Improving the Performance of the Global Economy: The Challenges Ahead

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IMPROVING THE ECONOMIC PERFORMANCE OF THE GLOBAL ECONOMY: THE CHALLENGES AHEAD

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Below is the text of the presidential address delivered to the twelfth international conference of the International Trade and Finance Association. The meeting was held in Bangkok, Thailand during May 29 - June 1, 2002. This article discusses some broad conceptual challenges that need to be addressed in order for the world to benefit more from the ongoing process of globalization. At the broadest level, the theme of the article is that globalization requires a complimentary institutional infrastructure that needs to be improved. As a result of this existing deficiency, the social benefits from globalization have often been disappointing.

I. INTRODUCTION

Globalization appears to be moving forth on what appears to be an unstoppable path. When globalization began is arbitrary; maybe it began when our descendants left Africa over 10,000 years ago, or maybe it began with the voyage of Columbus and the Renaissance, after which world trade has consistently increased faster than world GDP (Maddison, 2001), or maybe it began with the Pax Britannia under which there was for the first time a structured global economic order (along with the opening up of Japan and China, the invention of the steamboat, and the building of the Suez canal). Regardless of its beginning, it is sure to continue into the

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1 The views are those of the author and do not represent the official positions of the U.S. Labor Department. The author is grateful to Jorge Gonzalez and H. Peter Gray for helpful comments.

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future as technology continues to reduce the costs of moving people, goods and information. However, we know from the experience of the first half of the 20th century, that government policy can slow down the process of globalization; between 1913-50 world GDP grew faster than world trade. The latest wave of globalization began with the creation of the GATT after War World II. The industrial countries began by lowering tariffs and later moved to liberalize their capital flows. Liberalization in most of the developing nations started later but appears to have really taken off after the debt crisis of the early 1980s, although much of this liberalization was not “voluntary” but was undertaken in order to get external financing from the IMF and World Bank. The trade to GDP ratio for the world tripled between 1950 and 2000.

After 50 years of continual increases in trade and financial flows, it is now popular to describe the world as highly integrated; however, the world still remains significantly segmented by political borders. In a world without political borders, the volume of international trade might possibly be 40 times the current level;\(^2\) likewise it has been estimated that the transportation costs equivalence of crossing the U.S.-Canadian border is 75 thousand miles and crossing the U.S.-Japanese border is 13 million miles (Parsley and Wei, 1999). Capital markets also seem to still be significantly segmented since there are real interest rate differentials, an extreme home bias in portfolios, and a high correlation between a nation’s level of investment and savings (Feldstein and Horioka, 1980). Thus globalization still has a long way to go. In addition to falling transport and transaction costs and the political liberalizations, the world population and income explosion of the last 50 years have created significant trans-boundary externalities; in addition, depletion of global common property resources is beginning to produce a “tragedy of the commons” at the global level. More and more, the welfare of an individual in one corner of the world is being intertwined with the welfare of everyone else. Are the benefits of globalization such that this inevitable trend should be embraced so that the extreme position is reached where national borders become economically irrelevant, or are there rising social costs so there is an optimal level of globalization, after which policy should attempt to retard this trend? Have

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\(^2\) McCallum (1995) finds the trade between a Canadian province and a U.S. state to be only 1/22 of what trade is between regions within either country (controlling for distance, etc.). Since U.S.-Canada trade is already subject to few restrictions, a doubling of other country trade flows would likely result from simply bringing restrictions to the current U.S.-Canada level.
we reached that level already? What are the future potential roadblocks that could derail us from achieving the optimal level of global economic integration?

The basic theme of this article is that a well-functioning market economic system requires a complex set of accompanying institutions. A global economic system requires some institutions of global scope, and domestic institutions appropriately adjusted for the international dimension. The failure to appreciate the need for this complimentary institutional infrastructure explains to a significant degree the large variation in economic outcomes that countries have experienced from globalization and has reduced the overall economic performance of the world economy. This absence of appropriate institutions, instead of globalization in the abstract, also explains why there is so much populist opposition to the current global economic system.

In a number of areas, there is a high level of consensus that certain problems exist, and reforms are needed. A new round of WTO trade negotiations is underway, and the IMF and the World Bank are continually reassessing their roles and policy stances. These more immediate issues which are already on the front burner and are already being appropriately addressed by large cadres of international lawyers and economists will not be considered in detail in this article. The inappropriately tight monetary policies in Europe and Japan that are keeping current world growth below its potential are also not addressed. Nor is the overvalued dollar and the increasing U.S. trade deficit (see Gray, 2002) which Noble laureates Modigliani and Solow (2001) have characterized as “the greatest potential danger facing the economy in the years to come.” Instead the focus is on broader conceptual challenges standing in the way of improving the performance of the world further down the road.

The benefits from increased openness to trade and capital are well documented. However, these benefits have often been exaggerated; the required institutional structures that are necessary in order to reap these benefits are more complex and difficult to establish than is often acknowledged. The experience of Thailand demonstrates both of these points precisely.

Between 1975 and 1995, Thailand’s exports of goods and services increased at an average annual rate of 17.6 percent; this was the fastest of any nation on earth except for Korea whose export growth rate was a minuscule 0.005 of a percent higher (World Bank CD). Over this same period (1975-1995), Thailand’s per capita income grew at an average annual rate of 5.9 percent; only three countries did better — Korea, China, and
Botswana\(^3\) (Human Development Report, Table 11). The per capita income growth during this twenty year period corresponds very roughly with the per capita income growth obtained by Great Britain over the 300 years between 1550 and 1850. This rapid growth of Thailand’s exports and income during 1975-95 is testimony to the benefits from globalization. Crafts and Venables (2001) have referred to the Asian miracle of the last quarter century as “the most spectacular shift of the center of gravity in the world economy since the rise of the United States.” However, with the Asian economic crisis of 1997, Thailand has also experienced the downside of globalization. In the 5 years before the crisis, Thailand’s fixed exchange rate, combined with capital account convertibility led to capital inflows which could not be fully sterilized. The result was an annual inflation rate about 2 percent higher than in the U.S. to whom Thailand had fixed its currency. With this higher inflation, the currency depreciations by China, Japan, and Indonesia, and the continuing economic slump in its second largest export market – Japan, Thailand’s current account deficit progressively increased and approached 8 percent of GDP by 1997. Viewing a depreciation as inevitable, capital rushed out, and depreciation followed; the result was bankruptcies for those holding dollar liabilities. The currency crisis thus turned into a financial crisis, with a deep recession at the end. By the end of 2001, neither real GNP, real per capita GNP, nor real wages had returned to the level that existed in 1996. This crisis was the result of institutional failure; the IMF implemented improper policies before and after the crisis, and Thailand failed to have the appropriate financial regulations and institutions in place to deal with the potential volatility of international capital. Thailand also failed to have an appropriate safety net in place.

Thailand’s experience reflects the broader theme of this paper, that being that globalization’s effect on a country is not necessarily good or bad, instead globalization presents countries with increased options, which provides tremendous opportunities for either prosperity or catastrophe. In order to be on the winning side of globalization, it is necessary for a country to carefully create and cultivate a set of institutions that can take advantage of a nation’s natural inclinations. Although this has been an ongoing objective of the IMF and World Bank, a number of other international institutions have recognized this explicitly and have created divisions with-

\(^3\) Note that Korea, China, and Botswana also had some of the world’s highest export growth rates; their rates averaged over 10 percent a year between 1980-1996. The per capita income growth of all these nations during this period was significantly below that of the all-time per capita income growth champion, Japan, which increased per capita income by almost 8.1 per year during 1950-73.
in their organizations to help countries establish the appropriate institutions. This includes the Outreach Division of the trade directorate of the OECD, and the Capacity Building Section of UNCTAD. Appropriately, the World Bank has titled its World Development Report for 2002 as Building Institutions for Markets. At times it seems that trade and financial liberalization along with privatization are being advanced for their own sake. The basic problem is that the advocates for globalization have simply ignored the theory of second best; international economic policy has been made in an isolation chamber with too little regard for the existing institutional infrastructure, much of which cannot be readily modified for political reasons. Reform of the international sector has proceeded without regard for the economic conditions in the rest of the economy instead of moving in tandem with domestic reform. The most obvious example was capital account liberalization (as in Thailand) which occurred without the required complementary domestic financial market reform. Essentially the same thing has occurred with trade liberalization in a number of other countries. At the most general level, it is really a question as to the proper sequencing of reforms. At the global level, there is also a need for the strengthening and expansion of global institutions; it would appear that the gap between what is needed and what exists has never been greater. The need for action in this regard is well recognized; advocates are as diverse as the Declaration of the United Nations’ Millennium Summit to the Global Governance Report of the World Economic Forum. The problem is that individual citizens and their governments have so far not gotten the message.

What policy changes are needed to improve the performance of the world economy? As a first step the current economic performance of the world can be evaluated using the four fundamental economic objectives: 1) efficiency, 2) growth, 3) macroeconomic utilization, and 4) distribution. Finally, the deficit of global institutions and their political legitimacy are discussed and some examples of how this deficit has resulted in questionable rules covering global trade.

II. EFFICIENCY AND GROWTH

Because the issues of efficiency and growth are so intertwined, these two objectives are discussed together. These issues are especially difficult to separate empirically; when policy changes (such as trade liberalizations) are spread out over time, the subsequent economic effects are likely to be even more spread out. Thus, in practice, it is difficult to distinguish empirically between one-time efficiency changes and changes in growth rates.
The degree to which openness promotes growth remains controversial; given the almost religious fervor of the globalization advocates and the almost universal support of academic economists, it is truly surprising how weak the actual evidence is. The overall cross-country statistical relationship between openness and growth appears to have varied through time, and within any time period there are important exceptions. History demonstrates that trade openness is neither a necessary nor sufficient condition for sustained rapid economic growth. The time series evidence flatly rejects the proposition that openness promotes growth. Global growth has generally been higher during the protectionist phase, and lower during the liberalized phase. As the trade to GNP ratio has progressively increased throughout the post-War World II period, the average growth rate has progressively fallen. World real per capita GDP growth increased by 37.6 percent in the 1960s, 21.5 percent in the 1970s, 14.1 percent in the 1980s, and 8.7 percent in the 1990s (WB-CD). In the 1960s per capita income grew almost as much every two years as it did in the entire 1990s. The decline in growth in much of the developing world is even more dramatic. Per capita income growth in Latin America and the Caribbean increased by 75% from 1960 to 1980, but increased by only 7% from 1980 to 2000. Likewise in sub-Saharan Africa, per capita income increased by 34% in the earlier period but actually fell by 15% during 1980-2000 (Weisbrod, 2002). The time series evidence for Europe during 1860-1913 was similar. During the 1860-1891 period, trade was liberalized and growth was relatively low; protectionism slowly gained favor, and during the protectionist phase of 1891-1913 growth was much faster. Few of the rich countries today followed a development path similar to what is currently being prescribed by the international institutions (or the Washington consensus). Obviously the increased protectionism and economic chaos during the inter-war period suggests the opposite relationship.

The cross-sectional evidence is more ambiguous. In every historical period since 1870, some of the fastest growing countries have practiced rather protectionist policies, while some of the most open countries have stagnated. The broad statistical relationship is that growth was positively related to tariffs before 1914, ambiguous between 1914-1970, and negatively related since 1970. Clemens and Williamson (2001) have concluded that this difference is due to a changed world economic environment; when

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4 Figure 2 in Irvin (2002) shows this strong relationship; however, Irvin (2002) and DeLong (2001) argue that despite the rapid growth of some closed economies during the 19th century, including that of the U.S. (see, Eckes, 1995), their growth would have been even faster if they had been more open.
most countries have high tariffs, it’s better to have high tariffs, while when others have low tariffs, it’s better to have low tariffs. The usual terms of trade argument appears to be the basis for this possible explanation.

At the most basic empirical level, more recent (post 1970) cross-sectional data generally find that a positive correlation exists between openness and growth. However, openness is highly correlated with other factors responsible for growth, such as the level of investment or the implementation of other market-friendly reforms, and it is not clear as to whether or to what degree these should be controlled for in interpreting the empirical data. The direction of causality is not clear; for example, an increase in investment in a developing country will normally increase imports (and thus exports through exchange rate effects) because most capital equipment is imported. A growth regression that includes both openness and investment generally finds openness as insignificant. Thus questions as to what to control for in an empirical test, as well as complex issues as to how openness should be quantified, have resulted in muddled conclusions.

Some researchers have concluded that even in the most recent periods, openness is not associated with economic growth once the proper controls are accounted for. Rodrik’s (2001) summary of the evidence is: “The available studies reveal no systematic relationship between a country’s average level of tariff and nontariff barriers and its subsequent economic growth. If anything, the evidence for the 1990s indicates a positive relationship between import tariffs and economic growth.” Support for this view can be found, for example, in the fact that average tariffs in Latin America and the Caribbean have been roughly similar to average tariffs in East Asia since at least 1980 (World Bank-GGP, 2001, p.55); not only have the performances of these regions been vastly different but the absolute performance in Latin America has been relatively poor with GDP per capita growth (1975-95) often negative (as in Argentina, Venezuela, Peru, Guyana, El Salvador, Guatemala, Jamaica, Nicaragua, and Haiti) or less than one percent per year (as in Mexico, Panama, Costa Rica, Ecuador, and the Dominican Republic). In addition, sub-Saharan Africa has rather high (e.g., higher than the world average) export-to-GDP ratios, ratios which have grown faster since 1980 than the world average, nevertheless this region has experienced negative per capita income growth during the last 25 years. Even the economic performance of some of the most open richer countries, such as New Zealand, has been quite poor.

The international financial institutions have taken the rather strong position that openness is important for growth and that for the last several decades, at least, there are no successful inward looking countries. The
empirical work of Dollar and Kraay (2001) is currently being promoted as supporting this position. This work is far more nuanced than they believe, and the fact that it is repeatedly cited reveals just how weak the actual evidence is that supports this position. There are real empirical problems, as Dollar and Kraay admit, in determining who the globalizers are; unfortunately their criteria, of changes in export to GDP ratios, is highly questionable.5 The globalizers in their study had average tariffs almost twice as high as the non-globalizers. The two countries that really drive their results (since they are population weighted) are China and India. Although both have liberalized significantly, neither is all that open in the traditional sense. It is true that both have liberalized since 1980, but average tariffs in China were still above 20 percent and India’s were almost 40 percent during 1995-97. In addition, China and India are still described as having “repressive capital markets” (Rogoff, 1999); China’s state banks control much of its investment and the renminbi is not convertible. Importantly, these countries’ growth rates reflect the fact that these restrictions on capital flows kept China and India out of the emerging market crises of 1997-98.6 Thus the evidence presented by Dollar and Kraay only suggests that partial liberalization from relatively high initial levels creates a “one-time” gain in income (as traditional trade suggests); since the average tariff of their so-called nonglobalizers is actually one-half the tariff of their globalizers, the evidence presented by Dollar and Kraay is actually inconsistent with the conclusion they draw, that more open economies grow faster than more closed economies.

Regardless of the overall statistical relationship between openness, efficiency and growth, what is important is that there are open economies that have not performed well and relatively closed economies that have. Why has trade openness not increased income and growth in so many countries, as one might expect from basic real trade theory? Generally it is a compilation of factors. Although the principle of specialization based on comparative advantage is universal, openness alters a number of other economic channels which can further magnify the benefits of openness or even negate them. This latter possibility is all the more possible if one

5 The key to their findings is the correlation between the trade-to-GNP ratio and the growth rate. The elasticity of imports to income is normally greater than one; growth therefore increases the trade to GNP ratio. The demonstration that trade/GNP ratios are positively correlated to growth may not show that openness increases growth but only that the elasticity is greater than one.

6 China not only limited foreign currency short-run liabilities, but had an impressive level of foreign exchange reserves.
takes as relatively given the existing institutional and political structure. In order for increased trade to increase social welfare, it is necessary that a nation’s institutions be finely tuned towards that objective. The failure of some nations to benefit from globalization is due primarily (but not solely) to their failure to establish these institutions. To a significant degree, this failure is highly correlated with poverty (Gray, 2000). In poor underdeveloped countries the complimentary institutional infrastructure is simply not there. The standard terms of trade and market imperfections arguments are not theoretical anomalies but important real world occurrences. The relationship between openness and investment is important; in may cases openness increases investment, but in other cases it may reduce it. Increased macroeconomic instability is another complication (Razin, Sadka, Coury, 2002). Liberalization also implicitly requires a currency depreciation (i.e., Mexico after NAFTA), which often does not occur for political reasons, thus producing macroeconomic complications. The full employment assumption usually does not hold.

Institutions that are needed include a legal structure to insure private property and contract enforcement, legitimate bankruptcy laws, flexible labor markets, social safety nets, financial institutions with the proper regulatory oversight and capital adequacy standards, transparency in government, an independent judiciary, an insurance market to minimize risks, and a competition policy. Government regulated natural monopolies have sometimes simply been turned into private “price gouging” monopolies with no systematic effort to create a competitive market (Mozambique’s case with cashew nuts received a lot of press attention). A sound fiscal policy based upon a well functioning system of tax collection is needed; liberalization eliminates a rather low-cost method of tax collection (i.e., tariffs). The connection between the economic policy changes and the resulting political changes are also too often ignored.

The concept of openness is often simplified to be a one dimensional variable; a country is either open or not. This may make sense within a two-good model, but does not in a complex economy. The successful countries appear to have pursued export promotion far more aggressively than import liberalization. The successful development strategy is therefore not a retreat into autarky, but a well administered industrial policy that strategically engages in trade. Some of the most successful countries of the

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7 Numerous concerns have been raised in the development literature about how trade openness may adversely affect national savings through distributional changes (Pattanaik, 1974).
20th century – Japan, Korea, and China – have followed this model. Unfortunately many aspects of such a strategy are now banned by the WTO. A foreign liberalization has a number of similarities to domestic export promotion; therefore the current movement to liberalize Northern markets for Southern goods, such as for agriculture and the elimination of the tariff spikes on processed labor-intensive goods, is likely to be quite beneficial for Southern growth. The sectors which are liberalized are often more important than the overall level of openness. In the South, liberalization of capital-goods imports from the industrial countries seems more important than liberalization of the consumer goods sectors. Partially for this reason, regional trade agreements amongst developing nations do not appear to have increased growth (Vamvakidis, 1998).

The pathetic economic performance during the 1990s of the states of the former USSR (CIS), and to some degree the East European countries, is due to the same reason that openness often is unsuccessful – that being the failure to establish the institutional infrastructure necessary to regulate a market system. Real GDP in most of the Eastern European states (except Poland) was in 2000 still below the level in 1989. In the CIS income in 2000 was only 2/3 of its 1989 level (UN, 2000, Table B1, p. 160). Not only did national income collapse but the increases in income inequality in the CIS have been the fastest ever recorded (HD, 1999; Lokshin and Popkin, 1999). Markets without the appropriate institutions simply do not work.

It is not an exaggeration to say that the international financial institutions (IFIs) and many Northern governments, especially the U.S., have waged a propaganda campaign to convince the public of the great benefits from trade liberalization. What lies behind this movement is not clear, but undoubtedly an important factor are the financial interests which control the governments (which then control the IFIs). A book could be written to document this (a possible introduction is already provided by To nelson, 2000, and the hype about all the jobs NAFTA would create could provide another long chapter) but consider just one very recent example. The Council of Economic Advisors (CEA, 2002) and the USTR have, as part of their push for fast track, been stating that a new round of global trade negotiations would result in a $2,500 increase in the annual income of the average family of four. They begin with a somewhat questionable (the degree

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8 It is not being suggested that the U.S. with vastly different attributes and circumstances should pursue an industrial policy; although the common argument against it as to why the government has better foresight than the private sector misses the point. An industrial policy allows a country to internalize externalities and adjust for market imperfections that cannot be corrected.
of liberalization is overstated), but nevertheless, scientifically legitimate study by Brown, Deardorff, and Stern (2001) which concludes with an estimated gain of $177 billion annually (or about 1.95 percent of GDP). Note that most of this comes from services liberalization, with goods liberalization producing a small gain of only .3 percent ($27.1 billion). Accepting the larger number, it would seem that the appropriate manner to estimate the gain for an “average family of four” would be to multiply this projected percentage increase in national income by the amount of the average family of four’s income (the mean is $77,086; the median is $62,233). The result is a gain of $1,214 to $1,503. This number, however, was not impressive enough. The CEA took the total gain and divided it by the total population, and then multiplied this by 4; this gives $2,500. Thus they effectively doubled the gain through a deceptive slight of hand. This calculation is similar to the way the Interior Department calculated the acres of land likely to impacted by drilling in the Arctic National Wildlife Refuge. Only the square footage of the pipelines supporting post is included in the calculation; the ground over which the pipes go is not considered nor are the roads. In both cases, there is some procedure to get a number — it simply wasn’t made up — but there is no way a reasonable person would consider the calculation appropriate. Unfortunately Dr. Krugman (2002a) has it right when he said, “why people made such a fuss about the Pentagon’s plan to disseminate false information. How would that differ from current policy?” In a similar vein Krugman (2002b) states, “the [CEA] job description included [includes] saying things that were [are] manifestly untrue.”

Long-term capital flows also create winners and losers. The growth rate of international capital flows is truly astounding. Since 1985, foreign direct investment has been growing at an annual rate of 28 percent; this amounts to doubling every three years (Schwartz et al, 1999). Southern concerns about FDI seem to have diminished over the last decades. In the early post-war decades Southern nations were often hostile to FDI out of a fear that it represented a new form of colonialism; development economists raised concerns about dualism. The South now seems convinced of the advantages of FDI in providing capital, management expertise, and technology. In addition, investment may increase employment since labor does not appear to be fully utilized in many Southern nations. Anxiety about the desirability of FDI is now concentrated in the North. The concern now is that the South may be competing “unfairly” in order to get a larger slice of investment. There is some merit to these concerns. The social benefits of
investment are often greater than the private returns, when government taxation and external benefits are considered. Capital outflows alter the distribution of income, benefitting capital and harming wages; a utilitarian welfare analysis as performed in the next section, might reveal that the actual welfare effects are negative even though the private income effects are positive.

It is interesting how the public views immigration (the share of U.S. foreign born doubled from 1970 to 2000) so differently than trade. Immigration, like trade, is efficiency enhancing, but the public understands that there are significant externalities and distributional issues involved and weights these as more important than the efficiency gains. But with trade, efficiency rules the day.

To summarize, trade and capital market liberalization has not always increased efficiency and growth; instead of concentrating so single-mindedly on liberalization, countries should concentrate more on insuring that the correct complimentary policies are in place. Just as the income gains from liberalization are constantly exaggerated, the stabilization and distributional effects are incorrectly minimized.

III. MACROECONOMIC UTILIZATION AND THE INTERNATIONAL MONETARY SYSTEM

The Asian and later global currency crisis of 1997-98 is the most obvious evidence that at least some component of the global monetary system is in need of reform. Although the crisis was ultimately contained after spreading around the world, tremendous damage and “bone carving pain” was inflicted on the affected countries. Some have yet to recover. The responsibility for that crisis is widely diffused. Taking the global monetary system as given, the affected countries had domestic financial institutions which were inconsistent with their policy towards international capital flows. It is now recognized that with a globalized capital market, the need for sound, honest, and transparent domestic financial institutions is more imperative than ever. More regulations were needed on banks and firms ability to assume dollar debts when all their future income would be in domestic currency. The global overseer of the system, largely the IMF, at the insistence of the U.S. Treasury, promoted capital market liberalization.

9 However, a recent paper by Davis and Weinstein (2002) concludes that U.S. natives have lost about one percent of GDP annually due to immigration.
aggressively\textsuperscript{10} although there was no real credible empirical evidence that capital account liberalization had any measurable impact on growth (Rodrik, 1998; Bhagwati, 1998).\textsuperscript{11} This was especially true for Asia where domestic savings were incredibly high and the need for foreign capital for long-term development was not present. Even when domestic savings are low, the theoretical case for capital market liberalization is questionable if the borrowing country has to keep a significant portion of the capital inflow as international reserves. The costs of accumulating and holding international reserves are high. Once the Asian crisis developed, the programs promoted by the IMF were less than optimal; they basically applied the conventional current account medicine to what was a capital account disease. These crises were not the result of current account problems stemming from fiscal and monetary excess. The rescue plans were not particularly successful. Despite the IMF, the damage was widespread. Malaysia chose not to adopt an IMF plan and did about as well as those that did.

The problem, however, is more systemic than just poorly regulated domestic financial institutions and the sloppy performance of the IMF. An internationally open financial system is inherently unstable. The current architecture of the international monetary system is ill prepared to deal with capital account crises. Just as each nation has learned that a central bank is necessary for economic stabilization, the world requires a central bank which can regulate the level of global liquidity. Where there is no lender of last resort in a national economy, as with Argentina’s currency board, a currency crisis can implode a domestic financial system and destroy the economy. Although the IMF and the U.S. Federal Reserve are able to partially carry out some central bank functions (as the Bank of England did in the 19th century), current IMF resources are simply too small to significantly stabilize the world economy. Without a global lender of last resort, the current international monetary system remains a highly unstable system subject to destabilizing capital flows. A lender of last resort does introduce moral hazard problems, where excessive risks are undertaken, but just as with domestic banking, this problem can be contained. In addition, the volatility of capital flows can be reduced with

\textsuperscript{10} In 1997 the IMF’s Interim Committee asked the Executive Committee to amend the IMF Articles of Agreement to make liberalization of the capital account one of the IMF’s primary missions.

\textsuperscript{11} Krol (2001) has more recently presented evidence of a positive effect, after controlling for a number of factors, such as per capita income, inflation, government size, stock market size, etc. The appropriateness of all these controls is questionable.
Chilean type penalties and restrictions on short-run flows and a Tobin tax. The IMF’s articles of agreement should be amended, as proposed by Anne Krueger, so as to give the IMF the right to override contractual agreements between private financial actors during times of crisis; the IMF needs the same bullying power (i.e., forced standstill agreements) that the Fed exercises over the domestic banking system. The U.S. Treasury’s weaker proposal for "collective action clauses" in which provisions for restructuring are incorporated into new bond contracts has a number of weaknesses including the fact that existing bonds, which will be in circulation for a long time, would not be covered.

The current institutional structure lacks the required resources needed to stabilize the international monetary system. John M. Keynes’ proposal leading up to Bretton Woods was for the future IMF to have resources equivalent to 50-100 percent of world imports, and this was in a world where capital flows were going to be highly constrained. Initially the IMF was set up with resources much below Keynes’ suggestion, and they have shrunk progressively ever since. Currently IMF resources ($275 billion) amount to 3% of world imports; if Fund resources had increased with the volume of trade they would be nine times larger ($2.5 trillion). With the increasing openness of the capital account, even this may be too low. However, the capital outflow from Asia in 1997-98 amounted to a net change in direction of slightly more than $100 billion (almost 10% of the affected countries GDPs); thus although the IMF did not have access to the full $275 billion since much of that was previously committed, the amounts needed are not so huge as to be totally unrealistic. In addition, with sizable assets the likelihood of an international run is less. The $275 billion figure should also be kept in perspective; the world’s ten richest couples have assets as great as the IMF (Forbes, p120, March 18, 2002).

Until a better global monetary authority is created, countries will have to implement policies which either constrain capital flows, constrain domestic policy options, or increase exchange flexibility in order to maintain economic stability. There remains some debate about the optimal balance in this trilemma between capital account openness, exchange rate flexibility and the capacity for domestic stabilization. The calls for a new International Financial Architecture seem to have been temporarily

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12 One sees the 50 percent figure regularly (i.e., UN Development Programme (HDR, 1999)), but in Keynes’ draft proposal of August 1, 1944, he explicitly suggests a figure one half of total trade which was defined explicitly by him as imports plus exports (Skidelsky, 2000).
replaced with the acceptance, by some at least, that some restrictions on capital flows may be required to deal with the instability of the world financial system. An important obstruction to reform is that the U.S. Fed can basically act as the global lender of last resort (as it did in 1998 after the collapse of Long-Term Capital Management) should a crisis affect the United States; thus the U.S. doesn’t need a global institution, and therefore the U.S. doesn’t promote one. The U.S. continues to push blindly for capital market openness; for example, the U.S. has been pressuring Chile to dismantle its highly regarded restrictions and penalties on short-run capital flows as part of their free trade agreement. Once the Euro becomes firmly established, and a truly multi-currency reserve system exists, the ability of the U.S. to act as the lender of last resort for itself may be diminished as the instability of the inter-war multiple reserve currency system may return.

The economies of the world, despite the recent increases in globalization, remain sufficiently segmented so that the benefits of a global currency are still outweighed by the gains from regional independent monetary policies. In time this may change, but for now the next great leap should be limited to a global lender of last resort instead of the establishment of a global currency. Current attempts to “dollarize” are likely to end as in Argentina. As will be discussed later, the ability to structure the appropriate economic institution is constrained by the absence of the necessary political institutions. Obviously, until there is another major crisis or two, the needed momentum for change will not exist.

Finally, it must be recognized that despite these problems, the overall macroeconomic performance of the global economy remains rather decent. The instances of negative global economic growth are so rare, with the last one occurring in the 1930s, that a global recession is often defined as global growth below two percent. The diversity of economic conditions throughout the world is such that the shocks to the global system are so defused that there is a high degree of cancellation of effects. If integration further synchronizes countries’ business cycles, the macroeconomic performance of the world may become more volatile.

IV. DISTRIBUTION: INEQUALITY BETWEEN COUNTRIES

Distribution is the ugly stepchild of the core economic objectives. International economists treat distribution like the classical economists of the 1920s treated unemployment: it’s a problem that either doesn’t exist, it doesn’t matter, or doesn’t belong in economics.
Global inequality has increased tremendously since the industrial revolution. Most of this is the result of widening inequality between nations; increased inequality within nations is less pronounced. Currently the nations comprising the richest fifth of the world’s population make 86% of the world’s income, the bottom 20% make about one percent. More shocking is the finding that the assets of the richest three people are greater than the combined income of all the 600 million people in the least developed countries (HDR, 1999, p.38). As a result of this poverty, it is estimated that 25,000 people per day die in these countries from treatable diseases because of the lack of minimal health care. With the relatively good economic performance of China and India during the 1990s, population weighted inequality between countries has just recently begun to fall.\footnote{Even this good news is tempered by the fact that the increasing rural-urban inequality in China may be increasing global inequality based upon the distributions of individuals (Milanovic, 2002).}

The role of globalization in causing inequality in the distribution of world income remains controversial. If globalization is defined broadly to include colonialism, then globalization may be responsible for a significant part of this; if it is defined narrowly to include only trade and investment flows, then there is more debate about its role. Although divergence is the overall long-term trend, evidence suggests that there is a convergence trend amongst highly integrated areas. The belief that openness should promote convergence is supported by three strong arguments: 1) openness promotes technological transfer, 2) factors move to where they are scarce, and 3) trade encourages factor price equalization.

Regardless of globalization’s role in this, the current level of inequality presents the world with a pressing problem that must be addressed by the world community since it is likely to be at the center of many of the major issues facing the globe in the new century. The Society of Atomic Scientists, who maintain the “countdown to doomsday” clock made famous during the cold war, in Feb. 2002 moved the hands of the clock closer to doomsday; one of the major reasons given was increasing global inequality.

Within a single economy, the distributional shortcomings of a market system have been accepted, and institutions to deal with this issue have been developed; without government involvement to redistribute income, many, and possibly a majority, would find the outcome of a market system unacceptable. At the global level there is no compulsory redistribution and actions by independent governments are unlikely to deal with this issue.
appropriately. It is understandable therefore why significant portions of the
global population may find the current institutional structure morally ille-
gitimate. Under a Rawlsian “veil of ignorance” few would choose the cur-
rent system. And what is worse, there is no political mechanism to alter this
inadequacy. The distributional component of the global economic system
is broken because an accompanying global political system, which is a
requirement for a welfare maximizing economic system, is non-existent.

As for the proper amount of needed redistribution, UN Secretary
General Kofi Annan, the NGO Forum,\footnote{A group of over 700 non-
governmental organizations.} and ex-President Jimmy Carter
have recently proposed at the UN Conference on Financing for
Development in Monterrey, Mexico, that the developed countries “con-
tribute” 0.7 percent of their GNPs to the UN for redistribution. This 0.7
percent figure is not a new number, but has been a suggested target since
the 1969 Pearson Commission on International Development. Incidentally,
this number was not chosen out of thin air but was arrived at as the amount
of capital flow that would double net capital formation in the developing
world as of 1962 (Atkinson, 1975, p.251). For the U.S., 0.7 percent
amounts to $70 billion, which breaks down to only 70 cents per day per
person.\footnote{The way the numbers work out, there is this simple mathematical correspondence
between the GNP percentage contribution and the daily costs per person. Thus, for
example, 1.2 percent translates to $1.20 per person per day. A similar relationship
would hold for those from the richer EU countries.} World Bank President Wolfensohn has proposed a more modest
target of 0.5 percent (Wolfensohn, 2002). Currently the U.S. gives about
10 cents per person per day ($10 billion); Europe does about three times
better. With the increased aid proposed by President Bush ($5 billion over
3 years), that will rise to 15 cents per person per day. It has been estima-
ted that an additional contribution of 10 cents per person per day by those
in the industrial countries towards health care in the developing world
would save 8 million lives a year (Sachs, 2002). These funds could be
transferred from direct taxes on Northern citizens or could be raised as part
of a global tax administered by the UN on currency transactions (the so-
called Tobin tax) or taxes on global common property resources including
seabed mining, ocean fishing, space and spectrum allocations, and pollu-
tion rights. Besides raising needed funds, these taxes could contribute to
efficiency by controlling the over-use of global common property
resources or reducing the speculative flow of capital.
These aid flows, although rather insignificant as a percentage of the industrial countries’ GDPs, nevertheless account for a sizeable percentage of the GDPs of the poorest nations; net official assistance is already over 10% of the GDPs of the least developed nations, and during the mid-1990s accounted for an average of 17% of African countries’ GDP (Easterly, WSJ). The lack of growth in Africa is disappointing and suggests that perhaps the money was not invested well; however, an alternative interpretation is that the money was used for projects that enhanced human welfare, such as health care, which had only a limited impact on growth, and on projects such as education whose long-term impact has yet to be realized. Much of the existing external debt of the less developed nations needs to be canceled. Attempting to get payment for this debt is similar to attempts to make Germany pay reparations after WWI: they may owe it, but payment is a receipt for social disaster.

V. DISTRIBUTION: INEQUALITY WITHIN COUNTRIES

Inequality in the North

There does not seem to be a consistent relationship between trade liberalization and inequality within countries. Within the standard Heckscher-Ohlin theory, increased trade should increase inequality in the North and reduce it in the South. This did appear to be the pattern during the first wave of globalization during the late 19th century (Williamson, 1997). A sizable literature has developed examining the role of increased trade in accounting for the increased income inequality that has occurred in the North over the last three decades. Empirical research seems to agree with the theoretical expectation that the U.S. wage consequences of trade with the South is different from trade with the other Northern nations. Trade with the South tends to increase rewards to skilled labor and reduce rewards to unskilled labor; the opposite appears to be the case with U.S.-Northern trade (Lovely and Richardson, 2000). This trend appears to be true regardless of whether the trade flow is largely inter-industry or intra-industry; this along with other evidence suggests that intra-industry trade with the South is fundamentally different from intra-industry trade with the North.

Although the emphasis has been on the need for institutional reform in the developing nations, it has become apparent that the changing nature of globalization has rendered the United States’ institutional structure deficient in transforming openness’s economic gains into welfare gains. The
policy of achieving Pareto optimality by one set of policies and then
addressing distribution by another set of policies has failed the political
test. This institutional failure has intensified the political opposition to
trade liberalization. How much of the increased inequality since 1970 that
is due to trade is still being debated; it seems that the more that this issue
is explored, the less that is known. Although it is often suggested that there
is consensus estimate of 20 percent, this consensus is due to the fact that a
number of researchers (using somewhat similar methods) have obtained a
similar value. However, real consensus exists when those with the outlier
estimates (especially from the more prominent economists such as Wood,
Leamer, Sachs, etc) come to agree that their initial estimates were off and
come to believe that the “average” estimate is correct; this type of consen-
sus however has not occurred. The 20% estimate comes from studies using
questionable empirical methods which have also defined the role of glob-
alization quite narrowly. The interaction between trade and endogenous
skill-biased technical change (Acemoglu, 2002), de-unionization, labor
rents, and outsourcing (Feenstra and Hanson, 2001) are normally ignored.
Regardless of the exact percentage, even accepting the lower estimates, a
small percentage of a negative number is still a negative number. The sim-
ple fact is that increased trade, especially with developing nations, has low-
ered the living standards of a sizable percentage of American workers. The
standard remedy of lump sum transfers to insure that trade increases social
welfare simply does not take place. In the early post-World War II years,
increased trade allowed the U.S. to obtain cheap natural resources from the
developing world and achieve economies of scale and increased product
diversity by trading with Europe and Japan. Neither of these produced sig-
nificant Stolper-Samuelson effects against labor, and the costs were pri-
marily in terms of adjustment costs for those displaced. In order to deal
with these costs, trade adjustment assistance programs were established.
Since the losers were being half-heartedly compensated, even organized
labor (i.e., the AFL-CIO and UAW) supported the Trade Expansion Act of
1962 which authorized the Kennedy Round of the GATT. In almost
every study undertaken, the benefits of liberalization have been found to
outweighed the adjustment costs. Estimates of the benefits to costs have
varied significantly depending on the industry examined and the assump-

16 Not withstanding Bhagwati’s demonstration that the average trade weighted wage of
importing nations relative to U.S. workers has not fallen.

17 It must be recognized that many of the highly unionized high wage workers were not
directly challenged by imports at this time.
tion about the length of displacement and the level of post-displacement wages. Extremes vary from 1.3 for iron and steel (Mutti, 1978) to 153 for shoes (Takacs and Winters, 1991). Current programs only attempt to soften the loss to those displaced. The average displaced worker suffers a discounted earning loss in excess of $123,000; about 25% of this is due to a spell of unemployment and 75 percent is due to lower lifetime earnings (Jacobson, 1998).18

The situation is different, however, if the losers are not just the displaced, but all of unskilled labor due to Stolper-Samuelson effects. United States institutions, however, have not adapted to this new situation; what assistance there is, is still limited to the displaced – no programs or institutions have been created to compensate the much more numerous losers through general equilibrium effects. To get labor’s support will require more than adjustment assistance (although adding health care for the displaced may be enough for Congressional support for fast-track).

Another effect of increased trade, is to increase the demand elasticity of labor. The result of this is that it becomes more difficult to improve labor’s income by using minimum wages, and unions lose their ability to obtain “labor rents.” Society has generally come to believe that higher wages gained through minimum wages or collective bargaining are more “legitimate” than higher incomes obtained through income redistribution through the tax system. Globalization, therefore, has reduced labor’s ability to obtain income through these more socially acceptable market modifying mechanisms; all that remains is redistribution through the tax system, which does not have the same level of social acceptance as these alternative mechanisms. In addition, the ability to redistribute income is reduced by the increasing mobility of capital.

In the United States, inequality decreased slightly between 1947 and 1970, but since 1970 has been increasing consistently and is now the highest in recorded U.S. history. Only one half of the increase in income inequality is due to changes in labor earnings, and only one third of this (1/6 of total) is due an increase in the inequality of labor earnings due to identifiable characteristics such as education. Thus the increase in the male college wage premium that has increased from 30% in 1979 to 70% in 1995 represents only a small part of this rising trend in inequality (Collins,

18 This figure underestimates the true loss since those over 50 who never were re-employed are not included. Also any fixed costs of relocation, such as selling a house, moving expenses, etc. are not considered. This figure has been adjusted by the author to 2000 dollars from the 1987 dollars presented by Jacobson.
Although increased trade can explain a portion of this increased wage premium, and may also be responsible for some of the non-wage earnings component, a significant amount of the increase in income inequality has yet to be tied to globalization. Examining the changes in family income distribution by quintiles reveals that from 1970 to 1992, the bottom 60% of families lost 3.85 percent of total national GNI to the top 40 percent.\textsuperscript{19} Most of this change occurred in the 1980s and half of the gain to the top 40% (e.g., 2% of GNI) went to the top 5 percent. Using the distribution of individual pre-tax income by quintiles, reveals that from 1970 to 1992, the bottom 60% of individuals lost 7.2 percent of national income to the top 20 percent.\textsuperscript{20}

The average advocate for trade greatly underestimates the amount of redistribution involved with trade policy changes. In their view trade produces large efficiency gains with only a second order distributional shift. The evidence, however, suggests that trade taxes are similar to most other taxes; the redistributions are large, and the efficiency gains are of only second order importance. Rodrik (1992) has created an index referred to as the political cost-benefit ratio (PCBR) calculated as the amount of redistribution required in order to obtain one dollar of net income gain. Rodrik concludes (p.12) “in most reasonable circumstances the PCBR lies above 5.”\textsuperscript{21} In other words, the losers will lose $5 in order for the winners to get $6. A similar magnitude is implicit in the standard H-O trade model. Using a simple miniature CGE (with a H-O core, and reasonable parameters for technical efficiency differences, trade tariffs, and endowment differences, etc.) developed in another paper (Shelburne, 2002) to describe North-South trade, this index is found to be 1.7 for a foreign (i.e., the poor country) liberalization, 3.4 for a mutual liberalization, and 7.7 for a domestic (i.e., rich country) liberalization. Obviously, the more that trade creates economies of scale or induces endogenous economic growth, the greater the efficiency gains relative to distributional shifts (a skeptical look at these factors is provided by Deraniyagala and Fine, 2001).

\textsuperscript{19} These estimates exclude households of unrelated individuals; data are from Cline (1997), Table 1.1. The bottom 60 percent of families went from 35.2 percent of national income in 1970 to 31.4 percent in 1992.

\textsuperscript{20} Individual incomes are based upon comprehensive household income adjusted by the square root of household size. Data from CBO (2001), Appendix table G-1c, pp.76-77.

\textsuperscript{21} Rodrik’s formula for the PCBR= -1/(\(\mu \times \epsilon \times t\)), where \(\mu\) := the share of imports, \(\epsilon\) = import demand elasticity, and \(t\) = tariff level.
An examination of other CGEs developed by other economists provides similar estimates. For example, it is possible to calculate the PCBR implicit in a model developed by Lawrence and Evans (1996). This model was developed to examine the trade and wages issue; Lawrence is well known as an author who has argued that wage effects from trade are minimal. Yet the PCBR in their “base case” model is 4.93; that being, $4.93 must be taken from unskilled workers (high school or less) for every $5.93 that goes to skilled workers (at least some college education). This study also presented various results using different assumptions about the parameters; from these it is possible to determine how these alter the implications for distribution and efficiency. Generally, as the elasticity of substitution between the factors in production is reduced (e.g., less elastic) and as the elasticity of substitution between the goods in consumption is increased, the greater the overall net efficiency gains from trade. Even in the case where the efficiency gains are the largest relative to the distributional change (production elasticity of .5 and consumption elasticity of .99), the PCBR is still 2.66. Generally, parameter changes that increase the efficiency gains from trade also increase the allocative distributional changes so that the implicit PCBR is relatively invariant to the assumed parameters.

Back of the envelop comparisons of actual efficiency gains and income transfers result in a similar ratio of distributional changes to efficiency gains. Using the current range of estimates that increased trade is responsible for 20% of the increased inequality, and translating these into the quintile income changes presented earlier suggest that trade has redistributed 1 or 2% of GNP to the highest quintile. Assigning a value to the efficiency gains from North-South manufactures trade produces a wide range of estimates. Despite an avalanche of studies examining the wage effects, few of these studies bother to examine the efficiency gains implicit in their analysis. These gains can not be large however, since it is repeatedly stated that Southern manufactures account for only 2% of U.S. GDP and the price of these goods hasn’t fallen measurably. The standard estimate of the effects of a GATT round of trade liberalization generally put the gain at about 1 to 2% of national income. Assuming two rounds, and assuming that trade liberalization only accounts for about half of increased Southern imports, and since only one-fourth of U.S. trade is in manufactures with countries with significantly different factor prices (i.e, the non-OECD countries), increased U.S. non-OECD manufactures trade has likely increased GNP by one to two percent. Thus as a very crude estimate, the income redistributed by U.S. non-OECD trade is from .5 to 2 times the amount of the efficiency gain.
The implications of the above are first to simply point out the large size of the distributional effects relative to the efficiency gains. This information, however, can be used to calculate how trade alters social welfare if one is willing to time travel back to the classic utilitarian welfare economics of Marshall and Pigou. With God briefly preoccupied with evil elsewhere in the world, let us commit the three forbidden sins of assuming cardinal utility, the law of diminishing marginal utility of income, and the sin of all sins, interpersonal utility comparisons. Having left the divine garden of modern welfare economics, a true normative evaluation of trade is now possible. Obviously with a decreasing marginal utility of income, a trade induced distributional change harming the poor can override an efficiency gain which increases national income, so that net social welfare falls. A reasonable assumption might be that utility is a function of the square root of income. This implies that someone making twice the income of someone else derives only 71% of the marginal utility of the poorer person from the last dollar of income. Although reasonable for this author, some may find this utility function as too equalitarian, so as an alternative the utility function is assumed to be the 4th root; this functional form is implicitly that of the late Brookings Institution’s scholar on inequality – Arthur Okun. With a fourth root function, someone making twice the income has a marginal utility of 84% of the poorer person. With a reasonable PCBR of 4, trade liberalization is neutral for social welfare if the winners from trade make approximately twice the income of the losers (as in Lawrence and Evans, 1996), or lowers social welfare if the winners have four times the income of the losers (the average individual income of the highest quintile is approximately four times the income of the middle quintile).

Note also that we have continued to assume that each person’s utility is dependent only on their own income; each person’s utility level is not a function of the incomes or welfares of others. However, there is evidence that utility levels are interdependent. Alesina, Tella, and MacCulloch (2001) find that the level of inequality in a society is a significant factor in explaining the level of happiness in Europe, but not America. Thus this would suggest that our proposed welfare function possibly undervalues.

22 Although purged from modern welfare economics, adherents remain (Harsanyi, 1977).

23 Okun (1975) provides several combinations of tax-transfers that would be acceptable to him; from these this author has derived a utility function that would be consistent with these transfers being desirable. Great liberties have been taken in invoking Okun’s name, however, since he was critical of interpersonal utility comparisons in the abstract.
economic equality by not adjusting the individual utilities appropriately. Since quantification of this interdependence involves another great leap into the normative abyss, it will not be undertaken. But it must be recognized that any gain in our social welfare function that includes greater inequality is probably less than it might appear.

Therefore using standard economic assumptions and reasonable ethical assumptions, it is easy to reach a conclusion that liberalized North-South trade, without accompanying redistribution, either does not increase social welfare in the North, or increases it just barely.

Is it possible to achieve gains in social welfare by redistributing the gains? That the gains can be redistributed so as to make everyone better off is the fundamental basis for the standard welfare conclusion that trade openness increases potential welfare. However, economists have been intellectually dishonest by introducing this assumption about costless lump-sum transfers since they don’t exist in reality. There have been a number of recent papers that have demonstrated why it may not be possible to redistribute the gains from trade. In the simple hypothetical case, the government is able to simply take the income from the winners and give it to the losers. However in the real world, the government does not know precisely who the winners are, and the tax structure does not allow specific groups to be targeted. For example, if the only tax is a progressive income tax, a lot of the income redistributed may have nothing to do with trade, and it’s possible that some money could be redistributed from the losers to the winners. Spector (2001) has demonstrated that if a country redistributes income using a non-linear income tax to maximize a social welfare function, that with free trade the country may end up with a lower level of social welfare relative to autarky. Within this model, social welfare is maximized with a combination of redistribution and tariffs. Thus the redistribution that is at the core of the basic proposition favoring free trade may, as a practical manner, not be possible with only income taxes.

The ability to redistribute through the tax system is further reduced by the administrative costs of redistributing and the disincentives created not only for those being taxed but for those receiving income, i.e. the “leaky bucket” losses of transferring income. Okun (1975) concluded that only about 20% of a transfer is lost for most redistribution schemes, while Burtless (1986) found 50% was lost with negative income tax welfare transfers. If the latter figure is accepted, and combined with the PCBRs presented earlier, it would appear that a trade liberalization combined with a tax-transfer is a losing proposition.
Furthermore, there exist a number of practical complications concerning redistribution so as to make the necessary redistributions unlikely to occur in practice. Just as the need to redistribute through the tax system has increased, the ability to do so has decreased. Rodrik has emphasized how the international mobility of capital has shifted taxes onto labor and made redistribution more difficult. The failure to redistribute the gains from openness has also been compounded by the perverse nature of the U.S. political system. Instead of being a “one man one vote” system, the U.S. has denigrated into a “one dollar one vote” plutocracy. As a result, increases in inequality are not corrected with increases in redistribution, but are further magnified with political gifts of tax cuts and regulatory reform that primarily benefit corporations and the rich. Inequality creates greater inequality through a vicious political cycle.

**Inequality in the South**

In general, inequality has been increasing within Southern nations over the last several decades. In the South, the role of openness and inequality seems to have varied significantly. In many of the Asian countries (Korea, Taiwan, Singapore, Malaysia) that liberalized in the 1960s and 1970s, the increased demand for unskilled workers for producing labor-intensive manufactures seems to have dominated. However, in other regions and time periods, especially Latin America in the 1980s, other factors appear to have dominated any increase in the demand for unskilled labor. In countries which have a comparative advantage in natural resources, the owners of these resources are primarily the rich and the workers required for their extraction are primarily skilled workers. Inequality seems to have increased after a number of liberalizations including Argentina, Bangladesh, Chile, Colombia, Costa Rica, Mexico, and Uruguay (Torres, 2001; Wood, 1997). It is no coincidence that where increased openness produced inequality, it did not produce long-term growth. Wood (1997) has argued that this difference in experience is also due the fact that with China’s entry into the global market, the price of labor-intensive goods has fallen and taken the wage of unskilled labor in the other Southern nations with it. There is also the view that the increased inequality in the South is due to the same technological factors often suggested for explaining Northern inequality; that being, technological change that was primarily capital-using.

The broad statistical relationship supports the conclusion that growth generally benefits all income groups, including the very poor; thus, the
importance of growth should not be minimized. However, it is wrong to simply focus on growth as the only mechanism to improve social welfare. Distribution and the provision of public services such as education and health are also important. For example, the UN Development Programme produces a Human Development Index (HDI) as a measure of social welfare that is based upon life expectancy, educational attainment, and the level and distribution of income. There are numerous cases where a country with twice the income of another nation actually has a lower HDI (HDR, 1999, p.129). It is well known that there is generally a negative cross-country relationship between the degree of inequality and a nation’s growth rate. Thus there is much room for redistributing income and improving welfare without reducing growth.

VI. INTERNATIONAL INSTITUTIONAL DEFICIT

Olson (1965, p.2) in his general theory of collective action concluded, “unless the number of individuals is quite small, or unless there is coercion or some other special device to make individuals act in their common interest, rational self-interested individuals will not act to achieve their common or group interests.” There would appear to be no reason to believe that a similar conclusion would not hold for sovereign nations. There are many nations, with quite diverse interests, and there is no political body which can coerce. There are a number of global issues which would appear in need of immediate attention but are being ignored because there is no international organization that has the mandate or power to address the issue. The need for institutions to address international externalities and public goods stems not only from increased trade and financial flows, but from increased global population and world economic activity and their transboundary effects whether this be pollution, diseases, the spread of genetically modified species, or exhaustion and overuse of common property resources. Long-term problems which affect countries differentially will be difficult to address. A solution for the CO2 problem is going to be especially difficult to achieve since most of the gases have been produced by the temperate nations and most of the damage is to the tropical nations. Thus the temperate nations are producing a negative externality and have little incentive to control it since the harm goes elsewhere. There is the possibility, of course, that the failure to properly address these problems is not due to an institutional deficit, but to the political difficulty of addressing problems where the costs are immediate but the benefits are uncertain.
and far into the future. Thus the failure to seriously address the worldwide CO2 problem may simply be due to the same tendency as ignoring the impending shortfall in the U.S. Social Security program.

Most of the current global institutions were created after the Second World War, and although they have proven to be rather adaptable in adjusting their missions to changing circumstances, their power structures are petrified and continue to give a small number of industrial countries effective veto power. The U.S. has the same voting strength at the IMF as East Asia, South Asia, Latin America and Sub-Saharan Africa combined; Belgium has more votes than India although it only has one% of India’s population. From a global democratic perspective, these institutions remain quite autocratic. It is rare in the history of mankind, that those with power surrender it voluntarily to the cause of equality. It is true that many of these organizations, including the WTO, IMF, and World Bank, attempt to achieve consensus for many issues, and this, in theory, provides those with minority views some influence. However, many of the developing countries view the outcome desired by industrial countries as fait accompli, and feel pressure to go along to avoid reprisals in obtaining their own benefits; thus as a practical matter these organizations are de facto far less democratic than they might appear de jure. The cracks in the coverage of issues that existed between these institutions 50 years ago have grown only larger through time while their political legitimacy has declined.

The likely route to global federalism is likely to follow the pattern that has developed in the European Union. As the EU becomes wider and deeper, unilateral actions by governments and the unanimity principle for community decisions are slowly being replaced by political institutions based upon majority rule and wielding coercive powers.

The current decisions of the international organizations result from a questionable (nondemocratic) political process, as such it is unlikely that they are being designed to promote global welfare. As an example, note the trend of the WTO (and trade agreements generally) to replace national standards with global standards. There is much economic logic to this, a global standard reduces transaction costs and creates economies of scale that can lower costs. However, it is one thing for a country to make this trade off on its own, but there has been a disturbing trend in which the choice for the global standard has been imposed from the outside. For example, it may be the case that any proposed restrictions on auditing and consulting coming out of the Enron collapse may be determined to be in violation of the GATS services agreement which restricts new rules limit-
ing competition (NYT, March 1, 2002, p.W1). The principle of national treatment – the similar treatment of foreign and domestic products, is being slowly replaced by a uniform “global” standard. There are two problems: 1) it is not inherently desirable in many cases to have one uniform standard, and 2) the global standards that are being established have been developed in an undemocratic manner which has resulted in standards that maximize the special interests of producers in a few powerful countries instead of maximizing global social welfare. The creation of universal standards is creating an homogenized MacWorld that does not seem to be a desirable target for human destiny—despite all the efficiencies that this entails. The right of nations to pursue their own idiosyncratic interests needs to be reaffirmed.

The controversial issue of hormone-feed meats provides an excellent example. This is an issue for which reasonable people can disagree. The United States takes an “innocent until proven guilty” approach, while Europe believes in a “better safe than sorry” approach. There is no overwhelming reason as to why there needs to be one global standard; each country should be allowed to set its own standard, or instead product labeling could be used which would allow each consumer to set their own standard. The U.S. position on labels has been that consumers are not entitled to information that they deem important — instead only information that has been determined to be scientifically relevant should be provided on a label. Consumer interests have been subsumed to producer interests not because the latter is more consistent with welfare maximization, but because producers made the right campaign contributions. Civil society has simply been locked out of the process. One example may suffice: Ralph Nader, America’s foremost consumer advocate, was unable to get a meeting with Clinton-Gore during their eight years in office, all the while Clinton was playing golf with Enron executives.

The Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS) set global minimum standards for patents, copyrights, and trademarks which were generally above the standards which existed in most of the developing nations. Thus instead of being allowed to have national standards which treated foreign and domestic intellectual property similarly, the developing nations were required to set a standard that benefitted foreign corporations over domestic consumer interests. Although it can be argued that the developing countries were provided trade concessions in order to obtain their agreement on these intellectual property issues, one is struck by the observation that at the end of the day,
when the goal of global free trade is finally reached, the intellectual prop-
erty regime will be the one that suits the interests of the industrialized
countries and not the developing countries. The inequity in bargaining
strength that produces this outcome can hardly be accepted as a moral jus-
tification for this outcome. Especially perplexing is the infamous Chapter
11 of the NAFTA where foreign capital is given rights that even domestic
capital doesn’t enjoy.

Another evolving example concerns the efforts by the North to place
minimum global labor standards into the WTO and other trade agreements
so that trade sanctions can be applied for violations. The penalties could
apply to the individual producers or to the country as a whole. This issue
has been a major roadblock to further liberalization of the trading system
and was a primary factor in the collapse of the WTO ministerial in Seattle.
Advocates of a labor-trade linkage fall into several groups. First, there are
those who argue that the failure to respect the so-called core labor rights
are a violation of workers’ basic human rights and that the world commu-
nity should impose these rights on nations that violate them; the world trad-
ing system simply provides the teeth that are needed to achieve this objec-
tive since a military option is not practical. In essence, this argument
results from a perceived deficit in desired global institutions and the
responsibility for addressing this task falls, by default, to the WTO because
the appropriate institution does not exist or (assuming it’s the ILO) does
not have the required power. This argument would seem strongest in deal-
ing with dictatorships where the population is being denied other basic
rights so that the resulting labor laws lack legitimacy. Restrictions on
South Africa for apartheid in the 1980s or on Burma’s forced labor today
could conceivably be viewed in this manner. The issue becomes more
complex in dealing with a democracy. Of course, it is theoretically possi-
bility for democracies to violate the basic human rights of their minorities.
i.e., a tyranny of the majority; however, are the core labor standards so
basic, as argued by ex-Labor Secretary Reich, that violations of them can
be interpreted as human rights violations when a democratically elected
government has decided not to adopt or aggressively enforce them?
Although the strength of that argument probably varies depending on
which core standard one is discussing, this argument does not seem ten-
able, especially in regard to union rights. It is sometimes argued that
restrictions on union rights violate some basic right to assemble. However,
in most countries, it is now a criminal offense for managers of firms to
meet and collude to raise product prices; thus it is clearly not a basic human
right to assemble if the intent is to alter prices in a manner inconsistent with a society’s economic objectives. Thus if a democratic society has determined that unions would raise wages above the desired level, it can not be reasonably argued that restrictions on unions violate some basic human right to assemble.

The strongest argument for WTO involvement would seem to deal with situations where Southern labor laws were lower in the export sector. In this case the effects of low standards are almost identical to the effects of a government subsidy. In both cases the foreign importer gains in terms of long-run real income (from their improved terms of trade) but could lose from short-run adjustment complications. Those nations competing with the low standard nation or subsidizing nation suffer from lower terms of trade. The nation committing the infraction moves away from the Pareto optimal set of policies, but when other distortions, or macro problems exist, that nation may achieve some gain, nevertheless. Since one policy is regulated by the WTO, it would seem that a similar policy that had exactly the same economic implications would also be regulated. Why the difference? Most importantly, any country can subsidize, and therefore every country can potentially find itself on either end of this issue, thus there is widespread support for controlling this type of behavior. However, with labor standards, it is clear who the plaintiffs and who the defendants are going to be. Therefore it is difficult to get widespread support for WTO sanctions.

More questionable is the case where standards are lower economy-wide. It would seem that the imposition of labor standards would be justified only if their absence harmed other nations (having dismissed the human rights argument). The case that other countries are harmed by low standard states is a difficult one to make. Low standards’ basic effect on the developed nations would appear to be to increase their terms of trade. This certainly does not harm them. There may be an undesirable distributional effect in the North as imports increase and thereby lower the wages of the Northern unskilled, but the developed nations could in most cases adjust this outcome with tax policy. Thus producing undesirable distributional effects on foreign countries would appear to be insufficient justification for imposing standards. If low standards attracted capital from the developed countries, why should this be viewed any differently from the case where capital outflows result from higher productivity abroad? The necessary harm to the developed countries simply does not exist in either theory or evidence. In a miniature CGE developed by the author it is demonstrated that in the most realistic case introduction of a trade-labor
linkage improves the welfare of Northern workers and lowers the welfare of Southern workers (Shelburne, 2002). A better case can be made that the low standard nations harm the competing high standard developing nations by lowering their terms of trade and attracting capital flows from them. These are not just distributional effects which can be corrected with domestic tax policy, but are real declines in real national income. Thus it would appear that the low standard developing nations can harm the competing high standard developing nations. Of course, many policies harm other nations through altering the international terms of trade, so the fact that some other nation is harmed is not justification in itself. For example, low tax states like the United States have probably harmed high tax European nations by attracting capital, or the U.S. subsidization of higher education has created an “artificial” comparative advantage in human capital intensive goods; however, these policies have never been used to impose sanctions on the United States. The tax harmonization schemes being promoted by the EU and the OECD do seem to raise this issue, but trade sanctions have not been suggested. As a practical matter, however, the empirical evidence that the low labor standard nations have harmed the high standard developing nations is weak if not nonexistent; support for a trade-labor linkage in the South is quite weak.

This negative assessment of a trade-labor linkage, however, should not be interpreted to mean that developing nations shouldn’t be encouraged to raise labor standards throughout their economies. In addition to the ILO, labor standards belong at the World Bank. It is that organization’s job to promote institutions which can promote equitable and sustainable development and standards can play an important role in this regard. In addition to the equity gain, the creation of a middle class increases the demand for locally produced manufactures which are subject to increasing returns, thus producing faster growth (Murphy, Shleifer, and Vishnu, 1989). The IMF should also promote labor standards to the degree that they provide an improved safety net; this increases the range of macroeconomic policies that can be enacted to deal with disturbances. However, these standards should not be imposed dogmatically; the standards should be considered as part of a nation’s overall policy framework. It is theoretically possible, although less so as a practical matter, that a nation may be able to design their labor markets in a manner that can address these development and macroeconomic concerns without implementing the so called core labor standards.
VIII. SUMMARY

Globalization is generally beneficial when nations have the appropriate complimentary domestic institutions; however, countries often do not have these and they are difficult to establish. More emphasis needs to be placed on fine-tuning this institutional structure and less on the single-minded pursue of openness. The global distribution of income, although probably not worsened by globalization, nevertheless presents the world with a moral and economic challenge. Globalization does appear to have increased inequality within both the North and the South. The distribution shifts in the North are so large that the benefits of further globalization can be seriously questioned. Institutions of global scope are needed to deal with an increasing number of problems; a more comprehensive and proactive approach towards global governance is needed. The absence of a global democratic political body with coercive powers limits the ability of the world to address a number of important economic problems. The push to establish universal standards, whether they be for products, or labor are eroding nations’ ability to achieve their idiosyncratic interests.

REFERENCES


