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Introduction

Labor strikes in France at the end of 1995, which were aimed at reversing the French government's efforts to bring its budget in line with the Maastricht criteria, threw the country into its worst crisis since 1968. Around the same time in the United States, a prominent Republican was running a vigorous campaign for the presidency on a plank of economic nationalism, promising to erect trade barriers and tougher restrictions on immigration. In the countries of Eastern Europe and in Russia, former communists have won most of the parliamentary elections held since the fall of the Berlin Wall, and communist candidate Gennady Zyuganov garnered 40 percent of the vote in the second round of the Russian presidential election held in July 1996.

These apparently disparate developments have one common element: the international integration of markets for goods, services, and capital is pressuring societies to alter their traditional practices, and in return broad segments of these societies are putting up a fight.[1] The pressures for change are tangible and affect all societies: In Japan, large corporations have started to dismantle the postwar practice of lifetime employment, one of Japan's most distinctive social institutions. In Germany, the federal government has been fighting union opposition to cuts on pension benefits aimed at improving competitiveness and balancing the budget. In South

1. See the perceptive column by Thomas L. Friedman (1996). Friedman stresses that the recent salience of such apparently diverse political movements as that of Patrick Buchanan in the United States, Communists in Russia, and the Islamists in Turkey may be due to a common root: a backlash against globalization. I thank Robert Wade for bringing Friedman's piece to my attention.

Korea, trade unions have gone on nationwide strikes to protest new legislation making it easier for firms to lay off workers. Developing countries in Latin America have been competing with each other in opening up to trade, deregulating their economies, and privatizing public enterprises. Ask business executives or government officials why these changes are necessary, and you will hear the same mantra repeatedly: ''We need to remain (or become) competitive in a global economy.''

The opposition to these changes is no less tangible and sometimes makes for strange bedfellows. Labor unions decrying unfair competition from underage workers overseas and environmentalists are joined by billionaire businessmen Ross Perot and Sir James Goldsmith in railing against the North American Free Trade Agreement (NAFTA) and the World Trade Organization (WTO). In the United States, perhaps the most free-market-oriented of advanced industrial societies, the philosophical foundations of the classical liberal state have come under attack not only from traditional protectionists but also from the new communitarian movement, which emphasizes moral and civic virtue and is inherently suspicious of the expansion of markets (see, e.g., Etzioni 1994; Sandel 1996).[2]

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.[3]

This book argues that the most serious challenge for the world economy in the years ahead lies in making globalization compatible with domestic social and political stability—or to put it even more directly, in ensuring that international economic integration does not contribute to domestic social *dis*integration.

Attuned to the anxieties of their voters, politicians in the advanced industrial countries are well aware that all is not well with globalization. The Lyon summit of the Group of Seven, held in June 1996, gave the issue central billing: its communique was titled ''Making a Success of Globalization for the Benefit of All.'' The communique opened with a

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2. The cheerleaders on the side of globalization sometimes make for strange bedfellows too. Consider, for example, the philosophy of an organization called the Global Awareness Society International: ''Globalization has made possible what was once merely a vision: the people of our world united together under the roof of one Global Village.''

3. See also Kapstein (1996) and Vernon (forthcoming). Kapstein argues that a backlash from labor is likely unless policymakers take a more active role in managing their economies. Vernon argues that we might be at the threshold of a global reaction against the pervasive role of multinational enterprises.

discussion of globalization—its challenges as well as its benefits. The leaders recognized that globalization raises difficulties for certain groups, and they wrote:

> In an increasingly interdependent world we must all recognize that we have an interest in spreading the benefits of economic growth as widely as possible and in diminishing the risk either of excluding individuals or groups in our own economies or of excluding certain countries or regions from the benefits of globalization.

But how are these objectives to be met?

An adequate policy response requires an understanding of the sources of the tensions generated by globalization. Without such an understanding, the reactions are likely to be of two kinds. One is of the knee-jerk type, with proposed cures worse than the disease. Such certainly is the case with blanket protectionism a la Patrick Buchanan or the abolition of the WTO a la Sir James Goldsmith. Indeed, much of what passes as analysis (followed by condemnation) of international trade is based on faulty logic and misleading empirics.[4] To paraphrase Paul Samuelson, there is no better proof that the principle of comparative advantage is the only proposition in economics that is at once true *and* nontrivial than the long history of misunderstanding that has attached to the consequences of trade. The problems, while real, are more subtle than the terminology that has come to dominate the debate, such as "low-wage competition," or "leveling the playing field," or "race to the bottom." Consequently, they require nuanced and imaginative solutions.

The other possible response, and the one that perhaps best characterizes the attitude of much of the economics and policy community, is to downplay the problem. Economists' standard approach to globalization is to emphasize the benefits of the free flow of goods, capital, and ideas and to overlook the social tensions that may result.[5] A common view is that the complaints of nongovernmental organizations or labor advocates represent nothing but old protectionist wine in new bottles. Recent research on trade and wages gives strength to this view: the available empirical evidence suggests that trade has played a somewhat minor role in generating the labor-market ills of the advanced industrial countries—that is, in increasing income inequality in the United States and unemployment in Europe.[6]

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4. Jagdish Bhagwati and Paul Krugman are two economists who have been tireless in exposing common fallacies in discussions on international trade. See in particular Bhagwati (1988) and Krugman (1996).

5. When I mention "economists" here, I am, of course, referring to mainstream economics, as represented by neoclassical economists (of which I count myself as one).

6. Cline (1997) provides an excellent review of the literature. See also Collins (1996).

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.

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[7]) 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).

7. Outsourcing refers to companies' practice of subcontracting part of the production process—typically the most labor-intensive and least skill-intensive parts—to firms in other countries with lower 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.

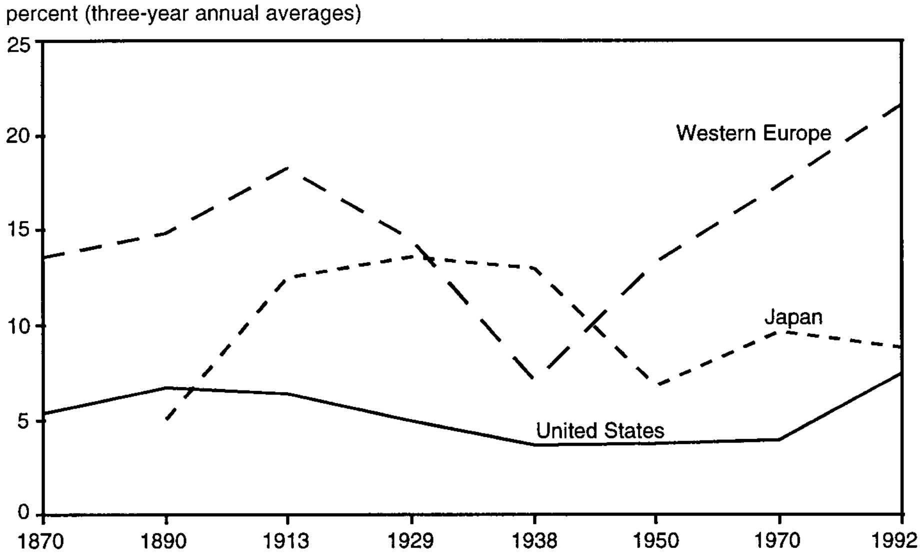
We cannot understand what is happening in these new areas until we take individual preferences for processes and the social arrangements that embody them seriously. In particular, by doing so we can start to make sense of people's uneasiness about the consequences of international economic integration 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

Figure 1.1 Japan, United States, and Western Europe: merchandise exports as a share of GDP, 1870-1992



Source: Bairoch and Kozul-Wright (1996).

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.

Globalization: Now and Then

This is not the first time we have experienced a truly global market. By many measures, the world economy was possibly even more integrated at the height of the gold standard in the late 19th century than it is now. Figure 1.1 charts the ratio of exports to national income for the United States, Western Europe, and Japan since 1870. In the United States and Europe, trade volumes peaked before World War I and then collapsed during the interwar years. Trade surged again after 1950, but none of the three regions is significantly more open by this measure now than it was under the late gold standard. Japan, in fact, has a lower share of exports in GDP now than it did during the interwar period.

Other measures of global economic integration tell a similar story. As railways and steamships lowered transport costs and Europe moved toward free trade during the late 19th century, a dramatic convergence in commodity prices took place (Williamson 1996). Labor flows were considerably higher then as well, as millions of immigrants made their way from the old world to the new. In the United States, immigration was responsible for 24 percent of the expansion of the labor force during the 40 years before World War I (Williamson 1996, appendix table 1). As for capital mobility, the share of net capital outflows in GNP was much higher in the United Kingdom during the classical gold standard than it has been since.

Does this earlier period of globalization hold any lessons for our current situation? It well might. There is some evidence, for example, that trade and migration had significant consequences for income distribution. According to Jeffrey Williamson, ''[G]lobalization . . . accounted for more than half of the rising inequality in rich, labor-scarce countries [e.g., the United States, Argentina, and Australia] and for a little more than a quarter of the falling inequality in poor, labor-abundant countries [e.g., Sweden, Denmark, and Ireland]'' in the period before World War I (1996, 19). Equally to the point are the political consequences of these changes:

> There is a literature almost a century old that argues that immigration hurt American labor and accounted for much of the rise in inequality from the 1890s to World War I, so much so that a labor-sympathetic Congress passed immigration quotas. There is a literature even older that argues that a New World grain invasion eroded land rents in Europe, so much so that landowner-dominated Continental Parliaments raised tariffs to help protect them from the impact of globalization. (Williamson 1996, 1)

Williamson (1996, 20) concludes that ''the inequality trends which globalization produced are at least partly responsible for the interwar retreat from globalization [which appeared] first in the rich industrial trading partners.''

Moreover, there are some key differences that make today's global economy more contentious. First, restrictions on immigration were not as common during the 19th century, and consequently labor's international mobility was more comparable to that of capital. Consequently, the asymmetry between mobile capital (physical and human) and immobile ''natural'' labor, which characterizes the present situation, is a relatively recent phenomenon. Second, there was little head-on international competition in identical or similar products during the previous century, and most trade consisted of the exchange of noncompeting products, such as primary products for manufactured goods. The aggregate trade ratios do not reflect the ''vast increase in the exposure of tradable goods industries to international competition'' that is now taking place compared with the situation in the 1890s (Irwin 1996, 42). Third, and perhaps most important, governments had not yet been called on to perform social-welfare functions on a large scale, such as ensuring adequate levels of employment, establishing social safety nets, providing medical and social insurance, and caring for the poor. This shift in the perceived role of government is also a relatively recent transformation, one that makes life in an interdependent economy considerably more difficult for today's policymakers.

At any rate, the lesson from history seems to be that continued globalization cannot be taken for granted. If its consequences are not managed wisely and creatively, a retreat from openness becomes a distinct possibility.

Implications

So has international economic integration gone too far? Not if policymakers act wisely and imaginatively.

We need to be upfront about the irreversibility of the many changes that have occurred in the global economy. Advances in communications and transportation mean that large segments of national economies are much more exposed to international trade and capital flows than they have ever been, regardless of what policymakers choose to do. There is only limited scope for government policy to make a difference. In addition, a serious retreat into protectionism would hurt the many groups that benefit from trade and would result in the same kind of social conflicts that globalization itself generates. We have to recognize that erecting trade barriers will help in only a limited set of circumstances and that trade policies will rarely be the best response to the problems that will be discussed here. Transfer and social insurance programs will generally dominate. In short, the genie cannot be stuffed back into the bottle, even if it were desirable to do so. We will need more imaginative and more subtle responses. I will suggest some guidelines in the concluding chapter.

Even so, my primary purpose in this book is not prescriptive; it is to broaden the debate on the consequences of globalization by probing deeper into some of the dimensions that have received insufficient attention and ultimately recasting the debate so as to facilitate a more productive dialogue between opposing groups and interests. It is only through greater understanding of what is at stake that we can hope to develop appropriate public policies.

One final introductory note. I hope the reader will soon realize that this book is not a one-sided brief *against* globalization. Indeed, the major benefit of clarifying and adding rigor to some of the arguments against trade is that it helps us draw a distinction between objections that are valid (or at least logically coherent) and objections that aren't. From this perspective, what I end up doing, at least on occasion, is strengthening the arsenal of arguments in favor of free trade. If this book is viewed as controversial, it will have done its job; I have failed if it is perceived as polemical.

The chapters that follow will elaborate on the three sources of tension between globalization and society identified above and will review the relevant empirical evidence. The objectives will be to cast the debate in terms that both sides—economists and populists alike—can join, marshal evidence on the likely significance of the tension in question, and where there is evidence for serious concern, open the debate on possible remedies.