The Globalization Paradox

Democracy and the Future of the World Economy

Dani Rodrik, 2011

Designing Capitalism 3.0

Capitalism is unequaled when it comes to unleashing the collective economic energy of human societies. That great virtue is why all prosperous nations are capitalist in the broad sense of that term: they are organized around private property and allow markets to play a large role in allocating resources and determining economic rewards. Globalization is the worldwide extension of capitalism. Indeed, so intertwined has capitalism become with globalization that it is impossible to discuss the future of one without discussing the future of the other.

Toward Capitalism 3.0

The key to capitalism's durability lies in its almost infinite malleability. As our conceptions of the institutions needed to support markets and economic activity have evolved over the centuries, so has capitalism. Thanks to its capacity for reinvention, capitalism has overcome its periodic crises and outlived its critics, from Karl Marx on. Looking at capitalism from the prism of the global economy, we have observed in this book how these transformations occur.

Adam Smith's idealized market society required little more than a "night-watchman state." All that governments needed to do to ensure the division of labor was to enforce property rights, keep the peace, and collect a few taxes to pay for a limited range of public goods such as national defense. Through the early part of the twentieth century and the first wave of globalization, capitalism was governed by a narrow vision of the public institutions needed to uphold it. In practice, the state's reach often went beyond this conception (as when Bismarck introduced old-age pensions in Germany in 1889). But governments continued to see their economic roles in restricted terms. Let's call this "Capitalism 1.0."

As societies became more democratic and labor unions and other groups mobilized against capitalism's perceived abuses, a new, more expansive vision of governance gradually took hold. Antitrust policies that broke up large monopolies came first, spearheaded by the Progressive movement in the United States. Activist monetary and fiscal policies were widely accepted in the aftermath of the Great Depression. The state began to play an increasing role in providing welfare assistance and social insurance. In today's industrialized countries, the share of public spending in national income rose rapidly, from below 10 percent on average at the end of the nineteenth century to more than 20 percent just before World War II. In the wake of World War II, these countries erected elaborate social welfare states in which the public sector expanded to more than 40 percent of national income on average. This "mixed-economy" model was the crowning achievement of the twentieth century. The new balance that it established between states and markets underpinned an unprecedented period of social cohesion, stability, and prosperity in the advanced economies that lasted until the mid-1970s. Let's call this "Capitalism 2.0."

Capitalism 2.0 went with a limited kind of globalization—the Bretton Woods compromise. The postwar model required keeping the international economy at bay because it was built for and operated at the level of nation states. Thus the Bretton Woods–
GATT regime established a "shallow" form of international economic integration, with controls on international capital flows, partial trade liberalization, and plenty of exceptions for socially sensitive sectors (agriculture, textiles, services) as well as developing nations. This left individual nations free to build their own domestic versions of Capitalism 2.0, as long as they obeyed a few simple international rules.

This model became frayed during the 1970s and 1980s, and now appears to have broken down irrevocably under the dual pressures of financial globalization and deep trade integration. The vision that the hyperglobalizers offered to replace Capitalism 2.0 suffered from two blind spots. One was that we could push for rapid and deep integration in the world economy and let institutional underpinnings catch up later. The second was that hyperglobalization would have no, or mostly benign, effects on domestic institutional arrangements. The crises—of both finance and legitimacy—that globalization has produced, culminating in the financial meltdown of 2008, have laid bare the immense size of these blind spots.

We must reinvent capitalism for a new century in which the forces of economic globalization are much more powerful. Just as Smith's lean capitalism (Capitalism 1.0) was transformed into Keynes's mixed economy (Capitalism 2.0), we need to contemplate a transition from the national version of the mixed economy to its global counterpart. We need to imagine a better balance between markets and their supporting institutions at the global level.

It is tempting to think that the solution—Capitalism 3.0—lies in a straightforward extension of the logic of Capitalism 2.0: a global economy requires global governance. But as we saw in the previous chapter, the global governance option is a dead end for the vast majority of nations, at least for the foreseeable future. It is neither practical nor even desirable. We need a different vision, one that safeguards the considerable benefits of a moderate globalization while explicitly recognizing the virtues of national diversity and the centrality of national governance. What we need, in effect, is an updating of the Bretton Woods compromise for the twenty-first century.

This updating must recognize the realities of the day: trade is substantially free, the genie of financial globalization has escaped the bottle, the United States is no longer the world's dominant economic superpower, and major emerging markets (China especially) can no longer be ignored or allowed to remain free riders on the system. We cannot return to some mythical "golden era" with high trade barriers, rampant capital controls, and a weak GATT—nor should we want to. What we can do is recognize that the pursuit of hyperglobalization is a fool's errand and reorient our priorities accordingly. What this means is laid out in this and the next chapter.

Principles for a New Globalization

Suppose that the world's leading policy makers were to meet again at the Mount Washington Hotel in Bretton Woods, New Hampshire, to design a new global economic order. They would naturally be preoccupied with the new problems of the day: global economic recovery, the dangers of creeping protectionism, the challenges of financial regulation, global macroeconomic imbalances, and so on. However, addressing these pressing issues requires rising above them to consider the soundness of global economic arrangements overall. What are some of the guiding principles of global economic governance they might agree on?

I present in this chapter seven commonsense principles. Taken together, they provide a foundation that would serve the world economy well in the future. The discussion in the present chapter stays at a general level. In the next chapter, I address the specific implications for some of the key challenges facing the world economy.

1. Markets must be deeply embedded in systems of governance.

The idea that markets are self-regulating received a mortal blow in the recent financial crisis and should be buried once and for all. As the experience with financial globalization demonstrates, "the magic of markets" is a dangerous siren song that can distract policy makers from the fundamental insight of Capitalism 2.0: markets and governments are opposites only in the sense that they form two sides of the same coin.

Markets require other social institutions to support them. They rely on courts and legal arrangements to enforce property rights and on regulators to rein in abuse and fix market failures. They depend on the stabilizing functions that lenders-of-last-resort and countercyclical fiscal policy provide. They need the political buy-in that redistributive taxation, safety nets, and social insurance programs help generate. In other words, markets do not create, regulate, stabilize, or sustain themselves. The history of capitalism has been a process of learning and relearning this lesson.

What is true of domestic markets is true also of global ones. Thanks to the trauma of the interwar period and the perspicacity of Keynes, the Bretton Woods regime sought a fine balance that did not push globalization beyond the ability of global governance to uphold it. We need a return to that same spirit if we are going to save globalization from its cheerleaders.

2. Democratic governance and political communities are organized largely within nation states, and are likely to remain so for the immediate future.

The nation state lives, and even if not entirely well, remains essentially the only game in town. The quest for global governance is a fool's errand, both because national governments are unlikely to cede significant control to transnational institutions and because harmonizing rules would not benefit societies with diverse

needs and preferences. The European Union is possibly the sole exception to this truism, but the one that proves the rule.

Overlooking the inherent limits to global governance contributes to globalization's present frailties. We waste international cooperation on overly ambitious goals, ultimately producing weak results that go little beyond the lowest common denominator among major states. Current efforts at harmonizing global financial regulations, for example, will almost certainly end up there. When international cooperation does "succeed," it often spawns rules that reflect the preferences of the more powerful states and are ill-fitting to the circumstances of others. The WTO's rules on subsidies, intellectual property, and investment measures typify this kind of overreaching.

The pursuit of global governance leaves national policy makers with a false sense of security about the strength and durability of global arrangements. Bank regulators with a more realistic sense of the efficacy of Basel rules' impact on capital adequacy or the quality of U.S. credit rating practices would have paid more attention to the risks that their financial institutions at home were incurring.

Our reliance on global governance also muddles our understanding of the rights of nation states to establish and uphold domestic standards and regulations, and the maneuvering room they have for exercising those rights. The worry that this maneuvering room has narrowed too much is the main reason for the widespread concern about the "race to the bottom" in labor standards, corporate taxes, and elsewhere.

Ultimately, the quest for global governance leaves us with too little real governance. Our only chance of strengthening the infrastructure of the global economy lies in reinforcing the ability of democratic governments to provide those foundations. We can enhance both the efficiency and the legitimacy of globalization if we empower rather than cripple democratic procedures at home. If in the end that also means giving up on an idealized, "perfect" globalization, so be it. A world with a moderate globalization would be a far better place to live in than one mired in the quixotic pursuit of hyperglobalization.

3. There is no "one way" to prosperity.

Once we acknowledge that the core institutional infrastructure of the global economy must be built at the national level, it frees up countries to develop the institutions that suit them best. Even today's supposedly homogenized industrial societies embrace a wide variety of institutional arrangements.

The United States, Europe, and Japan are all successful societies; they have each produced comparable amounts of wealth over the long term. Yet the regulations that cover their labor markets, corporate governance, antitrust, social protection, and even banking and finance have differed considerably. These differences enable journalists and pundits to anoint a succession of these "models"—a different one each decade—as the great success for all to emulate. Scandinavia was everyone's

favorite in the 1970s; Japan became the country to copy in the 1980s; and the United States was the undisputed king of the 1990s. Such fads should not blind us to the reality that none of these models can be deemed a clear winner in the contest of "capitalisms." The very idea of a "winner" is suspect in a world where nations have somewhat different preferences—where Europeans, for example, would rather have greater income security and less inequality than Americans are used to living with, even if it comes at the cost of higher taxation.[1]

This surfeit of models suggests a deeper implication. Today's institutional arrangements, varied as they are, constitute only a subset of the full range of potential institutional possibilities. It is unlikely that modern societies have managed to exhaust all the useful institutional variation that could underpin healthy and vibrant economies.[2] We need to maintain a healthy skepticism toward the idea that a specific type of institution—a particular mode of corporate governance, social security system, or labor market legislation, for example—is the only type that works in a well-functioning market economy. The most successful societies of the future will leave room for experimentation and allow for further evolution of institutions over time. A global economy that recognizes the need for and value of institutional diversity would foster rather than stifle such experimentation and evolution.

4. Countries have the right to protect their own social arrangements, regulations, and institutions.

The previous principles may have appeared uncontroversial and innocuous. Yet they have powerful implications that clash with the received wisdom among boosters of globalization. One such implication is that we need to accept the right of individual countries to safeguard their domestic institutional choices. The recognition of institutional diversity would be meaningless if nations were unable to "protect" domestic institutions—if they did not have the instruments available to shape and maintain their own institutions. Stating principles clearly makes these connections transparent.

Trade is a means to an end, not an end in itself. Advocates of globalization lecture the rest of the world incessantly about how countries must change their policies and institutions in order to expand their international trade and become more attractive to foreign investors. This way of thinking confuses means for ends. Globalization should be an instrument for achieving the goals that societies seek: prosperity, stability, freedom, and quality of life. Nothing enrages WTO critics more than the suspicion that when push comes to shove, the WTO allows trade to trump the environment, human rights, or democratic decision making. Nothing infuriates the critics of the international financial system more than the idea that the interests of global bankers and financiers should come before those of ordinary workers and taxpayers.

Opponents of globalization argue that it sets off a "race to the bottom," with nations converging toward the lowest levels of corporate taxation, financial regulations, or environmental, labor, and consumer protections. Advocates counter that there is little evidence of erosion in national standards.

To break the deadlock we should accept that countries can uphold national standards in these areas, and can do so by raising barriers at the border if necessary, when trade demonstrably threatens domestic practices enjoying broad popular support. If globalization's advocates are right, then the clamor for protection will fail for lack of evidence or support. If they are wrong, there will be a safety valve in place to ensure that these contending values—the benefits of open economies and the gains from upholding domestic regulations—both receive a proper hearing in the domestic political debate.

The principle rules out extremism on both sides. It prevents globalizers from gaining the upper hand in cases where international trade and finance are a back door for eroding widely accepted standards at home. Similarly, it prevents protectionists from obtaining benefits at the expense of the rest of society when no significant public purpose is at stake. In less clear-cut cases where different values have to be traded off against each other, the principle forces internal deliberation and debate—the best way of handling difficult political questions.

One can imagine the questions a domestic political debate might raise. How much social or economic disruption does the trade in question threaten? How much domestic support is there for the practices, regulations, or standards at stake? Are the adverse effects felt by particularly disadvantaged members of society? How large are the compensating economic benefits, if any? Are there alternative ways of achieving the desired social and economic objectives without restricting international trade or finance? What does the relevant evidence—economic and scientific—say on all these questions?

If the policy process is transparent and inclusive, these kinds of questions will be generated naturally by the forces of competition among interest groups, both pro-and anti-trade. To be sure, there are no fail-safe mechanisms for determining whether the rules in question enjoy "broad popular support" and are "demonstrably threatened" by trade. Democratic politics is messy and does not always get it "right." But when we have to trade off different values and interests, there is nothing else to rely on.

Removing such questions from the province of democratic deliberation and passing them on to technocrats or international bodies is the worse solution. It ensures neither legitimacy nor economic benefits. International agreements can make an important contribution, but their role is to reinforce the integrity of the domestic democratic process rather than to replace it. I will return to this point in the next chapter.

5. Countries do not have the right to impose their institutions on others.

Using restrictions on cross-border trade or finance to uphold values and regulations at home must be sharply distinguished from using them to impose these values and regulations on other countries. Globalization's rules should not force Americans or Europeans to consume goods that are produced in ways that most citizens in those countries find unacceptable. Neither should they require nations to provide unhindered access to financial transactions that undercut domestic regulations. They also should not allow the United States or the European Union to use trade sanctions or other kinds of pressure to alter the way that foreign nations go about their business in labor markets, environmental policies, or finance. Nations have a right to difference, not to impose convergence.

In practice, upholding the first right may lead sometimes to the same consequence as upholding the second. Suppose that the United States decides to block imports from India made with child labor because of concern that such imports constitute "unfair competition" for domestically produced goods. Isn't that the same as imposing a trade sanction on India aimed at changing India's labor practices to make them look more like those in the United States? Yes and no. In both cases, India's exports are restricted, and the only way India can get unhindered access to the U.S. market is by converging toward U.S. standards. But intentions matter. While it is legitimate to protect our own institutions, it isn't equally legitimate to want to change others'. If my club has a dress code that requires men to wear ties, it is reasonable for me to expect that you will abide by these rules when you join me at dinner—no matter how much you hate wearing ties. But this doesn't give me the right to tell you how you should dress on other occasions.

6. The purpose of international economic arrangements must be to lay down the traffic rules for managing the interface among national institutions.

Relying on nation states to provide the essential governance functions of the world economy does not mean we should abandon international rules. The Bretton Woods regime, after all, did have clear rules, even though they were limited in scope and depth. A completely decentralized free-for-all would not benefit anyone; one nation's decisions can affect the well-being of others. An open global economy—perhaps not as free of transaction costs as hyperglobalizers would like, but an open one nonetheless—remains a laudable objective. We should seek not to weaken globalization, but to put it on a sounder footing.

The centrality of nation states means that the rules need to be formulated with an eye toward institutional diversity. What we need are traffic rules that help vehicles of different size and shape and traveling at varying speeds navigate around each other, rather than impose an identical car or a uniform speed limit on all. We should strive to attain the maximum globalization that is consistent with maintaining space for diversity in national institutional arrangements. Instead of asking, "What kind of multilateral regime would maximize the flow of goods and capital around the world?" we would ask, "What kind of multilateral regime would

best enable nations around the world to pursue their own values and developmental objectives and prosper within their own social arrangements?" This would entail a significant shift in the mind-set of negotiators in the international arena.

As part of this shift we can contemplate a much larger role for "opt-outs" or exit clauses in international economic rules. Any tightening of international disciplines should include explicit escape clauses. Such arrangements would help legitimize the rules and allow democracies to reassert their priorities when these priorities clash with obligations to global markets or international economic institutions. Escape clauses would be viewed not as "derogations" or violations of the rules, but as an inherent component of sustainable international economic arrangements.

To prevent abuse, opt-out and exit clauses can be negotiated multilaterally and incorporate specific procedural safeguards. This would differentiate the exercise of opt-outs from naked protectionism: countries withdrawing from international disciplines would be allowed to do so only after satisfying procedural requirements that have been negotiated beforehand and written into those same disciplines. While such opt-outs are not riskless, they are a necessary part of making an open international economy compatible with democracy. In fact, their procedural safeguards—calling for transparency, accountability, evidence-based decision making—would enhance the quality of democratic deliberation.

7. Non-democratic countries cannot count on the same rights and privileges in the international economic order as democracies.

The primacy of democratic decision making lies at the foundation of the international economic architecture outlined so far. It forces us to recognize the centrality of nation states, given the reality that democratic polities rarely extend beyond their boundaries. It requires us to accept national differences in standards and regulations (and therefore departures from hyperglobalization), because it assumes that these differences are the product of collective choices exercised in a democratic fashion. It also legitimizes international rules that limit domestic policy actions, as long as those rules are negotiated by representative governments and contain exit clauses that allow for and enhance democratic deliberation at home.

When nation states are not democratic, this scaffolding collapses. We can no longer presume a country's institutional arrangements reflect the preferences of its citizenry. Nor can we presume that international rules could apply with sufficient force to transform essentially authoritarian regimes into functional democracies. So non-democracies need to play by different, less permissive rules.

Take the case of labor and environmental standards. Poor countries argue that they cannot afford to have the same stringent standards in these areas as the advanced countries. Indeed, tough emission standards or regulations against the use of child labor can backfire if they lead to fewer jobs and greater poverty. A democratic country such as India can argue, legitimately, that its practices are consistent with

the needs of its population. India's democracy is of course not perfect; no democracy is. But its civil liberties, freely elected government, and protection of minority rights insulate the country against claims of systematic exploitation or exclusion.[3] They provide a cover against the charge that labor, environmental, and other standards are inappropriately low. Non-democratic countries, such as China, do not pass the same prima facie test. The assertion that labor rights and the environment are trampled for the benefit of the few cannot be as easily dismissed in those countries. Consequently, exports of non-democratic countries deserve greater international scrutiny, particularly when they have costly ramifications—distributional or otherwise—in other countries.

This does not mean that there should be higher trade or other barriers against non-democratic countries across the board. Certainly not every regulation in such countries has adverse domestic effects. Even though China is an authoritarian regime, it has an exemplary economic growth record. And since countries trade to enhance their own well-being, blanket protectionism would not be in the interest of the importing countries in any case. Still, it would be legitimate to apply more stringent rules to authoritarian regimes in certain instances.

For example, there could be a lower hurdle for imposing restrictions on a non-democratic country's trade in cases where that trade causes problems in an importing country. If there is a requirement that compensation be paid to exporting countries when an escape clause is triggered, the requirement could be waived when the exporting country is non-democratic. And the burden of proof may need to be reversed in instances where an authoritarian regime seeks to exercise an opt-out—they should be required to demonstrate that the measure in question serves a real developmental, social, or other domestic purpose.

The principle of discrimination against non-democracies already has a place in the present trade regime. Duty-free market access to the United States under the African Growth and Opportunity Act of 2000 requires that the exporting country be democratic. When an African regime represses its political opposition or appears to rig an election, it is removed from the list of countries eligible for trade preferences.[4]

Universalizing this principle would no doubt be controversial. It is likely to be opposed both by trade fundamentalists and, more predictably, by authoritarian regimes. Nevertheless, it makes a lot of sense, especially in the context of the full set of principles considered here. Democracy, after all, is a global norm. It ought to be one of the cornerstone principles of the international trade regime, trumping non-discrimination when necessary.

What About the "Global Commons"?

There are a number of possible objections to the principles outlined here. I will address many of them in the next chapter, but I need to take up one major objection right away, as it derives from a fundamental misunderstanding. Some

argue that the rules of a globalized economy cannot be left to individual nation states. Such a system, the objection goes, would greatly reduce international cooperation, and as each nation pursues its own narrow interests, the world economy would slide into rampant protectionism. Everyone would lose as a result.

The logic relies on a false analogy of the global economy as a global commons. To see how the analogy works (or rather fails), consider global climate change, the quintessential case of global commons. Ample and mounting evidence suggests that global warming is caused by atmospheric accumulations of greenhouse gases, primarily carbon dioxide and methane. What makes this a global rather than national problem, requiring global cooperation, is that such gases do not respect borders. The globe has a single climate system and it makes no difference where the carbon is emitted. What matters for global warming is the cumulative effect of carbon and other gases in the atmosphere, regardless of origin. If you want to avoid environmental catastrophe, you need everyone else to go along. One might say that all our economies are similarly intertwined, and no doubt that would be true to an important extent. An open and healthy world economy is a "public good" which benefits all, just like an atmosphere with low levels of greenhouse gases.

But there the parallel ends. In the case of global warming, domestic restrictions on carbon emissions provide no or little benefit at home. There is a single global climate system, and my own individual actions have at best small effects on it. Absent cosmopolitan considerations, each nation's optimal strategy would be to emit freely and to free ride on the carbon controls of other countries. Addressing climate change requires that nation states rise above their parochial interests and work in concert to develop common strategies. Without international cooperation and coordination, the global commons would be destroyed.

By contrast, the economic fortunes of individual nations are determined largely by what happens at home rather than abroad. If open economy policies are desirable, it's because openness is in a nation's own self-interest—not because it helps others. Remember Henry Martyn's case for free trade: buying cheaper cotton textiles from India is just like technological progress at home. As we have seen repeatedly in this book, there are legitimate reasons why countries may want to stop at less than free trade. Barriers on international trade or finance may fortify social cohesion, avoid crises, or enhance domestic growth. In such instances, the rest of the world generally benefits. When trade barriers serve only to transfer income from some groups to others, at the cost of shrinking the overall economic pie, domestic rather than foreign groups bear the bulk of these costs.[5] In the global economy, countries pursue "good" policies because it is in their interest to do so. Openness relies on self-interest, not on global spirit. The case for open trade has to be made and won in the domestic political arena.

A few wrinkles complicate this picture. One is that large economies may be able to manipulate the prices of their imports and exports in ways that shift more of the

gains from trade to themselves—think about the impact of OPEC on oil, for example. These policies certainly harm other nations and need to be subject to international disciplines. But today such motives are the exception rather than the rule. Foreign economic policies are shaped largely by domestic considerations, as they should be. Another wrinkle involves the adverse effects on others of large external imbalances—trade deficits or surpluses. These also need international oversight. I will address this issue when I turn to China's trade surplus in the next chapter.

The principles above leave plenty of room for international cooperation over these and other matters. But they do presume a major difference, when compared to other areas like climate change, in the degree of international cooperation and coordination needed to make the global system work. In the case of global warming, self-interest pushes nations to ignore the risks of climate change, with an occasional spur toward environmentally responsible policies when a country is too large to overlook its own impact on the accumulation of greenhouse gases. In the global economy, self-interest pushes nations toward openness, with an occasional temptation toward beggar-thy-neighbor policies when a large country possesses market power.[6] A healthy global regime has to rely on international cooperation in the first case; it has to rely on good policies geared toward the domestic economy in the second.

Applying the Principles

A common but misleading narrative shapes our collective understanding of globalization. According to this narrative, the world's national economies have become so inextricably linked that nothing short of a new kind of governance and a new global consciousness can address adequately the challenges we face. We share a common economic destiny, we are told. We have to rise up above our parochial interests, responsible leaders implore us, and devise common solutions to common problems.

This narrative has the ring of plausibility and the virtue of moral clarity. It also gets the main story wrong. What is true of climate change, say, or human rights—genuine areas of "global commons"—is not true of the international economy. The Achilles' heel of the global economy is not lack of international cooperation. It is the failure to recognize in full the implications of a simple idea: the reach of global markets must be limited by the scope of their (mostly national) governance. Provided the traffic rules are right, the world economy can function quite well with nation states in the driving seats.