

Economic Trends

Figures 1.3 and 1.4 plot the average (cross-national) values of four key economic variables throughout the post–Bretton Woods period. The first two in figure 1.3 are the average percentage of workers employed in "tradable" sectors of the economy (i.e., manufacturing and agriculture) and the terms of trade volatility. The terms of trade measure is the average five-year moving standard deviation for the log difference in the ratio of export to import prices. The variables plotted in figure 1.4 are the percentage of possible capital account transactions that are unrestricted and the value of imports

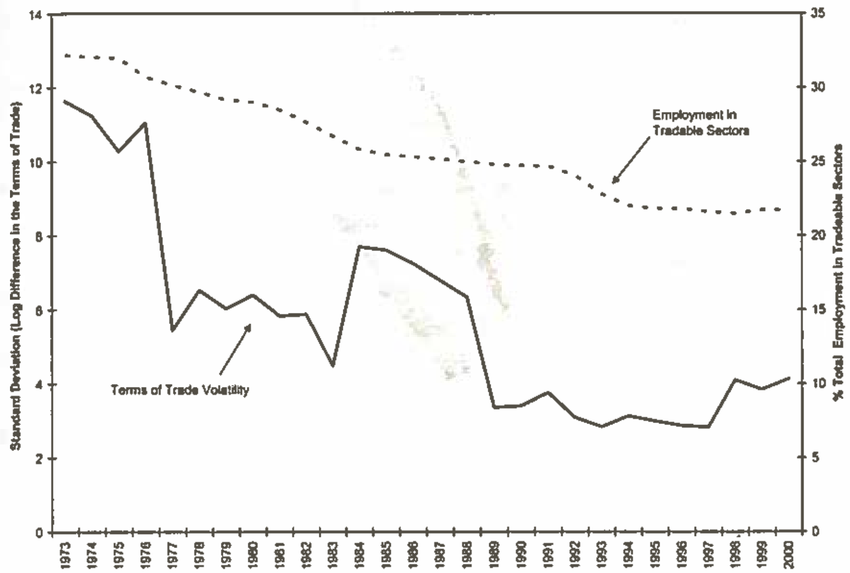

Figure 1.3 Average Exposure and Sensitivity to External Risk: Terms of Trade Volatility and Employment in Tradable Sectors (20 OECD Countries, Post–Bretton Woods)

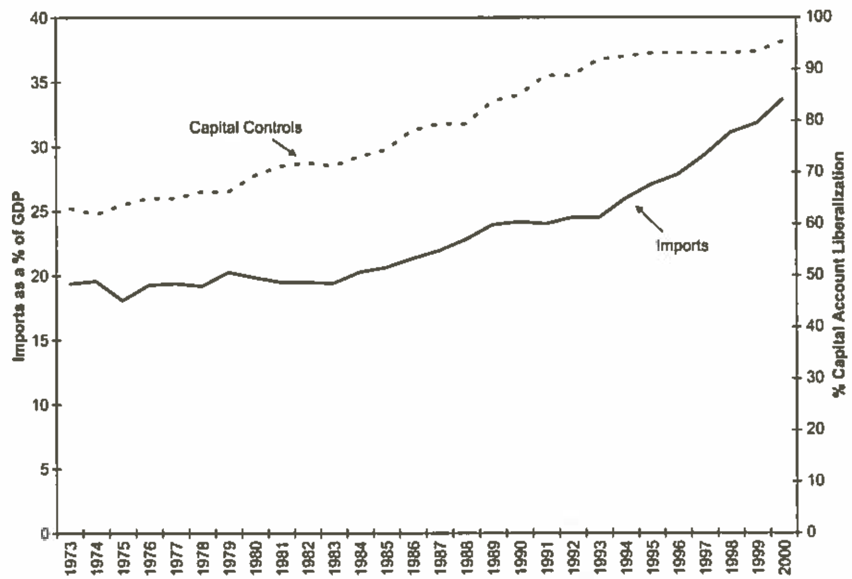

Figure 1.4 Average Exposure and Sensitivity to External Risk: Import Penetration and Capital Controls (20 OECD Countries, Post–Bretton Woods)

expressed as a percentage of GDP. From the graphs, it is clear that (on average) imports are rising; capital account restrictions are on the decline; fewer workers are employed in tradable sectors of the economy (deindustrialization); and terms-of-trade volatility is dropping. These trends are interesting because two of the changes—increased imports on the one hand and fewer capital account restrictions on the other—are making countries more susceptible to externally generated labor market risk, while the other two changes—declining terms of trade volatility and deindustrialization—are making countries less vulnerable.

Deindustrialization and the concomitant rise of the service economy represent one of the biggest changes underway in the OECD economies (Rowthorn and Ramaswamy 1999; Alderson 1999; Iversen and Wren 1998; Iversen and Cusack 2000; Alderson and Nielsen 2002). To the extent that services remain non-traded, this implies fewer workers exposed to trade competition and therefore lower levels of political opposition to free trade policies. This proposition receives substantial support from the empirical analysis in chapter 2, but there is an important caveat. Those employed in services sectors of the economy will become increasingly exposed to international competition over time.

Regarding the U.S. economy, trade in services is growing rapidly and the balance between exports and imports is shrinking (relative to the value of these flows). According to data from the Bureau of Economic Analysis, exports of private services were worth $197 billion and imports $130 billion in 1995. By 2005, these numbers were $360 billion and $281 billion, respectively. The recent American backlash against Indian phone centers is indicative of the increasingly competitive and global nature of service industries. Using measures of geographic industrial concentration, Jensen and Kletzer (2005) estimate that 13.7% of total U.S. employment is in *tradable service industries* and therefore, at least potentially, subject to international competition. In comparison, only 12.4% of total U.S. employment is in tradable manufacturing industries.

As for international prices, there is no reason to expect continued terms-of-trade stability. In fact, the oil price spike that occurred shortly after the U.S. invasion of Iraq sent a major terms-of-trade shock to most of the world's economies. International price stability may be a bygone feature of the global economy already.

Globalization Is Irreversible

Not everyone believes that globalization is reversible. Some contend that the degree of interdependence and its benefits are so great that reversal is unimaginable. Others argue that globalization is not simply the result of

policy choices made by states, but is also driven by exogenous forces like technological and organizational change that are difficult for governments to shape (Skolnikoff 1993; Winner 1977). In this sense, the international economy is beyond the control of states and acts as a structural constraint upon them (Andrews 1994; Cerny 1995). Some would go so far as to argue that the nation-state has become obsolete (Wriston 1992; Ohmae 1995). Much of the comparative politics literature on globalization also treats international economic integration as an exogenous force that acts upon domestic politics (Kitschelt et al. 1999; Garrett 1998a).

While it may be useful to assume that globalization is exogenous for analytical purposes, the historical record strongly contradicts the view that globalization is truly irreversible and exogenous. Though we sometimes forget, globalization has been stopped and reversed before, and many of the same arguments that are being made today about technology and interdependence also were made in the years prior to World War I (Angell 1914). In fact, the scholars who are most concerned about the future of the international economy seem to be ones who study globalization from a historical perspective.[25] For these scholars, the analogy of the early twentieth century and interwar periods has much to tell us about contemporary political responses to globalization.

For example, Kevin O'Rourke and Jeffrey Williamson (1999, 287) contend that distributional consequences of globalization during the late nineteenth and early twentieth centuries fueled the political backlash that ultimately destroyed the global economy; they argue that "globalization, at least in part, destroyed itself" and that "the globalization experience of the Atlantic economy prior to the Great War speaks directly and eloquently to globalization debates today." Jeffry Frieden (2006, xvi) writes "As was the case a hundred years ago, many people now take an integrated world economy for granted, regard it as the natural state of things, and expect that it will last forever. Yet the bases on which global capitalism rests today are not very different from what they were in 1900, and the potential for their disruption is as present today as then." A similar theme is echoed in the Bordo et al. (2003) conference volume, *Globalization in Historical Perspective*. In the book's introduction, the editors advise, "if we fear that the violent political reaction to globalization seen recently in Seattle, Ottawa, Gothenberg, and Genoa might cause a political retreat from liberal policy, then it would pay to look carefully at the twenty years or so before World War I." Globalization's losers—landowners in Europe and workers in the New World—became the political opponents of economic openness later on. Today, low- to medium-skilled workers in the OECD have the most to lose from globalization. The fear is that globalization will produce labor market uncertainty and a feeling of economic insecurity, which, in turn, will generate support for protectionism. If this happens on a widespread basis, the possibility of a protectionist backlash becomes more likely (Kapstein 1996, 1999).

Harold James (2001) has a slightly more sophisticated understanding of the political backlash against globalization that occurred during the 1930s, one that includes but goes beyond economic self-interest. In *The End of Globalization*, James argues that a number of additional factors contributed to the de-globalization period of the interwar years. Importantly, the initial idealism of the 1920s about the efficacy of managing globalization problems through international institutions led to unreasonable expectations about their effectiveness. When these institutions failed to live up to expectations, they became targets of widespread resentment. This fostered the development of nationalist ideologies such as the Soviet brand of Communism and the Fascism of Germany and Italy, which provided coherent alternatives to the liberal internationalism of the day.

According to James, the interwar backlash against globalization was more than a response to global economic integration; it was a backlash against internationalism broadly defined. From his perspective, the economists may be correct about the economic parallels between the current and earlier period of globalization, but the political and social preconditions for a backlash are missing today. Interestingly, the "divergent paths" proponents make a similar argument about politics in the liberal market economies. Because of the relative strength of right-wing parties in these countries, and the social preferences revealed by this fact, these scholars see dramatic trade policy reversals as unlikely. There are no alternatives to the free trade policies of the status quo available to voters, and even if there were, no one would vote for candidates or parties that espoused them.

In some ways, these arguments are reassuring. There does not seem to be a common nationalist agenda that unites today's "opponents" of globalization. Clearly, the leaders of the anti-neoliberal globalization movement do not espouse nationalism (Elliott et al. 2004). But James's argument begs the question of causation. Did nationalism make it possible for governments to justify and adopt the beggar-thy-neighbor policies that ultimately led to the "end of globalization"? Or, did the failing international economy fuel the flames of nationalism? Sheri Berman (2006) argues that the latter is true in her explanation for the rise of Fascism and National Socialism. The Depression played an important role in discrediting liberal institutions and policies, and this created the necessary ideological space for radical nationalism to emerge. Moreover, the argument that there are no coherent nationalistic ideological alternatives to liberalism today, like fascism and communism were in the 1930s, is a straw man. Political change on a much smaller scale could produce a retreat from policies of economic openness.

Those who argue that globalization is irreversible because there are currently no alternatives to the policies of economic openness—at least not ones supported by major parties—underestimate the potential for political change.

As I argued earlier in this chapter, we already see the emergence of a backlash against globalization that is beginning to influence foreign economic policy, particularly in the majoritarian democracies. In these cases, "critical realignments" are one possible mechanism of policy change. Nardulli (1995, 11) defines this concept, which comes out of the research on American politics, as an "abrupt, large, and enduring form of change in prevailing electoral patterns, one that is initiated by a critical election and results in a significantly different partisan balance in the electorate." These realignments overcome institutional checks and balances designed to stabilize policy in normal times.[26] Other scholars of American politics, particularly those who study macropartisanship, argue that change is more continuous than abrupt (Erikson et al. 2002). For my purposes, it matters little which of these models is the appropriate one. Most likely, both kinds of political change occur in majoritarian democracies. What does matter is that economic factors seem to drive both abrupt and continuous changes in the partisan balance of power by converting existing voters and mobilizing new ones.[27]

Careful studies of the New Deal realignment in the United States show convincingly that these are the kind of micro-level changes that brought Roosevelt to power. Brown (1988), for example, argues that both partisan conversion and participation by new voters explain the New Deal realignment. It started with conversion in the 1932 election. A large number of Republican voters in 1928 switched their votes in 1932 because, according to most accounts, the public became dissatisfied with the way the Hoover administration was handling the economy. The Democrats' hold on the presidency was cemented by an infusion of new "working class" voters in 1936. Interestingly, Brown argues that voters abandoned the Republican Party in 1932 not because the Democrats offered a coherent set of policy alternatives to end the Depression—this came later—but rather because the electorate was frustrated with ineffective Republican "solutions."

It is well beyond the scope of this book to present a complete model of political change in majoritarian democracies. My point is to challenge and make explicit what is frequently implicit in the varieties of capitalism literature: that the underlying societal preferences driving policy divergence among the developed democracies are fixed. If this were true, the current policy trajectory of the liberal market economies would be stable, and globalization would be, for all intents and purposes, irreversible. In this book I show that, in majoritarian democracies with liberal market economies, globalization is generating the kind of conditions that historically have led to significant political change by making existing voters frustrated with status quo policies and by mobilizing new voters. We should not dismiss the potential for a backlash against globalization because we discount the possibility of significant political change.

A New Bargain of Embedded Liberalism

The strongest safeguard for the international economy is a renewed commitment by politicians to policies of economic openness. This will require an updated version of the bargain of embedded liberalism, one that, at minimal cost, effectively protects workers in the liberal market economies from the new risks they face.

A number of policy recommendations have been made along these lines. Unfortunately, very little attention has been paid to the political sustainability of these recommendations. For example, one possible strategy for governments in the liberal market countries is labor market reform. These countries could "import" corporatism (Garrett 1998a, 155–157). This has been tried in two majoritarian democracies—Britain during the 1970s and Australia during the 1980s—and in both cases the experiment failed.[28] Simply put, these reforms are not robust to partisan changes in government. Unless these reforms follow a major realignment of New Deal proportions, they are unlikely to provide a solid foundation upon which a new bargain of embedded liberalism can be built.[29]

Another strategy that is frequently discussed and debated is the use of policies to improve the supply side of the labor market. If they work, active labor market programs keep unemployment low and generate income growth, which makes them cost effective. This strategy is the hallmark of third way social democracy. Tony Blair's and now Gordon Brown's Labour government in Britain is the test case, and the jury is still out. It is not yet clear whether this approach will spread elsewhere. If there is a downside to this strategy, at least for left-leaning governments, it may be in its political consequences over the medium to long term. What made Margaret Thatcher's economic reforms politically successful is that they helped cement the electoral dominance of the Tories. Privatization created a new set of property owners in Britain, and these individuals were more likely to vote Conservative in the next election (Garrett 1993, Boix 1998). Keynesian policies of demand management played a similar role for the Left throughout the OECD (Przeworksi 1985, chapter 5). Labour's new "supply side agenda" may be less effective in this respect and therefore less attractive to leftist governments. If one takes the literature on the economics of voting seriously, active labor market policies that generate human capital may actually undermine electoral support for leftist parties.

Moreover, active labor market policies benefit labor "outsiders" in ways that may undermine political support of "insiders," which some argue are the core constituency of leftist parties (Rueda 2005).[30] Also, the political reaction of firms, which matters greatly for the viability of active labor market policies, is highly contingent on the design of these programs (Mares 2003). Along these lines, recent work by Iversen and Soskice (2001) on the relationship between workers' skill sets and attitudes toward social policy suggests that the design of active labor market policies is critical in determining their effect on support for government spending and interventionist policies. Programs that increase workers' skill specificity are likely to increase support for government spending on things like unemployment insurance, health care, and pensions, while those that provide general skills are likely to undermine support for government spending.[31] This is because workers with sector-specific skills are much more likely than those with general skills to experience long spells of unemployment. Workers with general skills have more opportunities for reemployment since they can search for jobs across a large number of sectors.

Retraining programs that provide workers with general skills could also change the underlying nature of trade politics in a way that has unintended consequences for foreign economic policy making. Research in political science and economics on trade policy politics has identified the degree of intersectoral factor mobility as the key variable that determines the political cleavages over trade. If capital and labor are mobile across sectors of the economy, the political fault lines will divide classes, and, in the OECD countries, workers, particularly low-skilled workers, will be hurt the most by free trade. If capital and labor are immobile, the political cleavages will divide sectors of the economy. Those tied to export-oriented sectors will support free trade and those connected to import-competing sectors will oppose it. If they provided general skills to workers, retraining programs would increase the degree of intersectoral mobility, making it more likely that the major trade cleavages among producers would fall along class instead of sector lines (Hiscox 2001; Hiscox 2002). This could move trade policy from the realm of pressure politics to partisan politics (Verdier 1994), which, in turn, would make it more difficult for chief executive officers, particularly ones from leftist parties, to pursue free trade policies. Countries like the United States—where trade policy politics remains, to a significant degree, sector based—have delegated authority over trade policy to the executive branch of government as a way to depoliticize trade. Because they represent large diverse constituencies, chief executives are rarely dependent politically on one or two industries in the way that individual legislators frequently are. This strategy becomes much less effective when the degree of intersectoral mobility is high and trade becomes an issue around which the major (class-based) parties contest elections. My own individual-level empirical analysis in chapter 2 suggests that spending on active labor market programs may not increase support for free trade policies among those employed in tradable sectors of the economy.

Finally, countries with competitive labor markets could simply redesign (and boost) their unemployment insurance programs. The problem with unemployment insurance is that these programs create incentives for people to stay out of work and this makes them too costly. Therefore, these programs would need to be designed to minimize their labor market distortions (e.g., Shavell and Weiss 1979; Hopenhayn and Nicolini 1997; Acemoglu and Shimer 1999; Kletzer and Litan 2001). To a very limited extent, the United States has started down this path with the expansion of trade adjustment assistance and the new wage insurance experiment for older workers that accompanied the latest trade promotion authority bill. This is a positive development, and maintaining support for globalization will require further increases in government programs aimed at those who will be directly affected by greater competition. In order for these programs to be politically sustainable, however, they must be designed to minimize the forms of moral hazard that unemployment insurance can generate.

During the early postwar period, Keynesian policies of demand management were crucial to the bargain of embedded liberalism in the liberal market economies. Today, there is not yet a clear alternative to these policies. Labor market reform, retraining, and insurance all have political and economic costs that make them potentially problematic. Thus, the design of these programs is critical to their long-term success. I return to this topic—the possibility of a new bargain of embedded liberalism—in chapter 5.

SUMMARY

One of the most important debates in the globalization literature concerns the likelihood of a political backlash against policies of economic openness. Globalization optimists dismiss the possibility of a backlash because they believe the constraints that come with openness are exaggerated. They argue that countries that combine policies of economic openness with welfare state retrenchment—that is, the liberal market economies—have freely chosen this path and that the political forces giving rise to these policies are stable. Globalization pessimists disagree, but these scholars have failed to make a case for why globalization presents the liberal market economies with a unique set of political challenges.

I argue that the combination of competitive labor markets and majoritarian political institutions increases the vulnerability of countries like the United States, the United Kingdom, Canada, and Australia (the Anglo-American democracies) to globalization pressures and constraints that could lead them to abandon their policies of economic openness. The theoretical elaboration and empirical evaluation of this argument make up the core of this book (chapters 2–4). In chapter 5, I argue that the best guarantee against a return to autarky is a new bargain of embedded liberalism, one based on carefully crafted compensatory programs. I conclude in chapter 6.

2

Government Spending and Public Support for Trade in the OECD

Governments learned from the collapse of the interwar global economy that they could not ignore the domestic costs of adjustment to external shocks. Trade causes economic dislocation, exposes workers to greater risk, and, therefore, generates political opposition to which democratically elected leaders must respond. In order to pursue free trade policies, politicians have had to monitor and manage public support for economic openness. To accomplish the latter, governments have provided welfare state policies that protect their citizens from the vagaries of the international economy. John Ruggie calls this exchange the bargain of *embedded liberalism*.[1]

According to Ruggie's story of postwar reconstruction, a link between trade and welfare state spending was established soon after World War II ended. Of course, the specific form this bargain takes is both geographically and historically contingent. The Keynesianism that emerged in the United States, for example, differed from the social democratic corporatism that developed in Sweden and Austria, and the demand management policies of the Bretton Woods era have given way to the active (supply-side) labor market policies of the so-called Third Way. But the idea that there is a more or less universal expectation held by citizens in the developed democracies that their governments will limit the costs and distribute the benefits of open markets through some kind of government intervention and spending, and that public support for liberalism depends on the willingness and ability of governments to do this successfully, is the core of the embedded liberalism thesis. This is what distinguishes the embedded liberalism of the postwar period from the ideology of pure laissez-faire that guided economic policy under the gold standard.[2]

Recently, the argument that trade and government spending go hand in hand because governments in the developed democracies have to compensate market losers has come under attack. Several studies claim that the observed country-level (macro-level) relationship between trade and spending is weak at best and largely attributable to omitted variable bias. In other words, the critics claim, the relationship is spurious not causal. I take a fresh