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# Global Markets and National Politics: Collision Course or Virtuous Circle?

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The impersonal forces of world markets are now more powerful than the states to whom ultimate political authority over society and economy is supposed to belong. Where states were once the masters of markets, now it is the markets which, on many crucial issues, are the masters over the governments of states.<sup>1</sup>

Throughout the world today, politics lags behind economics, like a horse and buggy haplessly trailing a sports car. While politicians go through the motions of national elections—offering chimerical programs and slogans—world markets, the Internet, and the furious pace of trade involve people in a global game in which elected representatives figure as little more than bit players. Hence the prevailing sense, in America and Europe, that politicians and ideologies are either uninteresting or irrelevant.<sup>2</sup>

While the world stands at a critical time in postwar history, it has a group of leaders who appear unwilling, like their predecessors in the 1930s, to provide the international leadership to meet economic dislocations. . . . Like the German elite in Weimar, they dismiss mounting worker dissatisfaction, fringe political movements, and the plight of the unemployed and working poor as marginal concerns compared with the unquestioned importance of a sound currency and balanced budget. Leaders need to recognize the policy failures of the last 20 years and respond accordingly. If they do not, there are others waiting in the wings who will, perhaps on less pleasant terms.<sup>3</sup>

These three quotations reflect widely held beliefs about the fate of national autonomy in the global economy. The nation-state is purportedly an outmoded and beleaguered

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1. Strange 1996, 4.

2. Roger Cohen, "Global Forces Batter Politics," *The New York Times Week in Review*, 17 November 1996, 1.

3. Kapstein 1996, 37.

institutional form, on a collision course with the ever more international scale of markets. Policy autonomy, if not *de jure* sovereignty, is considered the primary casualty.<sup>4</sup> Governments competing for mobile economic resources are thought to have little choice but to engage in a policy race to the neoliberal bottom,<sup>5</sup> imperiling the efficacy and legitimacy of the democratic process itself.<sup>6</sup>

This article puts under the analytic microscope the proposition that global markets trump national politics as social forces. I focus on the relationships between three dimensions of integration into international markets—trade in goods and services, the multinationalization of production, and financial capital mobility—and the macroeconomic policy choices of the advanced industrial countries up until the mid-1990s.

One can certainly point to examples where globalization constraints on national policy choices are readily apparent. The mobility of financial capital, for example, has tended to put downward pressure on budget deficits because of the interest rate premiums the capital markets attach to them. But it is hard to make the case that globalization constraints are pervasive, or even the norm. Indeed, there are numerous instances in which various facets of market integration have been associated with both more interventionist government policies and greater divergence in national trajectories over a range of policy areas—without precipitating damaging capital flight in countries that have eschewed the neoliberal path.

Trade and government spending is the classic relationship that goes against simplistic conceptions of the lowest common denominator effects of market integration—not only in the Organization for Economic Cooperation and Development (OECD)<sup>7</sup> but also in the developing world.<sup>8</sup> Other globalization myths, however, should also be exposed. For example, increasing liquid capital mobility has been associated with faster growth in government spending and even with increases in effective rates of capital taxation—without resulting in capital flight or higher interest rates. Moreover, there is no evidence that the multinationalization of production has reduced macroeconomic policy autonomy.

There are two basic reasons why globalization constraints on policy choice are weaker than much contemporary rhetoric suggests. First, market integration has not only increased the exit options of producers and investors; it has also heightened feelings of economic insecurity among broader segments of society. This situation

4. Others have analyzed the effects of globalization on phenomena as diverse as culture (Barber 1995; Meyer et al. 1997), ethnic nationalism (Huntington 1996), urban development (Sassen 1997), and inequality (Wood 1994).

5. See Andrews 1994; Cerny 1990; Gill and Law 1989; Kurzer 1993; McKenzie and Lee 1991; Moses 1994; Scharpf 1991; and Schwartz 1994. There are, of course, stronger and weaker versions of the argument, as some analysts have been careful to point out; see Hirst and Thompson 1996; and Pauly 1995.

6. Not everyone considers the consequences of diminished national autonomy bad. Fukuyama and Ohmae, for example, argue that the effective demise of the nation-state will make the world more peaceful and wealthier. See Fukuyama 1992; and Ohmae 1995.

7. Cameron 1978.

8. Rodrik 1997.

has strengthened political incentives for governments to use the policy instruments of the state to mitigate market dislocations by redistributing wealth and risk.

Second, although there are costs associated with interventionist government (the familiar refrain of neoclassical economics about tax distortions, crowding out, and regulatory rigidities), numerous government programs generate economic benefits that are attractive to mobile finance and production. Today it is not controversial to argue that good government entails protecting property rights and increasing human capital and physical infrastructure. But the logic should be extended further. Some economists have argued that reducing inequality stimulates growth by increasing social stability.<sup>9</sup> Prominent political scientists contend that economic policies redistributing wealth and risk also maintain popular support for the market.<sup>10</sup>

It should be a central objective of globalization research to see how these two sets of dynamics—capital's exit threats versus popular demands for redistribution, and the economic costs and benefits of interventionist government—play out in different contexts. In this article I point to two sources of variation. The first concerns differences among various facets of market integration and aspects of government policy choice (see the preceding examples). The second source of variation concerns domestic political conditions. Countries in which the balance of political power is tilted to the left continue to be more responsive to redistributive demands than those dominated by center-right parties. The existence of strong and centralized organizations of labor and business that coordinate economic activity reduces the economic costs of interventionist government by mitigating free-rider problems.

In summary, I do not believe that “collision course” is the correct metaphor to apply to the panoply of relationships between interventionist national economic policies and global markets. Peaceful coexistence is probably a better general image, as all agree it was during the golden age of capitalist democracy after World War II. One might go further to argue that, even in a world of capital mobility, there is still a virtuous circle between activist government and international openness. The government interventions emblematic of the modern welfare state provide buffers against the kinds of social and political backlashes that undermined openness in the first half of the twentieth century—protectionism, nationalism, and international conflict. At a time when Ethan Kapstein and others voice fears of the 1930s all over again, it is important that the economic benefits of government activism be better understood.

The remainder of the article is divided into seven sections. First, I sketch the contours of the globalization and national autonomy debate. Second, I trace the genealogy and details of arguments about globalization constraints. Third, I elaborate my critique of the conventional wisdom. Fourth, I assay the differences across countries and market segments concerning the extent of market integration in the OECD. Fifth, I analyze the effects of globalization on macroeconomic policy choice in these countries. Sixth, I explore the macroeconomic consequences of interventionist eco-

9. Alesina and Perotti 1996.

10. See Katzenstein 1985; Przeworski and Wallerstein 1982; and Ruggie 1983b.

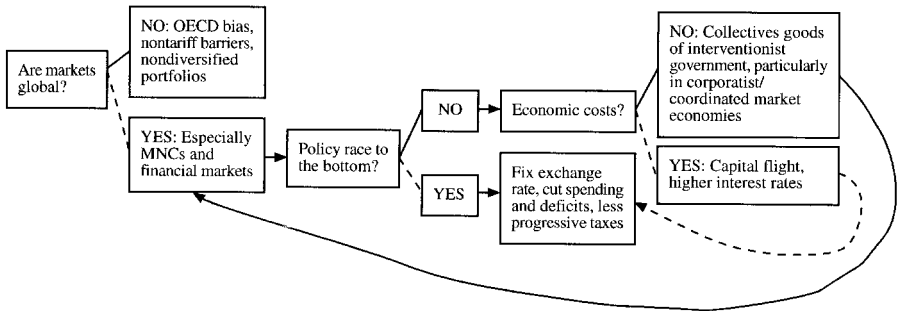


FIGURE 1. *Globalization and national autonomy*

conomic policies. The final section is a summary of my analysis of the opportunities for and constraints on governing in the global economy.

## The Globalization–National Autonomy Debate

Figure 1 depicts the contemporary globalization debate. Three central questions must be answered. First, are markets global? For many analysts, international market integration is the definitive characteristic of the contemporary world political economy. The case can be made regarding the rapid growth of trade in goods and services, but most attention focuses on the multinationalization of production (through foreign direct investment [FDI], international mergers, and strategic alliances) and the integration of financial markets (in equities, bonds, currencies, and ever more exotic derivatives). In many instances growth rates are exponential and the dollar figures involved are staggering. To take the classic example, the Bank of International Settlements estimates that global currency transactions in 1992 were worth \$1.2 trillion per day—almost double the 1989 figure and considerably larger than the currency reserves of the world's central banks.

Globalization skeptics, in contrast, voice numerous reservations about the extent of market integration. First, markets today are not much more internationally integrated on many dimensions than they were at the end of the nineteenth century.<sup>11</sup> From a longer historical perspective, the most important story about the twentieth century may well be the precipitous decline in globalization in the middle of the century, rather than the upswing in international activity in recent decades. Second, the bulk of international economic activity is still concentrated in the advanced industrial democracies, with growing linkages between East Asia and the OECD standing out as the most notable geographic extension of international markets.<sup>12</sup>

11. See Maddison 1995; and Obstfeld and Taylor 1997.

12. Wade 1996a.

Third, no international markets are nearly as integrated as they are within national borders. Domestic savings continue to constrain national patterns of investment,<sup>13</sup> and investors' portfolios are far from optimally diversified across countries.<sup>14</sup> The best estimates of multinationalized production indicate that such activity comprises less than 10 percent of output even in the world's most integrated economies.<sup>15</sup> Finally, notwithstanding the effects of the Uruguay Round of the GATT (General Agreement on Tariffs and Trade), substantial nontariff barriers continue to restrict trade.<sup>16</sup>

My intention is not to debate the merits of calling markets "global." Rather, I accept the more cautious proposition that markets have "globalized" in recent decades, allowing us to focus on the consequences of this process for national policy autonomy. This raises the second key question about globalization: does increased market integration exert lowest common denominator pressures on national economic policies? The conventional answer is unequivocal affirmation, based on the notion that internationally mobile capital (both financiers and multinational firms) can credibly threaten to exit national economies in which economic policies are not closely tailored to their preferences. Fixed exchange rates, balanced budgets, smaller government, regressive tax cuts, and deregulation are the likely result.

Globalization skeptics, however, note that this economic logic view does not take into account the fact that globalization increases economic insecurity among broad cross sections of society, strengthening political incentives for governments to redistribute market allocations of risk and wealth. This political logic of voice stands in marked contrast to the economic logic of exit.

The final question in the globalization debate is if policy regimes do not converge around a free market ideal type, does this have macroeconomic costs? The common answer to this question is again a resounding "yes." Productive and financial capital will hemorrhage, interest rates will rise, investment will decline, and economies will stagnate. The alternative view is that government may provide a range of collective goods that are valuable to firms and investors. These may at least balance the costs of interventionist government. Under certain conditions, the benefits of big government may even outweigh the costs.

Having sketched the contours of the globalization debate, the following two sections discuss in more detail the two contending views about the domestic effects of market integration.

## Globalization Constraints

### *Three Globalization Mechanisms*

Market integration is thought to affect national policy autonomy through three basic mechanisms. These are trade competitiveness pressures, the multinationalization of production, and the integration of financial markets.

13. Feldstein and Bacchetta 1991.

14. See French and Poterba 1991; and Gordon and Bovenberg 1996.

15. Lipsey 1998.

16. OECD 1996.

Increasing trade competition is the first component of the conventional globalization thesis. According to this view, big government is by definition uncompetitive.<sup>17</sup> Government spending crowds out private investment, is less efficient than market allocations, and cushions market disciplines on prices and wages. In turn, spending must be funded either by borrowing or by higher taxes. Taxes cut into firms' profits and depress entrepreneurial activity. Government borrowing increases interest rates. As a result of these effects, output and employment suffer from public sector expansion. Since no government can afford these consequences, trade competition must result in a rolling back of the public economy.

The second globalization mechanism concerns the multinationalization of production and the attendant credibility of firms' threats to move production from one country to another in search of higher rates of return. This was the "giant sucking sound" Ross Perot predicted the North American Free Trade Agreement would produce. Multinational exit has also been at the forefront of European debates in the 1990s. Indeed, for some, software engineers telecommuting from Bangalore to Seattle and Silicon Valley are the harbingers of the New World of the twenty-first century.<sup>18</sup> Robert Reich, for example, proclaimed in influential articles in the *Harvard Business Review* that the distinction between "us" and "them" in the global economy is not between countries, but rather between a nation's citizens and multinational firms operating in it, irrespective of where they are owned.<sup>19</sup>

As with trade, conventional arguments about the policy consequences of the multinationalization of production focus on the costs to business of interventionist government. The difference is that firms with production facilities in more than one country can evade these costs by exiting the national economy. Governments must thus embrace the free market if they are to compete for the investment and jobs provided by multinational firms.

The final argument made about globalization constraints focuses on the international integration of financial markets. Traders operating twenty-four hours a day can move mind-boggling amounts of money around the globe more or less instantaneously in ceaseless efforts to arbitrage profits. The potential for massive capital flight acts as the ultimate discipline on governments. In an already infamous aside, Clinton political strategist James Carville is said to have uttered "I used to think that if there was reincarnation, I wanted to come back as the president or the pope. But now I want to be the bond market: you can intimidate everyone."<sup>20</sup>

Scholarly analyses of the domestic effects of the integration of financial markets often are almost as strident, replete with evocative images such as "casino capitalism,"<sup>21</sup> "quicksilver capital,"<sup>22</sup> and "who elected the bankers?"<sup>23</sup> The central logic

17. See Pierson 1991; and Pfaller et al. 1991.

18. Greider 1997.

19. Reich 1990 and 1991.

20. "A Survey of the World Economy: Who's in the Driving Seat?" *The Economist*, 7 October 1995, 3.

21. Strange 1986.

22. McKenzie and Lee 1991.

23. Pauly 1997.

underpinning this research program is the power conferred on financial capital by the credibility of its exit threats. Governments are held to ransom by the markets, the price is high, and punishment for noncompliance is swift.<sup>24</sup> If the policies and institutions of which the markets approve are not found in a country, money will hemorrhage until they are.

### *Déjà Vu All Over Again?*

The urgent tenor of the contemporary globalization debate would seem to imply that the besieged nation-state is a new phenomenon. But the implications of international integration for domestic policy have been of concern for more than two hundred years—basically since the birth of industrial capitalism. David Hume, Charles Louis Montesquieu, and Adam Smith all believed that capital mobility would restrain the growth of the state.<sup>25</sup> Indeed, Adam Smith's argument about capital taxation in *The Wealth of Nations* is remarkably similar to contemporary claims:

The proprietor of stock is properly a citizen of the world, and is not necessarily attached to any particular county. He would be apt to abandon the country in which he was exposed to a vexatious inquisition, in order to be assessed a burdensome tax, and would remove his stock to some other country where he could either carry on his business, or enjoy his fortune more at ease A tax which tended to drive away stock from any particular country, would so far tend to dry up every ounce of revenue, both to the sovereign and to the society.<sup>26</sup>

In the twilight of the Victorian empire, Norman Angell thought that the effects of international economic integration were so pervasive that they had made the ultimate expression of sovereignty, war, virtually unthinkable.<sup>27</sup> The penultimate wave of concern about the future of the nation-state swelled in the late 1960s. Charles Kindleberger famously proclaimed that “the state is about through as an economic unit” as a result of the power of multinational firms.<sup>28</sup> Raymond Vernon entitled his influential book on the same subject *Sovereignty at Bay*.<sup>29</sup> In the first systematic analysis of domestic effects of interdependence, Richard Cooper argued that national economic policy autonomy was significantly constrained by the international integration of markets.<sup>30</sup>

In this subsection, I focus on two research themes spawned by the writings of Cooper, Kindleberger, and Vernon that occupied many pages in *IO* during the 1970s—transnational relations and interdependence, and dependency and underdevelopment. The 1971 special issue “Transnational Relations and World Politics,” edited

24. For review articles, see Cohen 1996; and Andrews and Willett 1997.

25. I thank Arthur Stein for informing me about these arguments. See also Hirschman 1981; and Stein 1993.

26. Quoted in Hirschman 1981, 256.

27. Angell 1911.

28. Kindleberger 1969, 207.

29. Vernon 1971.

30. Cooper 1968.

by Robert Keohane and Joseph Nye, was the journal's first concerted foray into international political economy.<sup>31</sup> The issue's central claim was that realist models stressing conflict among unitary states could not take into account the contemporary international environment populated, in addition to nation-states, by nonstate actors (including, but not limited to, multinational firms and international financiers) with links cutting across territorial boundaries.<sup>32</sup> Subsequent work in this tradition emphasized the effects of differential sensitivity and vulnerability to international economic developments on power relations among states,<sup>33</sup> the nature of cooperation in the international system,<sup>34</sup> and the role of international institutions in fostering cooperation.<sup>35</sup>

The primary focus of the transnational relations–interdependence school was outward looking—to build a new paradigm of international politics. Nonetheless, the parallels are striking between the analytic foundations of interdependence scholarship and contemporary arguments about globalization. Consider the following quotation from Edward Morse that opens his article in the transnational relations special issue of *IO*:

Changes in the structure of the global economy have resulted in a withering of governmental control of certain activities presumed to be de jure within the domain of governments. . . . [I]nternational monetary crises . . . have demonstrated the emergence of financial markets that seem to operate beyond the jurisdiction of even the most advanced industrial states of the West and outside their individual or collective control. The flourishing of multinational corporations has affected the . . . economic growth policies of highly developed and less developed states alike by restricting the freedom of those governments to establish social priorities. Tariff reductions . . . have similarly increased the number of nonmanipulable and unknown factors which must be accounted for in planning a wide spectrum of domestic and foreign economic policies—from regional development policy or anti-inflationary efforts on the domestic side to the international exchange rate of a state's currency.<sup>36</sup>

Morse thus argued that three (now familiar) facets of market integration posed a grave threat to national autonomy—trade, multinational firms, and international financial markets. Other authors in the transnational relations issue made similar claims. Louis Wells argued that “the enterprise with subsidiaries scattered around the globe clearly has the potential to evade the influence of many government policies.”<sup>37</sup> Lawrence Krause asserted that “the integration of financial markets is of particular concern because private international financial activities have seriously infringed on

31. Reprinted as Keohane and Nye 1972.

32. The special issue also contained articles on a diverse array of noneconomic actors, including the Ford Foundation and the Roman Catholic Church.

33. Keohane and Nye 1977.

34. Krasner 1983b.

35. Keohane 1984.

36. Morse 1972, 23.

37. Wells 1972, 97.



governmental sovereignty.”<sup>38</sup> Keohane and Nye concluded that “transnational relations create a ‘control gap’ between the aspirations for control over an extended range of matters and the capability to achieve it. The problem is not a loss of legal sovereignty but a loss of political and economic autonomy.”<sup>39</sup>

Transnational relations—interdependence, however, was not the only market integration—nation-state research program to feature prominently in *IO* in the 1970s. Disillusioned with the failures of mainstream economists’ policy prescriptions for development, Latin American scholars—beginning in the 1950s with the United Nations Economic Commission for Latin America headed by Raúl Prebisch—argued that international integration was not the path to prosperity, but rather the road to dependency and underdevelopment.

Only Peter Evans in the transnational relations issue squarely addressed development issues.<sup>40</sup> In 1978, however, *IO* devoted a special issue to the dependency thesis. The issue’s editor, James Caporaso, captured the distinctiveness of this enterprise by noting that the antonym of dependency is autonomy, not interdependence.<sup>41</sup> The bulk of the articles in the issue were ambivalent about the merits of the claims made by the Latin American dependentistas. Richard Fagen was the one clear exception. He argued that “hardly anyone anymore suggests that ‘the free play of market forces’ will bring in its wake movement toward the eradication of poverty, more equitable distribution of life chances, and other valued goals of development.”<sup>42</sup>

Fagen believed that developing countries could and should insulate themselves from damaging international economic ties, by nationalizing multinational firms and protecting domestic industry. This emphasis on multinationals and protectionism has subsequently been supplanted in development scholarship by a concentration on the domestic effects of financial integration.<sup>43</sup> Observers of the industrial democracies today, of course, share these fears about the consequences of capital mobility. The contemporary globalization debate thus blurs what was a clear distinction in the 1970s between interdependence and dependency.

### Summary

In this section I have made two basic points. First, there are three different facets of globalization that many consider to constrain national autonomy—trade, the multinationalization of production, and the internationalization of financial markets. Second, contemporary arguments about these globalization pathways are nothing new. One could transplant much of the work published in *IO* in the 1970s on interdependence and dependency into the 1990s globalization literature without fearing for its rejec-

38. Krause 1972, 189.

39. Keohane and Nye 1972, 393.

40. Evans 1972.

41. Caporaso 1978b, 18.

42. Fagen 1978, 292–93.

43. See Maxfield 1997; and Winters 1996.

tion as outmoded. Indeed, with appropriate changes in lexicon, the same could be said for Adam Smith.

With hindsight we know that the nineteenth century was one of great state building and that the 1970s was a decade in which the scale and scope of government activism increased rapidly. Should one expect things to be different today, as contemporary rhetoric suggests?

## **Reassessing the Policy Consequences of Globalization**

### *Trade, Compensation, and Embedded Liberalism*

Arguments about the constraining effects of market integration on economic policy choice have a long and distinguished history. There is, however, a very different approach to the globalization–domestic politics relationship that also has an impressive pedigree. Karl Polanyi’s analysis of the emergence of industrial democracy in the nineteenth century emphasized a “double movement” with two components.

One component was the principle of economic liberalism, aiming at the establishment of a self-regulating market, relying on the support of the trading classes, and using largely *laissez faire* and free trade as its methods; the other was the principle of social protection, aiming at the conservation of man and nature as well as productive organization, relying on the varying support of those most immediately affected by the deleterious action of the market, and using instruments of intervention as its methods.<sup>44</sup>

Forty years later, John Gerard Ruggie made a similar argument about the post–World War II reconstruction of open markets and democratic politics.<sup>45</sup> He characterized the Bretton Woods system as sustaining an “embedded liberalism” compromise that coupled trade liberalization with domestic policies that cushioned market dislocations. At about the same time, Peter Katzenstein argued that the distinctive feature of the small European democracies was their willingness to adjust and adapt to international markets while compensating those adversely affected by this process.<sup>46</sup> Most recently, Dani Rodrik showed that the trade openness–domestic compensation nexus continues to hold throughout the world, not just in the industrial democracies.<sup>47</sup>

The embedded liberalism perspective did not question the core proposition of trade theory that liberalization, in the long run, is good for all segments of society. The distinctive feature of this scholarship was the recognition that the short-run political dynamics of exposure to trade (and to other international markets) are very different. Openness increases social dislocations and inequality and hence heightens political pressures for dampening these effects. If protectionism (and the disastrous spiral of economic decline, nationalism, and conflict with which it was associated in

44. Polanyi [1944] 1957a, 132.

45. Ruggie 1983b.

46. Katzenstein 1985.

47. Rodrik 1997.

the 1930s) is to be averted, government must redistribute market allocations of wealth and risk.

Bretton Woods facilitated the twin goals of trade liberalization and domestic compensation by combining fixed exchange rates with capital controls.<sup>48</sup> Fixed rates promoted trade by stabilizing expectations about future price movements. Capital controls gave governments the macroeconomic autonomy to smooth business cycles through countercyclical demand management.

The impact of capital controls on policy autonomy is best understood in terms of the Mundell-Fleming approach to open economy macroeconomics.<sup>49</sup> Only two of the following three conditions can obtain at once: a fixed exchange rate, monetary policy autonomy, and free movement of capital across borders. If Bretton Woods had committed countries to removing all restrictions on capital flows in addition to fixing their exchange rates, countries would have lost their monetary autonomy as well. National governments would have been unable to mitigate economic downturns by printing more money because capital would have exited unless and until interest rates rose to the world rate. But the final Articles of Agreement obviated this possibility by adopting John Maynard Keynes' recommendation that the imposition of capital controls be allowed, if not encouraged.<sup>50</sup>

Strategies of domestic compensation in response to trade liberalization, however, were not limited to demand management. Rather, analysts describe the domestic policy regimes that emerged during the Bretton Woods era as the "Keynesian welfare state." In addition to the Keynesianism described earlier, the term also implied the public provision of social insurance (through pensions, unemployment benefits, and other income transfer programs) and social services (most notably education and health care), all paid for by relatively high and progressive systems of taxation.<sup>51</sup>

It is easy to see why the welfare state component served the political purposes of embedded liberalism. Social insurance directly supports those adversely affected by market risk. The public provision of social services not only provides benefits to consumers irrespective of their ability to pay but also generates a source of employment that is less vulnerable to the vicissitudes of market competition. Progressive taxes take into account the ability of different segments of society to pay for government programs. The welfare state redistributes wealth and risk, thereby dampening popular opposition to free markets.

But what about the economic effects of the welfare state (that is, assuming spending and taxation are in balance)? Here, the ambit of macroeconomic policy must be

48. The Bretton Woods system also allowed for consensually agreed adjustments in exchange-rate parities to correct fundamental disequilibrium in the balance of payments and IMF lending to support exchange rates during temporary crises. For an excellent analytic history of Bretton Woods, see Eichengreen 1996.

49. Mundell 1962. For a systematic application to politics, see Frieden 1991.

50. Many of Keynes' prescriptions were unacceptable to the United States, but this was not the case for capital controls.

51. The seminal study is Shonfield 1965. Other important examples include Esping-Andersen 1985; Goldthorpe 1984; and Lindberg and Maier 1985.

extended beyond that analyzed in the Mundell-Fleming framework to focus on the costs and benefits of different aspects of the public economy. The contending arguments mirror closed economy analyses from public finance, made all the more important by trade liberalization, which renders national economies price takers in international markets. Claims about the uncompetitiveness of the welfare state concentrate on the costs of government provision of social insurance and social services. The welfare state lessens market disciplines and crowds out private sector entrepreneurship; taxes distort investment decisions in ways that reduce efficiency.

On the other hand, many people argue that interventionist government generates numerous economic benefits that may at least offset these costs. The key notion here is the public provision of collective goods that are undersupplied by markets. Even economists in the Chicago school tradition consider some government services to be essential to capitalism: the rule of law and securing of property rights.<sup>52</sup> For new growth theorists, public education and the government provision of human capital and physical infrastructure are also important drivers of development.<sup>53</sup>

The logic of politically correctable market failures can, however, be applied more broadly. For example, it is well established in development economics that material inequality is bad for growth. Alberto Alesina and Roberto Perotti have argued that this is because inequality leads to social conflict, which stability-seeking investors do not like.<sup>54</sup> Since the welfare state mitigates conflict by reducing market-generated inequalities of risk and wealth, it may have beneficial rather than deleterious consequences for business.<sup>55</sup> Government spending may thus stimulate investment via two channels—increasing productivity through improvements in human and physical capital and increasing stability through maintaining support for market openness.

In summary, the embedded liberalism compromise of the Bretton Woods period combined an international regime of trade openness, fixed exchange rates, and capital controls with the domestic political economy of the Keynesian welfare state. The final observation that should be made about this combination is that many analysts believe that embedded liberalism was most prominent and worked best in countries characterized by strong and centralized (corporatist) labor movements and powerful social democratic parties. Center-left parties are more likely to be sensitive to the political demands of short-term market losers. Corporatist labor movements have incentives to tailor wage growth to benefit the economy as a whole and hence not to take advantage of government compensation (in the form either of Keynesian demand management or welfare state expansion) with demands for less work at higher pay.<sup>56</sup>

52. The most influential proponent of this view today is North; North 1990. It has also become a central component of official development policy; World Bank 1997.

53. See Aschauer 1991; and Barro and Sala-I-Martin 1995.

54. Alesina and Perotti 1996.

55. Garrett 1998a. For an alternative view, see Persson and Tabellini 1994.

56. See Alvarez, Garrett, and Lange 1991; Garrett 1998a; and Lange and Garrett 1985. Some scholars argue that the successes of this regime type had as much to do with the organization of business as the organization of labor; see Soskice 1990; and Swenson 1991.

*The Crisis of Embedded Liberalism?*

Notwithstanding the manifest successes of embedded liberalism in the Bretton Woods period, it is widely believed today that the open markets–domestic compensation compromise is no longer viable. The most prominent causal agent in its purported demise is heightened mobility of productive and financial capital and the decline on restrictions on international flows with which it has been associated.<sup>57</sup> No one suggests that political demands for compensation or the need for government to mitigate anti-international pressures have declined.<sup>58</sup> Rather, the conventional view is that the ability of government to deliver its side of the embedded liberalism compromise has been dramatically reduced.

There are two different mechanisms by which increased capital mobility is thought to render domestic compensation infeasible.<sup>59</sup> The first concerns financial market integration and traditional Keynesianism. Ruggie and others argue that financial integration makes fixed exchange rates imperative, to increase the markets' confidence about the stability of national economic policy.<sup>60</sup> But following Mundell-Fleming, fixing the exchange rate under capital mobility vitiates macroeconomic policy autonomy.

The second mechanism concerns the multinationalization of production and the nature of the public economy. Rodrik argues that governments can no longer maintain, let alone expand, the generous welfare state–progressive taxation mix.<sup>61</sup> Mobile firms are deemed unwilling to pay the taxes to fund government programs. Rodrik claims that the future of the welfare state can only be secured by shifting the tax burden from mobile (firms and financiers) to immobile (labor) asset holders, emasculating its redistributive effects.

Thus, two of the most perceptive students of the contemporary international political economy both accept the core proposition of the conventional wisdom on globalization. A quantum leap in the exit threats of mobile producers and investors has tilted the balance of power strongly in favor of the market over politics at the national level. The following two subsections question this argument by exploring in more detail the domestic effects of the multinationalization of production and financial market integration.

57. Some scholars suggest that financial integration has been driven by developments in information technology over which governments have had little control; see Bryant 1987; and Goodman and Pauly 1993. Others argue that the removal of capital controls was an ideological choice that could be reversed; see Sobel 1994; and Banuri and Schor 1992. I take the intermediate position of Frieden and Rogowski that, even if theoretically still effective, the opportunities costs associated with capital controls have increased greatly in recent decades; Frieden and Rogowski 1996.

58. Pierson 1996a.

59. Scholars often argue that corporatist labor market institutions have eroded over time, particularly in Scandinavia. Iversen 1996; and Pontusson and Swenson 1996. But more broadly based studies suggest that the structure of organized labor movements has been remarkably stable; see Golden 1998; Lange and Scruggs 1997; and Lange, Wallerstein, and Golden 1995.

60. Ruggie 1996a. See also Scharpf 1991.

61. Rodrik 1997. For a similar argument, see Steinmo 1993.

*The Multinationalization of Production and the Collective Goods of Government*

Embedded liberalism, Bretton Woods style, comprised three elements—fixed exchange rates and capital controls, Keynesian demand management, and extensive government spending and redistributive taxation. How might we expect these to be affected by the multinationalization of production?

One could argue that multinationals favor fixed exchange rates because these lessen uncertainty about the consequences of internationally diversified production regimes.<sup>62</sup> If this were the case in a world of liquid capital mobility, governments that acceded to the demands of multinationals would also be giving up their monetary autonomy. But today there is arguably a better way than pressing for fixed exchange rates for multinational producers to insure against international price movements: hedging using financial instruments. The range of derivatives options available to investors is limited only by the imagination of market makers. And multinationals would probably prefer to control their own risk portfolios than to cede this right to governments. This is all the more likely given the difficulty of running stable pegged exchange rates in the contemporary era (see the next subsection). As a result, it seems unlikely that the multinationalization of production should significantly increase the incentives for governments to fix their exchange rates and hence tie their hands with respect to monetary policy.

The primary concern of the globalization literature with respect to the multinationalization of production, however, is the reaction of mobile producers to high levels of government spending and taxation (and to other production costs, most notably wages). The conventional view is that the decisional calculus of multinationals is simple: produce in the lowest cost location. If this were correct, increased exit options for firms would put considerable downward pressures on the size and scope of the public economy.

For those who study FDI decisions and corporate alliance strategies for a living, however, the behavior of multinational producers is more complex. First, the right metric of costs controls for productivity, and on this score small government–low-wage economies do not look nearly so attractive.<sup>63</sup> Second, the literature on international corporate strategy focuses primarily on accessing new technology, new distribution channels, and new markets as the drivers of FDI and strategic alliances.<sup>64</sup> Third, if a firm opens, acquires, or allies with a production facility in a foreign country, this does not necessarily imply that it reduces activity in its home country. Under many circumstances new foreign activities will go hand in hand with increased activity and employment at home—“upstream”—in portions of the productive, marketing, and distributive processes where more of the final value is added.

62. Moravcsik makes this argument, for example, with respect to European efforts to fix exchange rates since the end of Bretton Woods; Moravcsik 1998.

63. Krugman 1996. Nonetheless, many fear that the rapid dissemination of technology will soon dramatically reduce productivity differences among countries.

64. See Cantwell 1989; Caves 1996; Dunning 1988; and IMF 1991.

Finally, international diversification provides another way for firms to hedge against currency risk. Taken together, these considerations belie the notion of a lowest cost mantra in the location decisions of multinational producers.<sup>65</sup>

Why might multinationalized producers be willing to locate in countries with large public economies and high taxes? My answer is the same as that for trade. Multinational producers care about the real economy, and factors such as productivity and stability heavily influence their investment decisions. Activist governments can do something positive to influence these decisions, by increasing human and physical capital stocks and by promoting public support for open markets. Indeed, these collective goods may be even more important than was the case for trade as a result of the heightened feelings of economic insecurity among citizens generated by multinationalization.

There is an important objection to my argument, however, that was not germane to the trade discussion—tax competition among governments for mobile producers. Rodrik rightly argues that even if multinational producers benefit from government interventionism in the ways I have suggested, they nonetheless have incentives to try to free ride on these collective goods by not paying the taxes to fund them.<sup>66</sup> Multinationals can use threats of exit to force governments to shift the tax burden away from capital and onto labor. But before making such threats, firms must weigh the costs and benefits of helping finance the provision of collective goods from which they benefit in one country versus paying lower taxes but receiving fewer benefits in another.<sup>67</sup> It is an empirical, not a theoretical, matter whether the costs of big government outweigh the benefits I have outlined and hence whether multinationalization should put downward pressures on capital taxation.

In summary, there is little reason to expect that the multinationalization of production produces strong pressures for fixed exchange rates or constrains macroeconomic policy autonomy in the classical Keynesian sense. A better argument can be made about constraints on the spending, and particularly the taxing, policies of governments. But these constraints will be much less apparent if, as I argue is this case, large public economies generate numerous outcomes that are attractive to multinationals.

### *The Mobility of Financial Capital, Exchange Rate Regimes, and Fiscal Policy*

Even if I am right to question common assumptions about the behavior of multinationalized producers, the debate could simply shift to policy constraints generated by the integration of financial markets. Here again, I wish to argue that the strictures

65. This is not to claim, however, that production costs are irrelevant. There are some sectors, such as textiles and apparel, where labor costs have a large bearing on location decisions. Leamer 1996. Moreover, there are temptations for governments to try to attract FDI by offering specific tax concessions and other monetary inducements; see Hines 1997.

66. Rodrik 1997.

67. Of course, multinational firms could still try to free ride on government services through tax evasion or accounting tricks.

imposed by global capital are not nearly so tight as is often presumed. Unpacking the likely policy effects of the international integration of financial markets should begin with its implications for the choice of exchange-rate regimes.

There is only one clear case where financial integration vitiates macroeconomic policy autonomy—monetary policy where there are no barriers to cross-border capital movements and where a country's exchange rate is fixed.<sup>68</sup> But this only raises the questions: why do countries choose to fix their exchange rates? How important is globalization to this choice?<sup>69</sup> European Union officials in the context of the monetary union debate have revived old arguments from Bretton Woods about the importance of currency stability to trade.<sup>70</sup> Empirical work, however, fails to show any strong positive impact of fixed rates on trade expansion, presumably because of the effectiveness of currency-hedging instruments under floating rate regimes.<sup>71</sup> The more common argument these days concerns the policy credibility of governments with the financial markets. By fixing the exchange rate, governments are supposed to be able to mitigate the damaging effects of capital flight or other policies that would be required to stop it.

Unlike exporters and multinational producers, financial market actors care much less about productivity and the real economy than they do about monetary phenomena that affect day-to-day returns on financial transactions. Inflation is the key variable. If the markets expect inflation to increase in the future, the price they are willing to pay for a national currency will decrease, and the interest rates they charge on loans will be higher. Thus, governments have incentives to establish reputations for price stability because inflationary expectations lead the financial markets to behave in ways that harm the real economy.

Few economists dispute the argument that inflation-fighting credibility is important to macroeconomic performance.<sup>72</sup> There is much less support, however, for the notion that fixing the exchange rate is a good way to achieve credibility under conditions of financial integration. The evidence is at best mixed as to whether participation in fixed exchange-rate regimes lowers inflation rates.<sup>73</sup> There may be better domestic ways to gain credibility with the financial markets, such as making the central bank more independent or enacting balanced budget laws.<sup>74</sup> Moreover, one should expect financial market actors to prefer floating exchange rates to fixed ones since they make money from arbitrage and commissions.<sup>75</sup>

On the other side of the equation, the costs of fixed exchange rates are often high. Although fiscal policy may be quite effective in a country that pegs its exchange rate,

68. Mundell 1962.

69. For a good precis of the various arguments about the determinants of exchange-rate regime choice, see Eichengreen 1994.

70. Commission of the European Communities 1990.

71. IMF 1983.

72. This is the core of the rational expectations revolution in macroeconomics. See Friedman 1968; and Lucas 1972.

73. Collins was the first to question the inflation-fighting properties of the EMS; Collins 1988.

74. Fratianni and von Hagen 1992.

75. Frieden 1991.



it cannot use monetary policy to adjust to any economic shock that affects it differently from the object of the peg (gold, a single currency, or a basket of currencies). Depreciating the nominal value of a currency remains a very effective way to increase the real competitiveness of an economy in recession—because domestic prices do not rise immediately in response to nominal depreciations.<sup>76</sup> But smooth depreciations are not possible for countries seeking to defend currency pegs. Rather, governments typically engage in desperate efforts to maintain a given exchange rate and are often vanquished by the markets in damaging waves of speculative attacks. In this context it should be noted that the headline currency crises of the 1990s—in Europe, Mexico, and East Asia—all involved countries seeking to sustain pegs that the markets deemed untenable.

For these reasons many economists today recommend that fixed exchange-rate regimes under conditions of financial integration should only extend to countries that constitute optimal currency areas. These areas comprise only those countries for whom there is little need to maintain domestic monetary autonomy—because their business cycles move together, wages adjust quickly to asymmetric shocks, labor is mobile across national borders, or fiscal arrangements transfer funds from boom to bust regions.

In the headline case of European monetary union, for example, most analysts believe that Europe's optimal currency area extends only to Austria, the Benelux countries, Germany, and perhaps France—but certainly not to Italy.<sup>77</sup> One could argue that Italy's fervent desire to participate in Europe's monetary union reflects its need to overcome long-standing credibility problems. Italy's economic history in the 1990s does not seem to lend much credence to this view. The lira was forced out of the exchange-rate mechanism of the European Monetary System (EMS) in 1992—an ignominious defeat for the Italian government at the hands of the foreign exchange markets. But the lira did not go into uncontrollable free fall, nor did instability and a lack of market confidence paralyze the Italian economy. On the contrary, the currency depreciated relatively smoothly to a level that could be easily sustained. Italian economic activity quickly picked up, against the continuing deep recession among the remaining EMS members. Thus, even in the Italian case, one probably must look beyond market credibility considerations to explain the government's desire to participate in monetary union.

In summary, the arguments in favor of the common globalization proposition that the integration of financial markets creates irresistible pressures for government to fix their exchange rates to increase market credibility are far from convincing. Fixed exchange rates may make sense for some highly interdependent economies. Countries that cannot gain market credibility with domestic policies (for example, some

76. Obstfeld 1997.

77. If this is correct, why would Germany want irrevocably to fix its exchange rate against Italy? Analyses of Germany's EMU position typically involve politics, specifically Helmut Kohl's ambitions concerning political union in Europe. For an accessible survey of the contending arguments and evidence, see Garrett 1998b.

unstable developing nations) may have little choice but to fix their exchange rates. But for many countries, and probably the bulk of the OECD, floating the exchange rate makes more sense under conditions of financial capital mobility.

Moving to fiscal policy, increasing public sector deficits clearly puts upward pressure on interest rates in a world of capital mobility (particularly if the exchange rate floats). But how large is this interest-rate premium? Financial integration reduces the costs of fiscal expansion by making available an immense size of potential lenders.<sup>78</sup> At some point, of course, higher debt burdens may trigger fears of governments' defaulting on their loans—resulting in dramatic reductions in the availability of credit and skyrocketing interest rates. This was the case during the Latin American debt crises of the 1980s, but this limit seems not yet to have been reached in any industrial democracy.<sup>79</sup>

Belgium is the clearest instance of the weakness of fiscal constraints under capital mobility. The Belgian franc has long been stably pegged against the deutsche mark, with very small interest-rate differentials between the two countries. This is despite the fact that Belgian public debt has been the highest in the OECD for most of the last decade, and more than twice as large as Germany's. To take a harder European case, public debt is also very high in Italy. Italian interest rates have sometimes during the past twenty years been as much as three or four points higher than German rates. But if this is the most brutal fiscal repression wrought by global finance among the industrial countries, the proclamations of many commentators would seem somewhat hyperbolic.

I have now discussed two conventional parts of macroeconomic policy—exchange-rate regime choice and the running of fiscal deficits—in the context of global finance. What about constraints on the size of government itself? Here a distinction should be drawn between the preferences of financial markets actors and those of multinationalized producers. The latter can and should pay predominant attention to the effect of government policy on productivity and real aggregates—and hence ask whether the costs of big government outweigh the benefits (as discussed in the previous subsection). Financial market participants, in contrast, focus almost exclusively on the effect of government policy on the supply of and demand for money.

The financial markets must ask a simple question: will a government raise new taxes to pay for higher spending, or will it seek to borrow money? If the answer is "tax," one should expect the markets to be relatively unconcerned—even if some of these revenues are raised by capital taxation. But if the answer is "borrow," the markets know that the government will have an incentive to inflate in the future to try to reduce the real cost of their debt. Higher interest rates must be charged if bond yields are to be maintained, the currency must depreciate if real exchange rates are to remain stable. Thus, the financial markets care much less about the size and scope of government interventions than about how they are paid for.

78. Corsetti and Roubini 1995.

79. Corsetti and Roubini 1991.

### *Summary*

In this section I have made three basic points. First, contemporary claims about the dire consequences of globalization for national autonomy are nothing new. With respect to the industrial democracies at least, history proved wrong previous proclamations of the demise of the nation-state. Second, the policy constraints imposed by market integration are likely to be different for trade and the multinationalization of production, on the one hand, than for the integration of financial markets, on the other. For the former, the relationship between the public economy and productivity is most important. With respect to financial integration, issues affecting the value of monetary instruments are paramount. Third, there are good reasons to believe that the policy constraints generated by these relationships are weaker and less pervasive than is often presumed.

### **Market Integration in the OECD**

In the remainder of the article I examine the empirical record for the OECD countries since the 1960s. I focus on these countries for pragmatic and methodological reasons. The data on both market integration and government policy are better for the OECD.<sup>80</sup> More importantly, the advanced industrial countries are more integrated into global markets than developing countries are; they are also presumably better equipped (in terms of political resources) to respond to the constraints globalization may generate. If the mixed economies of the OECD have not fared well under globalized markets, this cannot portend well for other countries.

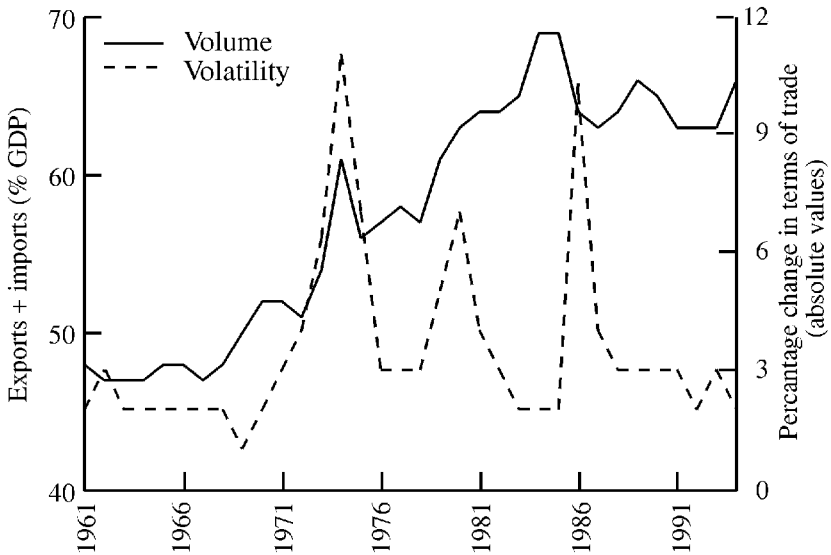
### *Aggregate Trends over Time*

The average exposure of the OECD countries to trade in goods and services (exports plus imports as a percentage of gross domestic product [GDP], unweighted by country size) increased consistently from less than 50 percent in 1960 to almost 70 percent by the mid-1980s, before stabilizing in the following decade (see Figure 2). Over the same period, the various GATT rounds reduced average tariff rates from around 25 percent to under 5 percent, although the use of nontariff barriers increased (at least until the Uruguay Round).<sup>81</sup> Rising trade, however, has not been accompanied by a secular increase in trade volatility. Volatility only increased markedly during the two oil shocks in the 1970s and with the halving of oil prices in the mid-1980s.

The aggregate data also suggest that the popular canard about the heightened importance of imports from low-wage economies should be qualified (see Figure 3). The oil shocks did result in a surge of non-OECD imports. But isolating OECD imports from low-wage economies (that is, excluding OPEC) shows that they have

80. For an analysis of available data for the developing world, see Garrett 1998d.

81. Wade 1996a, 69.



Source: OECD, *Historical Statistics*, 1960–94.

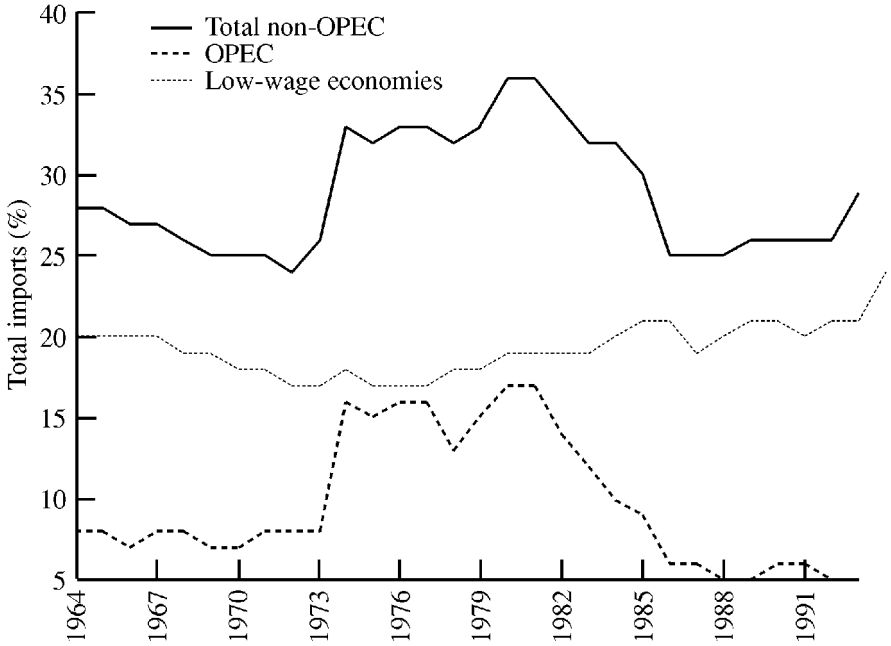
FIGURE 2. *The volume and volatility of trade*

consistently constituted over the period under analysis around 20 percent of all OECD imports. As Paul Krugman has argued with respect to the United States, it would be hard to blame rising low-wage imports for all economic problems in the industrial countries.<sup>82</sup>

Figure 4 presents data on intra-industry trade across the OECD from 1980 to 1992. The data measure the extent to which a country exports the same types of goods and services as it imports (based on two-digit SITC codes). A score of 0 would reflect pure inter-industry (Ricardian) trade; 1 would indicate that a country imported exactly the same types of products as it exported. Coupled with the stability in low-wage imports over time, high and rising intra-industry trade suggests that if competition has intensified, this has more to do with intra-OECD trade in the same sector (automobiles is a classic example) than with low wage competition from the developing world.

Turning to the globalization of capital, Figure 5 shows that (combined inflows and outflows of) FDI and international portfolio investments (assets and liabilities for bonds and equities) have grown much more rapidly than trade. These data underscore conventional views about the rise of footloose capital. The FDI numbers are particularly important since they represent the best available data on the multinationalization of production.

82. Krugman 1996.



Note: Unweighted country averages.  
 Source: OECD, *Historical Statistics*, 1960–94.

FIGURE 3. Imports from outside the OECD

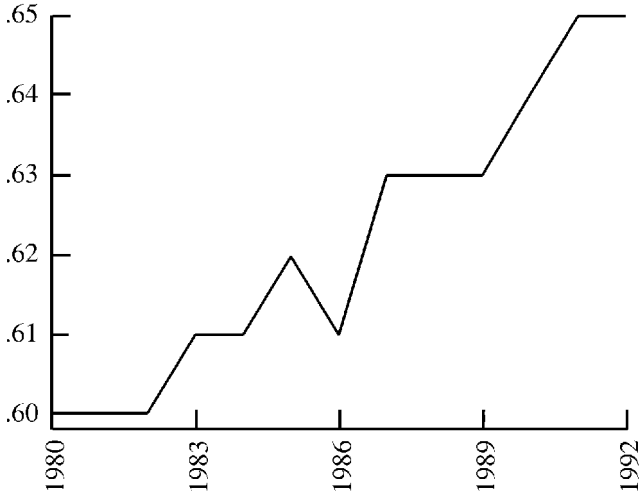
Economists are reticent to conclude, however, that the rapid growth of portfolio capital flows signifies a real increase in the mobility of financial capital. The dramatic upturn in flows since the early 1970s, for example, is no doubt in part the product of the end of the Bretton Woods fixed exchange-rate regime, necessitating international diversification to hedge against currency risk. In a seminal paper, Martin Feldstein and Charles Horioka argued that financial markets were, in fact, not very internationally integrated in the 1970s—because domestic investment was highly correlated with domestic savings.<sup>83</sup> Feldstein later reported similar results for the 1980s.<sup>84</sup> The Feldstein–Horioka approach, however, has been criticized on many grounds. Perhaps the most important is that anything that affects both savings and investment behavior will tend to inflate correlations between them and hence understate capital mobility.<sup>85</sup> As a result, I do not examine savings–investment correlations in the empirical analysis of globalization constraints on policy.

There are two measures of financial market integration that are arguably superior to savings–investment correlations. The first is based on official government restric-

83. Feldstein and Horioka 1980.

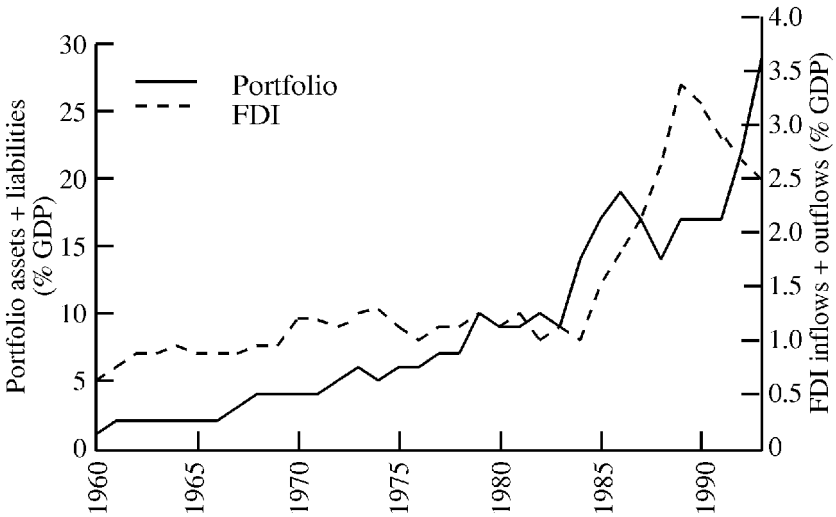
84. Feldstein and Bacchetta 1991.

85. Hallerberg and Clark 1997.



Source: OECD, *Trade Statistics*, various years, based on two-digit SITC. Definition from Grubel and Lloyd 1975, 36.

FIGURE 4. *Intra-industry trade*



Source: IMF, *Balance of Payments Statistics*, various years.

FIGURE 5. *International capital flows*

tions on cross-border capital movements.<sup>86</sup> Capital controls, however, are not ideal instruments for assessing the independent effects of globalization constraints on policy autonomy because they are another aspect of government policy choice (even if one constrained by exogenous factors such as changes in information technology).

The second measure of financial market integration is based on differences in the costs of capital. Interest rates would converge in a truly global capital market. But when exchange rates float, one must first take into account expectations about future currency movements to isolate remaining differences in capital costs. This can be done using “covered” interest-rate differentials—the difference between interest rates on a given instrument in one country and those in an offshore benchmark (typically, the eurodollar market), controlling for the forward exchange rate against the dollar.<sup>87</sup> Remaining differentials reflect either sovereign risk or barriers to the movement of capital. Sovereign risk (the probability that governments will default on their debts) is generally thought to be low in the OECD, but in some cases (in the newer members of the rich nations’ club, for example) it is surely not negligible. As a result, one cannot perfectly infer the magnitude of barriers to international financial flows from covered interest-rate differentials. Compared with capital controls, however, the advantage of this measure is that it is based on actual market behavior rather than on government policy.

I use both measures of financial market integration in this article, specifically Dennis Quinn’s financial openness index (higher scores signify more integration) and the absolute value of covered interest rate differentials (higher differentials indicate less integration). Figure 6 plots cross-national averages for both variables over time. At this level of aggregation, the data on financial openness and interest rates are highly correlated (as they are with international portfolio flows). The story they tell is familiar, reflecting rapid increases in financial integration since the 1960s.

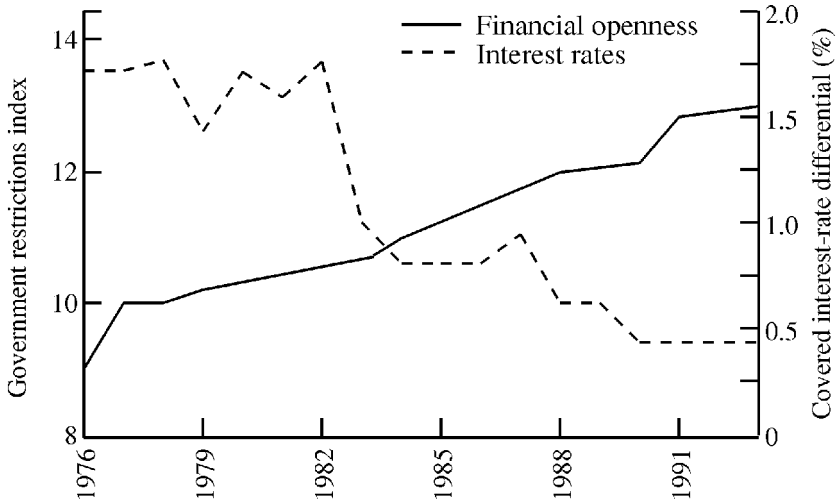
### *Variations Across Countries and Markets*

Reading much of the globalization literature, one would assume that most industrial economies are similarly integrated into most international markets. Tables 1 and 2 show that this is manifestly not the case. I concentrate on two sets of summary statistics—the coefficients of variation within categories of market integration (the bottom row of Table 1) and Pearson’s  $r$  correlations between pairs of categories (Table 2). The former provides a good measure of dispersion and convergence across countries; the latter is indicative of the extent to which different facets of market integration go together.

The coefficients of variation represent the standard deviation of the national observations divided by their mean. A score of zero would indicate complete cross-national convergence. There are only two coefficients of variation in Table 1 that could plausibly be interpreted as “near zero”—intra-industry trade and financial open-

86. See Quinn 1997; and Quinn and Inclan 1997.

87. See Frankel 1993; and Marston 1995.



Source: Financial openness index from Quinn 1997. Covered interest rates from Shepherd 1994, 265–71.

FIGURE 6. *Capital mobility*

ness. Intra-industry trade does not feature prominently in many analyses of globalization. But the financial openness index coefficient is even lower, giving some support to the conventional wisdom.

Table 2 presents a matrix of correlations for the post-1985 period based on the same globalization data. Are economies that are globalized in one market highly integrated into other international markets as well? Not really. Consider the correlations between total trade and the other indicators of integration. Trade was positively (but not strongly) associated with more intra-industry trade, lower tariffs, and greater volumes of FDI and international portfolio flows. But bigger traders tended to be less dependent on low-wage imports, to have less volatile trade patterns, and to be more reliant on nontariff barriers. Moreover, there was no relationship between trade dependence and either measure of financial market integration. In turn the correlations between financial integration and other facets of globalization were generally not strong and positive. More financial openness and smaller covered interest-rate differentials were associated with more intra-industry trade and higher FDI flows but with less trade volatility and smaller portfolio investment flows.

Finally, one would expect Quinn's financial openness index to be highly correlated with covered interest-rate differentials. It certainly is over time for the OECD as a whole (as Figure 6 shows). At the cross-national level, the correlation is in the expected direction (more openness is associated with smaller differentials). But it is not very strong. This might suggest either that sovereign risk is quite significant in the OECD or, more plausibly, that important barriers to capital mobility are not captured



TABLE 1. Market integration since 1985

Country	Structure of trade			Trade policy		Multinationalization of production		Financial integration		
	Total trade (% GDP)	Low-wage imports (% total)	Trade volatility <sup>e</sup>	Intra-industry trade	Tariffs <sup>b</sup>	NTBs <sup>c</sup>	FDI (% GDP)	Portfolio investment (% GDP)	Financial openness index	Covered interest-rate differentials
Australia	36.0	21.0	9.9	0.26	10.4	0.7	3.2	56.0	11.1	1.33
Austria	76.2	14.6	3.8	0.80	6.3	15.1	0.9	13.1	12.1	0.20
Belgium	140.7	11.0	2.5	0.81	4.6	22.1	6.0	45.7	11.8	0.46
Canada	54.6	14.0	1.9	0.70	5.7	8.3	1.5	8.7	13.5	0.16
Denmark	65.1	13.3	2.1	0.74	4.6	22.1	1.7	21.6	12.8	1.52
Finland	53.3	22.6	4.8	0.61	9.2	7.9	1.9	14.0	11.3	—
France	43.7	17.0	4.0	0.86	4.6	22.1	2.6	9.0	11.8	0.65
Germany	50.6	18.8	5.2	0.72	4.6	22.1	1.5	10.7	14.0	0.14
Greece	45.4	15.7	3.9	0.36	3.2	22.1	—	—	8.2	—
Iceland	—	—	—	—	4.2	3.0	—	—	—	—
Ireland	115.2	9.1	2.6	0.68	4.6	22.1	0.3	25.6	11.2	—
Italy	41.3	18.2	4.9	0.69	4.6	22.1	0.9	10.3	12.1	0.75
Japan	19.1	34.1	10.9	0.36	3.7	11.4	0.9	11.2	10.6	0.45
Luxembourg	191.1	—	—	—	4.6	22.1	—	—	—	—
Mexico	30.8	—	—	—	13.4	2.0	—	—	—	—
Netherlands	101.8	13.0	2.0	0.83	4.6	22.1	5.3	18.7	14.0	0.65
New Zealand	56.5	15.3	4.8	0.38	10.0	0.4	—	—	12.8	—
Norway	71.7	13.2	8.2	0.54	3.1	5.9	2.0	16.3	11.3	0.94
Portugal	66.6	11.7	—	0.49	4.6	22.1	—	—	9.9	—
Spain	39.5	16.7	5.1	0.71	4.6	22.1	—	—	11.7	—
Sweden	62.0	11.5	3.6	0.73	3.3	3.7	3.4	21.6	11.7	0.77
Switzerland	71.5	8.9	3.7	0.66	2.4	3.6	4.4	14.3	13.0	0.34
Turkey	33.6	—	—	0.47	9.8	0.2	—	—	13.0	—
United Kingdom	51.7	15.5	2.3	0.82	4.6	22.1	5.1	19.0	14.0	0.21
United States	20.6	34.0	2.2	0.64	4.5	23	1.3	2.5	13.7	0.11
Coefficient of variation <sup>d</sup>	0.60	0.41	0.58	0.28	0.49	0.66	0.69	0.72	0.12	0.75

Note: Country averages are for longest available period, 1985–present (see Figures 2–6). Dashes indicate that data are not available.

<sup>a</sup>Standard deviation of annual changes in the terms of trade, 1985–94.

<sup>b</sup>Post-Uruguay MFN (most-favored nation) tariff rates (binding on all merchandise trade) (Finger, Ingco, and Reineke 1996, 67).

<sup>c</sup>Percentage of all products subject to nontariff barriers in 1993 (OECD 1996, 52–55).

<sup>d</sup>Standard deviation/mean.

TABLE 2. *Correlations across market segments*

<i>Correlation with:</i>	<i>Low-wage imports</i>	<i>Trade volatility</i>	<i>Intra-industry trade</i>	<i>Tariffs</i>	<i>NTBs</i>	<i>FDI</i>	<i>Portfolio investment</i>	<i>Financial openness</i>	<i>Covered interest rates</i>
Total trade	-0.71	-0.44	0.44	-0.26	0.29	0.43	0.43	0.03	0.02
Low-wage imports		0.45	-0.35	0.17	0.02	-0.38	-0.29	0.01	-0.19
Trade volatility			-0.70	0.22	-0.46	-0.25	0.22	-0.44	0.30
Intra-industry trade				-0.41	0.52	0.30	-0.31	0.53	-0.33
Tariffs					-0.52	-0.10	0.44	0.10	0.29
NTBs						-0.02	-0.23	-0.02	-0.22
FDI							0.45	0.29	0.01
Portfolio investment								-0.36	0.51
Financial openness									-0.45

*Note:* Correlations are Pearson's  $r$ , based on the data in Table 1.

by formal government restrictions on capital flows. Either way, empirical analyses of the policy consequences of financial integration for national autonomy could differ considerably depending on which indicator of capital mobility is used. Reporting results for both is the prudent course.

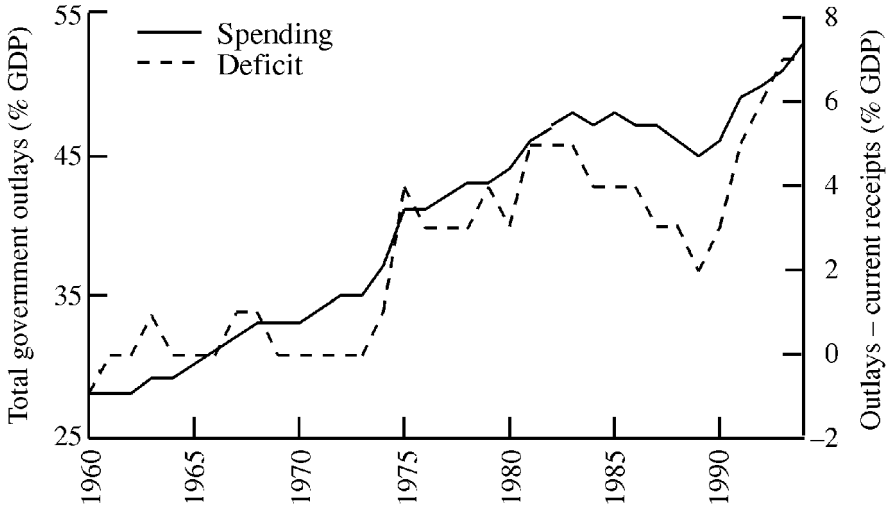
### *Summary*

In this section I have made two simple points about market integration in the OECD. First, the pace of globalization has varied considerably across different markets. Second, substantial cross-national differences in market integration endure. The OECD is not one giant seamless market. I now turn to the policy effects of globalization.

## **Macroeconomic Policy**

In this section I examine the relationships between market integration and macroeconomic policy. I concentrate on three policy indicators: total government spending, public sector deficits, and capital taxation. Spending is a simple summary indicator of government involvement in the economy. Deficits measure overall budgetary stances. Capital taxation is the single part of tax systems that many believe to be most vulnerable to globalization constraints.<sup>88</sup>

88. These indicators exclude important facets of microeconomic reform that arguably have been driven by globalization in recent decades—deregulation and privatization, for example. The qualitative evidence on microeconomic reform, however, is not conclusive. For insightful analyses, see Berger and Dore 1996; and Vogel 1995.



Source: OECD, *Historical Statistics*, 1960–94.

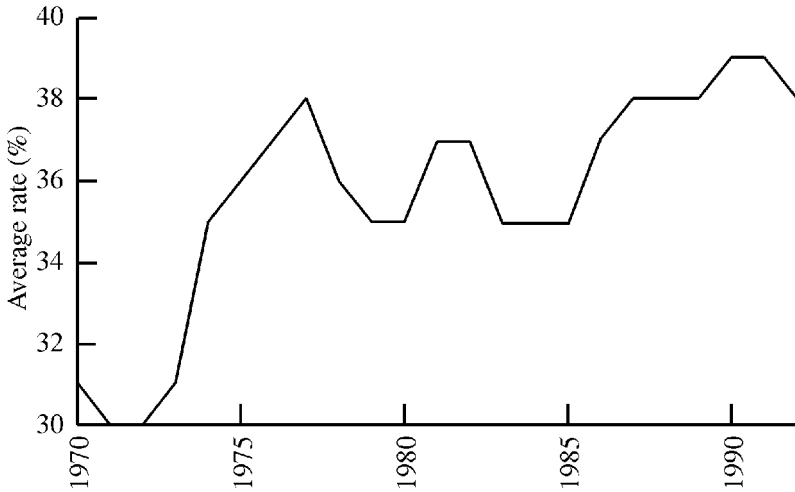
FIGURE 7. Government spending and public sector deficits

### Over-Time Trends

Figures 7 and 8 present over-time policy trends for the OECD as a whole. Average government spending basically doubled as a portion of GDP from 1960 to the mid-1990s, when it comprised over half of total output. As might be expected, spending increased most during the deep recessions of the mid-1970s, early 1980s, and early 1990s. But the size of the public economy only decreased as a portion of GDP during one upturn in the business cycle—the mid-1980s. Given that this is the period on which many influential analyses of globalization constraints are based, this may explain the prominence of assertions about public sector rollback. Nonetheless, the history of government spending in the postwar OECD is predominantly one of sustained growth.

The expansion of the public economy has not been wholly matched by increased taxes. Budget deficits increased by about seven points from 1960 to 1994. It is often assumed that this revenue shortfall reflects the declining ability of governments to tax increasingly mobile capital. Changes in marginal rates of corporate income taxation are consistent with this view—they have declined considerably in most OECD countries in the past fifteen years.<sup>89</sup> But from the perspective of revenue-hungry governments, these marginal rates are not the whole story. Governments certainly have incentives to reduce taxes that impede growth-creating investment, of which marginal corporate tax rates are a clear example. But most cuts in marginal rates in the OECD have been accompanied by other reforms that have increased the tax

89. Cummins, Hassett, and Hubbard 1995.



*Note:* See text for definition.

*Source:* Mendoza, Milesi-Ferreti, and Asea 1997.

**FIGURE 8.** *Capital taxation*

base—reductions in investment incentives, depreciation allowances, and other loopholes that pertain to capital taxation.<sup>90</sup>

Figure 8 presents data on average effective rates of capital taxation that take into account both changes in marginal rates and in the tax base.<sup>91</sup> Notwithstanding the short-term volatility of this measure resulting from variability in profits, the overall trend in effective rates of capital taxation has been upward, quite strongly so. Rates in the early 1990s averaged almost 40 percent, up from around 30 percent in the early 1970s. This is a long way from predictions of a free fall in capital taxation resulting from the exit threats of multinational firms and financial speculators.

In summary, the trends over time in Figures 7 and 8 are hard to square with the notion of pervasive globalization constraints on national economic policy autonomy. Does one get a different picture by examining economic policy data on a country-by-country basis?

#### *Variations Across Countries and Market Segments*

In this subsection I explore cross-national variations in economic policy and their relationships with globalization. Three indicators of market integration are used—

90. Swank 1998.

91. These are calculated as government revenues from all sources of capital income—corporate profits, capital gains, financial transactions, and property holdings—as a percentage of the gross operating surplus (profits) in an economy. See Mendoza, Milesi-Ferreti, and Asea 1997.

total trade (a simple proxy for competitiveness pressures),<sup>92</sup> FDI flows (for the multinationalization of production),<sup>93</sup> and the financial openness index and covered interest-rate differentials (the integration of financial markets). These relationships are also compared with the associations between economic policy and a simple partisan politics variable (the combined power of left-wing parties and organized labor movements) that historically has had a marked impact on economic policy choice.

Table 3 presents data that allow us to answer a basic question: is it the case, as the conventional wisdom would suggest, that fiscal policy strategies have converged in the era of more globalized markets? The data in Table 3 are for the post-1985 period as well as for changes in policy from historic averages.

The coefficient of variation for total government spending since 1985 is quite small. One could debate whether OECD public economies have become “about the same size.” After all, Switzerland’s public economy is still only half the size of Sweden’s. What is more interesting, however, is that national trajectories diverged considerably from historical averages (1960–84) to the post-1985 period. Taking the extreme cases, spending grew six times as much in Spain as in the United Kingdom. This divergence is precisely the opposite of the conventional wisdom about the effects of globalized markets.

The deficits data are even less supportive of the conventional view. There was considerable dispersion in budgetary stances in the post-1985 period as well as in terms of changes from historical averages. Some of the cross-national differences are dramatic. Switzerland ran surpluses of over 2 percent of GDP after the 1985 period, whereas deficits in neighboring Italy were over 10 percent. Deficits in Greece increased by more than six points from the pre- to post-1985 periods, but they declined by almost two points in Japan.

Perhaps most surprisingly of all, the capital tax coefficients of variation do not look much different from the spending and deficits numbers. In the post-1985 period, considerable dispersion in capital tax rates remained. But the divergence from pre- to post-1985 rates of capital taxation was even more marked. Capital tax rates declined by 2.7 points in the United States, but they increased by more than 10 points in Finland, Japan, and Sweden.

These descriptive data can only support one conclusion: fiscal policies among the OECD countries have not converged in recent years. Is there any more evidence of globalization constraints when one breaks market integration down into its components? Table 4 provides a reference set of hypotheses based on the conventional wisdom. Exposure to trade is thought to put downward pressures on government spending. But these effects should be stronger for the multinationalization of production and stronger still for financial integration. Moving across the table, the efficiency perspective would suggest that the downward pressures of each globalization vari-

92. Garrett and Mitchell show that the effects of total trade on welfare state expenditures are not significantly different from those of trade volatility or imports from low-wage economies; Garrett and Mitchell 1998.

93. Note that these flow numbers do not take into account the stock of foreign investment in a country, nor strategic alliances among multinational firms from different countries.

TABLE 3. *Fiscal policy since 1985*

Country	Total government spending		Public sector deficit		Effective rate of capital taxation	
	Level <sup>a</sup>	Change <sup>b</sup>	Level	Change	Level	Change
Australia	37.9	8.9	3.5	2.1	46.8	8.3
Austria	51.5	8.5	3.9	2.5	22.6	2.3
Belgium	57.9	10.7	7.4	2.1	36.7	2.9
Canada	47.9	11.9	6.7	3.8	41.4	0.7
Denmark	59.8	17.1	1.9	1.2	34.8	—
Finland	51.2	16.5	1.3	3.8	44.4	14.4
France	51.6	10.0	4.9	3.4	26.0	3.2
Germany	47.5	5.3	2.6	1.1	28.5	2.4
Greece	51.2	16.5	13.8	6.6	—	—
Iceland	39.6	8.1	3.7	4.3	—	—
Ireland	46.3	5.5	5.6	-1.4	—	—
Italy	52.8	14.3	10.9	4.5	28.1	—
Japan	32.6	8.2	-0.3	-1.8	48.8	19.4
Luxembourg	51.4	9.6	-3.1	-2.1	—	—
Mexico	—	—	—	—	—	—
Netherlands	59.0	10.9	5.1	2.4	30.5	—
New Zealand	—	—	—	—	36.7	—
Norway	52.4	10.7	-2.8	0.3	39.2	0.7
Portugal	43.2	15.6	5.8	3.6	—	—
Spain	43.7	18.4	6.1	4.7	—	—
Sweden	64.2	16.5	3.8	4.0	60.6	14.0
Switzerland	32.4	8.1	-2.4	1.7	28.2	6.2
Turkey	—	—	—	—	—	—
United Kingdom	43.7	3.1	4.3	1.0	57.5	1.9
United States	36.8	5.5	5.1	2.5	40.5	-2.7
Average	47.9	10.9	4.0	2.3	38.3	5.7
Coefficient of variation	0.18	0.41	1.02	0.96	0.28	1.15

*Note:* Dashes indicate that no data are available.

<sup>a</sup>Levels based on 1985–94 for spending and deficits; 1985–92 for capital taxation.

<sup>b</sup>Changes are 1985 averages minus 1960–84 for spending and deficits; 1965–84 (or first available year) for capital taxation.

able should be stronger on deficits than on spending and stronger still on the capital taxation. Finally, many commentators believe that the effects of partisan politics on policy have diminished considerably in recent years. This should be manifest in near zero correlations with economic policy in the contemporary era and negative associations in the change data (that is, larger reductions in activism in countries with stronger left-wing parties and trade unions).

The correlations for the post-1985 period in Table 5 send mixed signals. On the one hand, and consistent with my arguments, exposure to trade, FDI flows, and left-labor power were all associated with greater spending after 1985. On the other

**TABLE 4.** *The conventional wisdom about globalization and fiscal policy*

<i>Globalization mechanism</i>	<i>Economic policy</i>		
	<i>Government spending</i>	<i>Public sector deficit</i>	<i>Capital tax rate</i>
Exposure to trade	—	— —	— — —
Multinationalization of production	— —	— — —	— — — —
Capital mobility	— — —	— — — —	— — — — —
Left-labor power	0/—	0/— —	0/— — —

*Note:* Minus signs denote strength of the negative relationships.

**TABLE 5.** *Globalization, partisan politics, and fiscal policy since 1985*

<i>Globalization mechanism</i>	<i>Economic policy</i>		
	<i>Government spending</i>	<i>Public sector deficit</i>	<i>Capital tax rate</i>
Exports + imports/GDP (%)	.38	-.25	-.24
FDI inflows + outflows/GDP (%)	.18	-.01	.19
Financial openness index	.02	-.29	-.19
Covered interest rates <sup>a</sup>	-.34	.13	-.09
Left-labor power	.58	-.31	.27

*Note:* Figures are Pearson's *r* correlation coefficients. All data are averages for periods after 1984 to the latest available year, except left-labor power. Left-labor power is the standardized sum of cabinet portfolios held by left-wing parties, 1950–93 plus union density, 1960–89.

<sup>a</sup>Multiplied by  $-1$  so that higher scores reflect more capital mobility.

hand, the covered interest rate–spending correlation implies a constraining effect of capital mobility on the public economy. One way to reconcile these findings would be to endogenize capital mobility, hypothesizing that strong left-labor regimes have chosen to protect their public economies by retaining significant controls on the mobility of capital.<sup>94</sup> This may have been the case in the past, but the correlation between the power of the left and the strength of trade unions and capital mobility all but evaporated by the latter half of the 1980s.<sup>95</sup>

An alternate explanation is that countries have reacted in very different ways to increasing capital mobility, based on the balance of partisan power within their borders. I have presented elsewhere more sophisticated analyses—using panel regressions with multiplicative interactions between globalization and partisan politics—

94. Quinn and Inclan 1997.

95. Garrett 1998a.

that support this view.<sup>96</sup> Strong left-labor regimes responded to financial market integration with ever-higher levels of public spending, whereas governments in countries with much weaker left parties and trade unions cut back the public economy.

Now consider the correlations for public sector deficits after 1985. Contra standard assumptions about left-labor power, deficits historically have been smaller in strong left-labor regimes than elsewhere.<sup>97</sup> Nonetheless, one should expect globalization—especially financial market integration—to have put downward pressures on deficits. The bivariate correlations do not strongly support this expectation. Financial openness and total trade were somewhat correlated with smaller deficits. But this was not the case for FDI or interest-rate differentials.

Finally and perhaps most surprisingly, the capital tax correlations for the post-1985 period were no more supportive of globalization conventional wisdom. Lower tax rates were correlated with greater exposure to trade, financial openness, and covered interest-rate differentials, but none of these associations was at all strong. In contrast, FDI flows were weakly associated with higher capital taxes. Finally, the association between left-labor power and capital tax rates was positive and larger than any of the globalization–taxation correlations were.

No great weight can be attached to these simple bivariate correlations. But even the most sophisticated existing research on taxation and globalization does not strongly support a race-to-the-bottom interpretation. Rodrik finds that capital mobility constrains capital taxation but only in countries with high levels of trade dependence and trade volatility.<sup>98</sup> Quinn and Swank report little or no relationship between capital mobility and corporate taxation.<sup>99</sup> Garrett argues that the effects of globalization on capital taxes, as was the case for spending, are contingent on the partisan balance of power.<sup>100</sup> Hallerberg and Basinger demonstrate that the number of veto players, not capital mobility, best explains changes in marginal corporate tax rates in the latter 1980s.<sup>101</sup>

Let us now turn to correlations based on changes in economic policy pre- and post-1985 (see Table 6). These data are no more indicative of a policy race to the bottom. Both measures of financial integration were quite strongly associated with faster increases in government spending (as was left-labor power). The financial integration–deficit correlations were much weaker and of contradictory signs.

Consistent with the over-time analysis, the bivariate correlations presented in this subsection belie common notions about strong and pervasive globalization constraints on national autonomy. These analyses are certainly not definitive, but they should prompt further research into what are undoubtedly complicated relationships between globalization and policy choice.

96. Garrett 1995.

97. Garrett and Lange 1991.

98. Rodrik 1997.

99. See Quinn 1997; and Swank 1998.

100. Garrett 1998c.

101. Hallerberg and Basinger 1998.



TABLE 6. *Changes in globalization and fiscal policy since 1985*

<i>Globalization mechanism</i>	<i>Economic policy</i>		
	<i>Government spending</i>	<i>Public sector deficit</i>	<i>Capital tax rate</i>
Exports + imports/GDP (%)	.00	-.14	-.22
FDI inflows + outflows/GDP (%)	.09	.23	.19
Financial openness index	.41	.10	.18
Covered interest rates <sup>a</sup>	.47	-.20	.03
Left-labor power	.51	.11	.22

*Note:* Figures are Pearson's  $r$  correlation coefficients. All data are averages for periods after 1984 minus historic averages (beginning in 1960 or first available year), except left-labor power (which is measured as in Table 5).

<sup>a</sup>Multiplied by  $-1$  so that higher scores reflect more capital mobility.

## Capital Flight

If the OECD countries have not converged around a less interventionist macroeconomic policy regime in recent years, have countries with larger public economies or bigger budget deficits suffered from debilitating capital flight? If the answer is "yes," one might reasonably suspect that globalization-induced convergence would soon become the norm. If not, continuing cross-national variations in policy regimes would seem more likely. This section examines the policy-capital flight relationship with respect to multinational exit, interest rate premiums, and currency depreciation.

The first column of Table 7 presents data on average annual net outflows (that is, outflows minus inflows) of FDI since 1985. These are correlated with the three policy variables from the last section—government spending, public sector deficits, and effective capital tax rates—over (as close as possible to) the same period. The spending and capital tax correlations were trivially small. Larger public sector deficits were associated with smaller, not larger, net outflows of FDI—reflecting the need for domestic debt to be funded by infusions of foreign capital. These correlations should give pause to purveyors of conventional globalization parables, for whom the loss of multinational investment as a result of interventionist government is a central theme.

Things were different, however, with respect to the behavior of the financial markets, measured by the long-term interest rates charged on government debt and the strength of currencies in foreign exchange markets. There was a clear correlation between a country's budgetary stance and the reaction of the financial markets. Bigger deficits were associated with higher interest rates and with greater depreciations against the dollar. Furthermore, interest rates were higher in countries with larger public economies, and depreciations were associated with higher rates of capital taxation.

TABLE 7. *Capital flight and fiscal policy*

Country	Net outflows of FDI <sup>a</sup>	Long-term interest rates <sup>b</sup>	Depreciation against the dollar <sup>c</sup>	Inflation <sup>d</sup>
Australia	0.7	11.8	3.3	4.7
Austria	-0.2	7.6	-5.2	3.3
Belgium	0.8	8.9	-4.9	3.5
Canada	-0.2	9.8	0.1	2.8
Denmark	-0.4	9.8	-4.4	3.2
Finland	-1.1	10.3	0.3	4.0
France	-0.6	9.5	-4.2	3.2
Germany	-0.9	7.2	-5.2	3.0
Greece	—	—	8.6	15.8
Iceland	—	7.0	9.6	15.1
Ireland	0.3	9.9	-2.8	3.1
Italy	-0.1	12.0	-0.3	6.3
Japan	-0.8	5.4	-7.5	1.2
Luxembourg	—	—	-4.9	4.6
Mexico <sup>e</sup>	—	17.1	46.0	47.8
Netherlands	-1.6	7.3	-5.2	1.5
New Zealand	—	12.6	0.9	6.4
Norway	-0.4	11.1	-1.2	3.1
Portugal	—	—	1.6	12.9
Spain	—	12.5	-1.9	6.7
Sweden	-1.8	11.1	0.2	5.6
Switzerland	-2.2	5.1	-4.2	3.3
Turkey <sup>e</sup>	—	—	46.8	62.3
United Kingdom	-1.0	9.7	-0.9	5.0
United States	0.2	8.4	—	3.2
Correlation with: <sup>f</sup>				
Total spending	0.05	0.40	-0.12	-0.09
Public sector deficit	-0.47	0.42	0.44	0.46
Capital tax rate	0.09	0.07	0.44	-0.03
Inflation		0.63	0.98	

<sup>a</sup>1985–93 average for annual outflows minus inflows of FDI (% GDP).

<sup>b</sup>1985–94 average for annual interest rates on ten-year government bonds, from OECD Historical Statistics, 1960–94.

<sup>c</sup>1985–93 average depreciation against the \$US, from OECD Historical Statistics, 1960–94.

<sup>d</sup>1985–94 averages for annual GDP price deflator, from OECD Historical Statistics, 1960–94.

<sup>e</sup>Not used in correlations because of absence of economic policy data.

<sup>f</sup>Economic policy variables are averages from 1985 to the latest available year; correlations exclude all missing data.

In most analyses of policy credibility, inflation is the key link between fiscal policy and the behavior of international financial markets. The market's expectations about movements in exchange rates are the proximate determinant of differences in interest rates. In turn, differences in inflation rates are the best predictors of exchange-rate movements. These relationships are clearly demonstrated in Table 7. The correlation between deficits and inflation was quite strong but not nearly as strong as that be-

tween inflation and interest-rate premiums. Moreover, the correlation between higher inflation and currency depreciation was almost perfect.

Analyzing in detail the interrelationships among the size of the public economy, budget deficits, inflation, and interest rates is beyond the scope of this article. Here I will only sketch two possible approaches to the problem. The first is a path model that reflects the logic underpinning the conventional wisdom about the costs of big government in the global economy. The results based on post-1985 averages are<sup>102</sup>

$$\begin{array}{ccccccc} \text{Spending} & \rightarrow & \text{Budget deficit} & \rightarrow & \text{Inflation} & \rightarrow & \text{Interest rates} \\ & & (.22) & & (.56) & & (.63) \end{array}$$

These correlations are all in the expected direction—more spending was correlated with larger deficits, which were associated with higher inflation rates, which tended to result in higher interest rates. But note that the correlations increase in size along the path. A history of high inflation is certainly likely to lead the financial markets to impose an interest-rate premium on today's borrowing. Countries with larger public sector deficits are more likely to be inflationary, but this connection is less strong. Finally, although the correlation between the size of government and deficits is positive, it is even weaker.

The other basic approach to these relationships is to assume that spending, deficits, and inflation rates all have independent effects on interest rates. The following equation is a simple multivariate regression estimating these effects for the post-1985 period:<sup>103</sup>

$$\text{INTRATE} = 2.53 + 0.06\text{SPEND}^* + 0.04\text{DEFICIT}^* + 1.00\text{INFLATION}$$

$$\begin{array}{ccccccc} & & (2.00) & (0.04) & & (0.11) & & (0.26) \end{array}$$

All the estimated parameters were in the expected direction, but only the effects of inflation were significant at traditional levels. This is not to say that spending and deficits were irrelevant—because of their impact on inflation. The path model suggests, however, that these effects are not very strong.

In summary, there is some evidence supporting the view that governments that have persisted with activist fiscal stances in recent years have paid a price in global capital markets. The causal pathways between fiscal policy and the propensity for capital flight, however, are quite diffuse. It is possible, of course, that the absence of globalization constraints on government spending and taxation only shows that financial markets are not yet sufficiently integrated for these effects to be apparent. There may be a threshold—not yet reached in the OECD—beyond which the policy race to the bottom will ensue. One preliminary way to test this argument is to examine the

102. Numbers in parentheses are Pearson's *r* correlations.

103. *n* = 18. The regression equation is based on the eighteen countries for which all the data were available (Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Italy, Japan, the Netherlands, Norway, Spain, Sweden, Switzerland, the United Kingdom, and the United States). Adjusted *R*<sup>2</sup> = .56. Figures in parentheses are standard errors. \**p* > .10, two-tailed test.

TABLE 8. *Tax rates among U.S. states*

<i>State</i>	<i>Average tax rate</i>
Top five	
Minnesota	8.8
Hawaii	7.9
Michigan	7.0
District of Columbia	7.0
Utah	6.8
Bottom five	
Louisiana	2.0
Wyoming	1.9
Texas	1.7
North Dakota	1.6
Alaska	0
Coefficient of variation (for 50 states)	0.32

*Note:* Average rate of income and sales tax paid in 1983 by individuals with \$20,000 income (1979 dollars). Data are from Feenberg and Rosen 1986, 175–76.

political economy of fiscally decentralized countries, where there are effectively no barriers to movement across state lines. The United States is a good example.

Table 8 presents data for the fifty U.S. states on combined rates of sales and income taxation (by far the largest two components of state-level revenues). The data do not indicate a race to the bottom. The relevant comparison with respect to the OECD is not overall tax rates (given the size of the federal government in the United States), but rather the dispersion of tax rates. The coefficient of variation for state taxes is .32. This is higher than the comparable OECD-wide coefficients for both capital taxation and government spending (see Table 3). The complete integration of the U.S. market has not resulted in convergence of tax rates around a minimal mean. Nor is it the case that the low-tax states are the best macroeconomic performers—Louisiana, North Dakota, and Wyoming are quite poor. Texas and Alaska can afford low taxes because of their wealth of natural resources. The data should give pause to those who believe that it is only a matter of time before market pressures force fiscal convergence on the OECD.

## Governing in the Global Economy

In this article I have sought to paint in broad brush strokes the relationship between the globalization of markets and national autonomy in the OECD. I have made two basic points. First, there are strong parallels between recent arguments about the constraining effects of globalization on national autonomy and those all the way back to the eighteenth century about the domestic effects of market integration. With hind-

sight, we know that past predictions of the effective demise of the nation-state were unfounded. Are there signs that things will be different in the contemporary epoch?

My second point is that, up until the mid-1990s, globalization has not prompted a pervasive policy race to the neoliberal bottom among the OECD countries, nor have governments that have persisted with interventionist policies invariably been hamstrung by damaging capital flight. Governments wishing to expand the public economy for political reasons may do so (including increasing taxes on capital to pay for new spending) without adversely affecting their trade competitiveness or prompting multinational producers to exit. The reason is that governments provide economically important collective goods—ranging from the accumulation of human and physical capital, to social stability under conditions of high market uncertainty, to popular support for the market economy itself—that are undersupplied by markets and valued by actors who are interested in productivity. This is particularly the case in corporatist political economies where the potential costs of interventionist government are mitigated by coordination among business, government, and labor.

This is not to say, however, that no facet of globalization significantly constrains national policy options. In particular, the integration of financial markets is more constraining than either trade or the multinationalization of production. But even here, one must be very careful to differentiate among various potential causal mechanisms.

Talk of lost monetary autonomy only makes sense if one believes that the integration of financial markets forces governments to peg their exchange rates to external anchors of stability. On recent evidence, the credibility gains of doing so are far from overwhelming; indeed, noncredible pegs (that is, those not consistent with other political and economic conditions) have promoted the most debilitating cases of financial speculation and instability. On the other hand, the costs of giving up the exchange rate as a tool of economic adjustment are great, and economies that allow their currencies to float freely seem to benefit as a result. Governments simply should not feel any compunction to give up monetary autonomy in the era of global financial markets.

But even if countries float their exchange rates, the financial markets—fearing inflation—do impose interest-rate premiums on governments that persistently run large budget deficits. Some governments have been willing to pay this price in the name of other objectives. Others have sought domestic solutions to credibility problems in the markets, such as central banking reforms. Still others (especially in the developing world) apparently have been unable to attain reputations for fiscal responsibility. For these countries, fixing the exchange rate may be the only option, but there can be no guarantee that this will not just fuel even more financial speculation.

Finally, there is no evidence that the financial markets attach interest-rate premiums to the expansion of the public economy per se—that is, provided new tax revenues balance increased spending. This is even true if the taxation of capital is one source of new revenues. Moreover, the empirical connections between expansion of the public economy and deficits are quite weak and heavily mediated by domestic political conditions. Strong left-labor regimes, for example, have historically been

able to increase government spending without incurring large debts. The financial markets are essentially disinterested in the size and scope of government. Their primary concern is whether the government balances its books.

My analysis is thus considerably more bullish about the future of the embedded liberalism compromise than some of its earlier advocates suggest. As a result, I do not believe that supporters of interventionist government must call for a dose of protectionism or the reimposition of capital controls to maintain the domestic balance between equity and efficiency. Nor must advocates look to international cooperation and institutions as the only attractive option for the future. As has been the case for more than two hundred years, the coupling of openness with domestic compensation remains a robust and desirable solution to the problem of reaping the efficiency benefits of capitalism while mitigating its costs in terms of social dislocations and inequality.