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Has Globalization Gone Too Far?

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The process that has come to be called "globalization" is exposing a deep fault line between groups who have the skills and mobility to flourish in global markets and those who either don't have these advantages or perceive the expansion of unregulated markets as inimical to social stability and deeply held norms. The result is severe tension between the market and social groups such as workers, pensioners, and environmentalists, with governments stuck in the middle. [...]

While I share the idea that much of the opposition to trade is based on faulty premises, I also believe that economists have tended to take an excessively narrow view of the issues. To understand the impact of globalization on domestic social arrangements, we have to go beyond the question of what trade does to the skill premium. And even if we focus more narrowly on labor-market outcomes, there are additional channels, which have not yet come under close empirical scrutiny, through which increased economic integration works to the disadvantage of labor, and particularly of unskilled labor. This book attempts to offer such a broadened perspective. As we shall see, this perspective leads to a less benign outlook than the one economists commonly adopt. One side benefit, therefore, is that it serves to reduce the yawning gap that separates the views of most economists from the gut instincts of many laypeople.

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Sources of Tension

I focus on three sources of tension between the global market and social stability and offer a brief overview of them here.

First, reduced barriers to trade and investment accentuate the asymmetry between groups that can cross international borders (either directly or indirectly, say through outsourcing) and those that cannot. In the first category are owners of capital, highly skilled workers, and many professionals, who are free to take their resources where they are most in demand. Unskilled and semiskilled workers and most middle managers belong in the second category. Putting the same point in more technical terms, globalization makes the demand for the services of individuals in the second category *more elastic* – that is, the services of large segments of the working population can be more easily substituted by the services of other people across national boundaries. Globalization therefore fundamentally transforms the employment relationship.

The fact that "workers" can be more easily substituted for each other across national boundaries undermines what many conceive to be a postwar social bargain between workers and employers, under which the former would receive a steady increase in wages and benefits in return for labor peace. This is because increased substitutability results in the following concrete consequences:

- Workers now have to pay a larger share of the cost of improvements in work conditions and benefits (that is, they bear a greater incidence of nonwage costs).
- They have to incur greater instability in earnings and hours worked in response to shocks to labor demand or labor productivity (that is, volatility and insecurity increase).
- Their bargaining power erodes, so they receive lower wages and benefits whenever bargaining is an element in setting the terms of employment.

These considerations have received insufficient attention in the recent academic literature on trade and wages, which has focused on the downward shift in demand for unskilled workers rather than the increase in the elasticity of that demand.

Second, globalization engenders conflicts within and between nations over domestic norms and the social institutions that embody them. As the technology for manufactured goods becomes standardized and diffused internationally, nations with very different sets of values, norms, institutions, and collective preferences begin to compete head on in markets for similar goods. And the spread of globalization creates opportunities for trade between countries at very different levels of development.

This is of no consequence under traditional multilateral trade policy of the WTO and the General Agreement on Tariffs and Trade (GATT): the "process" or "technology" through which goods are produced is immaterial, and so are the social institutions of the trading partners. Differences in national practices are treated just like differences in factor endowments or any other determinant of comparative advantage. However, introspection and empirical evidence both reveal that most people attach values to processes as well as outcomes. This is reflected in the norms that shape and constrain the domestic environment in which goods and services are produced – for example, workplace practices, legal rules, and social safety nets.

Trade becomes contentious when it unleashes forces that undermine the norms implicit in domestic practices. Many residents of advanced industrial countries are uncomfortable with the weakening of domestic institutions through the forces of trade, as when, for example, child labor in Honduras displaces workers in South Carolina or when pension benefits are cut in Europe in response to the requirements of the Maastricht treaty. This sense of unease is one way of interpreting the demands for "fair trade." Much of the discussion surrounding the "new" issues in trade policy – that is, labor standards, environment, competition policy, corruption – can be cast in this light of procedural fairness.

We cannot understand what is happening in these new areas until we take individual preferences for processes and the social arrangements that embody them seriously. In particular, by doing so we can start to make sense of people's uneasiness about the consequences of international economic integration and avoid the trap of automatically branding all concerned groups as self-interested protectionists. Indeed, since trade policy almost always has redistributive consequences (among sectors, income groups, and individuals), one cannot produce a principled defense of free trade without confronting the question of the fairness and legitimacy of the practices that generate these consequences. By the same token, one should not expect broad popular support for trade when trade involves exchanges that clash with (and erode) prevailing domestic social arrangements.

Third, globalization has made it exceedingly difficult for governments to provide social insurance – one of their central functions and one that has helped maintain social cohesion and domestic political support for ongoing liberalization throughout the postwar period. In essence, governments have used their fiscal powers to insulate domestic groups from excessive market risks, particularly those having an external origin. In fact, there is a striking correlation between an economy's exposure to foreign trade and the size of its welfare state. It is in the most open countries, such as Sweden, Denmark, and the Netherlands, that spending on income transfers has expanded the most. This is not to say that the government is the sole, or the best, provider of social insurance. The extended family, religious groups, and local communities often play similar roles. My point is that it is a hallmark of the postwar period that governments in the advanced countries have been expected to provide such insurance.

At the present, however, international economic integration is taking place against the background of receding governments and diminished social obligations. The welfare state has been under attack for two decades. Moreover, the increasing mobility of capital has rendered an important segment of the tax base footloose, leaving governments with the unappetizing option of increasing tax rates disproportionately on labor income. Yet the need for social insurance for the vast majority of the population that remains internationally immobile has not diminished. If anything, this need has become greater as a consequence of increased integration. The question therefore is how the tension between globalization and the pressures for socialization of risk can be eased. If the tension is not managed intelligently and creatively, the danger is that the domestic consensus in favor of open markets will ultimately erode to the point where a generalized resurgence of protectionism becomes a serious possibility.

Each of these arguments points to an important weakness in the manner in which advanced societies are handling – or are equipped to handle – the consequences of globalization. Collectively, they point to what is perhaps the greatest risk of all, namely that the cumulative consequence of the tensions mentioned above will be the solidifying of a new set of class divisions – between those who prosper in the globalized economy and those who do not, between those who share its values and those who would rather not, and between those who can diversify away its risks and those who cannot. This is not a pleasing prospect, even for individuals on the winning side of the divide who have little empathy for the other side. Social disintegration is not a spectator sport – those on the sidelines also get splashed with mud from the field. Ultimately, the deepening of social fissures can harm all. [...]

The Role of National Governments

Policymakers have to steer a difficult middle course between responding to the concerns discussed here and sheltering groups from foreign competition through protectionism. I can offer no hard-and-fast rules here, only some guiding principles.

Strike a balance between openness and domestic needs

There is often a trade-off between maintaining open borders to trade and maintaining social cohesion. When the conflict arises – when new liberalization initiatives are under discussion, for example – it makes little sense to sacrifice social concerns completely for the sake of liberalization. Put differently, as policymakers sort out economic and social objectives, free trade policies are not automatically entitled to first priority.

Thanks to many rounds of multilateral trade liberalization, tariff and nontariff restrictions on goods and many services are now at extremely low levels in the industrial countries. Most major developing countries have also slashed their trade barriers, often unilaterally and in conformity with their own domestic reforms. Most economists would agree that the efficiency benefits of further reductions in these existing barriers are unlikely to be large. Indeed, the dirty little secret of international economics is that a tiny bit of protection reduces efficiency only a tiny bit. A logical implication is that the case for further liberalization in the traditional area of manufactured goods is rather weak.

Moreover, there is a case for taking greater advantage of the World Trade Organization's existing escape clause, which allows countries to institute otherwise-illegal trade restrictions under specified conditions, as well as for broadening the scope of these multilateral safeguard actions. In recent years, trade policy in the United States and the European Union has gone in a rather different direction, with increased use of antidumping measures and limited recourse to escape clause actions. This is likely because WTO rules and domestic legislation make the petitioning industry's job much easier in antidumping cases: there are lower evidentiary hurdles than in escape clause actions, no determinate time limit, and no requirement for compensation for affected trade partners, as the escape clause provides. Also, escape clause actions, unlike antidumping duties, require presidential approval in the United States. This is an undesirable situation because antidumping rules are, on the whole, consistent neither with economics principles nor, as discussed below, with fairness. Tightening the rules on antidumping in conjunction with a reconsideration and reinvigoration of the escape clause mechanism would make a lot of sense.

Do not neglect social insurance

Policymakers have to bear in mind the important role that the provision of social insurance, through social programs, has played historically in enabling multilateral liberalization and an explosion of world trade. As the welfare state is being pruned, there is a real danger that this contribution will be forgotten.

This does not mean that fiscal policy has to be profligate and budget deficits large. Nor does it mean a bigger government role. Enhanced levels of social insurance, for better labor-market outcomes, can be provided in most countries within existing levels of spending. This can be done, for example, by shifting the composition of income transfers from old-age insurance (i.e., social security) to labor-market insurance (i.e., unemployment compensation, trade adjustment assistance, training programs). Because pensions typically constitute the largest item of social spending in the advanced industrial countries, better targeting of this sort is highly compatible with responsible fiscal policies. Gearing social insurance more directly toward labor markets, without increasing the overall tax burden, would be one key step toward alleviating the insecurities associated with globalization.

There is a widespread feeling in many countries that, in the words of Tanzi and Schuknecht, "[s]ocial safety nets have … been transformed into universal benefits with widespread free-riding behavior, and social insurance has frequently become an income support system with special interests making any effective reform very difficult." Further, "various government performance indicators suggest that the growth in spending after 1960 may not have brought about significantly improved economic performance or greater social progress." However, social spending has had the important function of buying social peace. Without disagreeing about the need to eliminate waste and reform in the welfare state more broadly, I would argue that the need for social insurance does not decline but rather increases as global integration increases. So the message to reformers of the social welfare system is, don't throw the baby out with the bath water.

Do not use "competitiveness" as an excuse for domestic reform

One of the reasons globalization gets a bad rap is that policymakers often fall into the trap of using "competitiveness" as an excuse for needed domestic reforms. Large fiscal deficits or lagging domestic productivity are problems that drag living standards down in many industrial countries and would do so even in closed economies. Indeed, the term "competitiveness" itself is largely meaningless when applied to whole economies, unless it is used to refer to things that already have a proper name – such as productivity, investment, and economic growth. Too often, however, the need to resolve fiscal or productivity problems is presented to the electorate as the consequence of global competitive pressures. This not only makes the required policies a harder sell – why should we adjust just for the sake of becoming better competitors against the Koreans or the Mexicans? – it also erodes the domestic support for international trade – if we have to do all these painful things because of trade, maybe trade isn't such a wonderful thing anyhow!

The French strikes of 1995 are a good case in point. What made the opposition to the proposed fiscal and pension reforms particularly salient was the perception that fundamental changes in the French way of life were being imposed for the sake of international economic integration. The French government presented the reforms as required by the Maastricht criteria, which they were. But presumably, the Maastricht criteria themselves reflected the policymakers' belief that a smaller welfare state would serve their economies better in the longer run. By and large, the French government did not make the case for reform on its own strengths. By using the Maastricht card, it turned the discussion into a debate on European economic integration. Hence the widespread public reaction, which extended beyond just those workers whose fates would be immediately affected.

The lesson for policymakers is, do not sell reforms that are good for the economy and the citizenry as reforms that are dictated by international economic integration.

Do not abuse "fairness" claims in trade

The notion of fairness in trade is not as vacuous as many economists think. Consequently, nations have the right – and should be allowed – to restrict trade when it conflicts with *widely held* norms at home or undermines domestic social arrangements that enjoy *broad* support.

But there is much that is done in the name of "fair trade" that falls far short of this criterion. There are two sets of practices in particular that should be immediately suspect. One concerns complaints made against other nations when very similar practices abound at home. Antidumping proceedings are a clear example: standard business practices, such as pricing over the life of a product or pricing over the business cycle, can result in duties being imposed on an exporting firm. There is nothing "unfair" about these business practices, as is made abundantly clear by the fact that domestic firms engage in them as well.

The second category concerns cases in which other nations are unilaterally asked to change *their* domestic practices so as to equalize competitive conditions. Japan is frequently at the receiving end of such demands from the United States and the European Union. A more recent example concerns the declaration by the US Trade Representative that corruption in foreign countries will henceforth be considered as unfair trade. While considerations of fairness and legitimacy will guide a country's own social arrangements, even by restricting imports if need be, such considerations should not allow one country to impose its own institutions on others. Proponents of fair trade must bear this key distinction in mind. Thus, it is perfectly legitimate for the United States to make it illegal for domestic firms to engage in corrupt practices abroad (as was done with the Foreign Corrupt Practices Act of 1977). It is also legitimate to negotiate a multilateral set of principles with other countries in the Organization for Economic Cooperation and Development (OECD) with broadly similar norms. It may also be legitimate to restrict imports from a country whose labor practices broad segments of the domestic population deem offensive. But it is not acceptable to unilaterally threaten retaliation against other countries because their business practices do not comply with domestic standards at home *in order to force these countries to alter their own standards*. Using claims of fairness to advance competitive aims is coercive and inherently contradictory. Trying to "export" norms by asking other countries to alter their social arrangements to match domestic ones is inappropriate for the same reason. [...]