Grappling with Globalisation: Challenges for Economic Governance

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1. ISSUES

Demonstrations by citizen groups against the World Trade Organisation (WTO) in Seattle (29 November–3 December, 1999) and more recently against the World Bank and the International Monetary Fund (IMF) in Washington, DC (16–17 April, 2000) raise issues about the legitimacy of globalisation processes.¹ To examine key domestic institutional challenges posed by globalisation, this paper focuses on the following questions: how does economic globalisation differ from other types of economic integration, what is its impact on the extant national institutions of economic governance, what institutional innovations are required to cope with the challenges, and how can institutional change be made politically feasible? This paper surveys literatures on these subjects and distills key implications.

¹ There have been many other instances of public opposition to international/regional regimes and organisations that seek to facilitate cross-border economic exchanges. These include the opposition to the North American Free Trade Agreement (NAFTA) and the Multilateral Agreement on Investment.
2. BACKGROUND

The efficacy and the efficiency of governance systems are contingent on, _inter alia_, their legitimacy among social groups. Enforcing rules that lack legitimacy is costly, thereby diverting the surplus from productive economic investments to coercive expenditures (North, 1990). The recent debates on globalisation have raised questions about the legitimacy of policies that favour market-friendly governance systems. Some suggest that with the inexorable march of market systems (particularly, the Anglo-American kind), governments are now subservient to markets.\(^2\) This is because multinational enterprises (MNEs) can relocate their activities across jurisdictions at low costs (Ohmae, 1991). The possibilities of 'regulation arbitrage' constrain government's policy autonomy, thereby abetting races-to-the-bottom (Spar and Yoffie, 2000). Further, financial markets 'punish' governments that do not institute 'market-friendly' policies and whose budgetary deficits 'crowd out' private investment. If these contentions are correct, governments operate in significantly shrivelled policy spaces. It seems that economic policymaking is now limited to correctly anticipating market signals and quickly translating them into market-friendly policies.

This paper contends that although factor, intermediate product, and final product markets have become more globally integrated, governments remain important in establishing, monitoring, and enforcing the rules of economic governance, sanctioning violators, and providing dispute resolution services. Of course, governmental capacities and willingness to undertake such functions vary, depending both on their internal and external attributes. However, demands from private actors for newer kinds of collective goods suggest that governments are legitimate actors in influencing resource allocation.\(^3\)

Without doubt, the levels and foci of governmental involvement are changing. While national governments are more constrained in many realms, they retain capacities, incentives, and justifications to rearticulate themselves (Evans, 1997; and Falk, 1997) in the realm of technology, trade, and investment policies (Hart and Prakash, 1997), human capital development (Reich, 1992), and redistributive policies (McGinnis, 1999). In some policy arenas, governments can also reverse market liberalisation and cross-border integration at low costs (Cohen, 1996). The

\(^2\) For an extended discussion on the convergence hypothesis, see Berger and Dore (1996), Boyer and Drache (1996), and Kitschelt, Lange, Marks and Stephens (1999).

\(^3\) There is a major political crisis brewing in Northern Virginia (which now leads the Silicon Valley in terms of employment in high-technology industry) over traffic congestion. A coalition of 15,000 area businesses, 'Region,' has urged the state government to _levy one percentage point sales tax_ to the amount of $1 billion to finance new roads. America Online, a prominent information technology firm of this area, has led the chorus for new taxes (Washington Post, 1999a). Similarly, multiple opinion polls suggest that the majority of Americans do not want the projected budgetary surplus to be returned to them as tax cuts. Rather, they want the federal government to invest in collective goods such as schools, social security, and health services.

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recent East Asian crisis, although disputed in its etiologies and implications, is a case in point. In September 1998, President Mahathir Mohamad of Malaysia imposed capital controls (in the form of a twelve month moratorium on capital withdrawal), thereby locking in $3.5–4.0 billion held by foreign portfolio managers. Though the policy’s long-term implications are unclear, it stabilised the Malaysian economy in the short run by allowing the government to lower interest rates and to revive commercial bank lending. Prominent economists such as Krugman (1998) and Bhagwati (1998) also agreed that governments need to reign in capital flows and capital controls may be necessary to control fluctuation in financial markets.

In light of the above discussion, Section 3 examines the notion of economic globalisation and how it differs from other types of economic integration. Section 4 probes how globalisation impacts some of the extant national institutions of economic governance. Finally, Section 5 surveys the literature on the key challenges confronting policymakers, institutional innovations required to cope with them, and the feasibility of institutional change to grapple with globalisation.

3. CONCEPTUALISING ECONOMIC GLOBALISATION

Globalisation is a multi-faceted phenomenon impacting economic, political, and social spheres of human existence. This paper focuses on economic globalisation (henceforth globalisation) that is defined as a set of processes leading to increasing integration of input, factor, and final product markets coupled with the increasing salience of MNEs’ value-chains in cross-border flows (Prakash and Hart, 2000a, 2000b). As the reader will note, globalisation is defined as a set of processes and not as an end-state. If we were to define globalisation in terms of the latter, measuring levels of globalisation would be necessary.

As argued elsewhere (Prakash and Hart, 2000c), there are three approaches to assess a country’s levels of cross-border economic integration. First, by examining the extent of institutional convergence or harmonisation across

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4 In February 1999, capital controls were replaced with a graduated exit levy (10–30 per cent) on investments of duration of less than one year. In September 1999, capital controls were relaxed further with a uniform exit levy of 10 per cent. Did financial markets penalise Malaysia? Perhaps not, at least in the short run. The Kuala Lumpur Stock Exchange’s composite index increased by 39 per cent in 1999 (ADB, 2000). Capital outflows during the third and fourth quarters of 1999 remained moderate (RM 5.2 billion and RM 3.2 billion) and there was net inflow in the first quarter of 2000 (RM 6.9 billion). From $31.4 billion in the third quarter of 1999, foreign exchange reserves marginally increased to $32.8 billion by end February 2000 (Bank Negara Malaysia, 2000).

5 For non-economic dimensions and implications of globalisation, see Appadurai (1996) and Babe (1996).
countries. Second, by focusing on the outcomes of integration such as the ratio of foreign trade to gross domestic product (GDP), the ratio of foreign direct investment to GDP, and integration at the factors of production level. The third approach examines convergences in prices of good and services across countries. As this discussion suggests, much work needs to be done in developing standardised tools to measure globalisation.

Globalisation processes lead to market integration at various levels of MNEs’ value-chains. MNEs seek to tap multiple locations for sourcing inputs or selling final products by employing institutional arrangements such as foreign direct investment (FDI), strategic alliances, and dedicated sub-contractors. Market integration is unlikely to be uniform across and within countries. The jury is still out on whether regional integration is a ‘building bloc’ or a ‘stumbling bloc’ to global integration (Lawrence, 1995). Data suggests that international economic flows are concentrated in the so-called triad that accounts for 60 per cent of FDI inflows (UNCTAD, 1998).

Cross-boundary economic integration is not a new phenomenon. Complex webs of economic linkages existed among ancient civilisations – sea-based trade among the ancient Indus valley, Chinese, Tigris, and Nile civilisations being one of them (Frank and Gills, 1993; and Chase-Dunn, 1994). Land-based trade on the Central Asian Silk-Route still evokes memories of the adventurous past. In more recent times, the East India Company succeeded in integrating India and other colonies with the British empire both politically and economically. Based on trade and capital flows, the world economy was perhaps more integrated on the eve of World War I than it is today (Zevin, 1992; and Rodrik, 1997). There also existed concerns about the impact of economic integration on national sovereignty. Adam Smith, David Hume, and Charles Montesquieu were concerned that capital mobility would restrain governments (Garrett, 1998).

In 1913, industrialised countries’ merchandise exports were 13 per cent of GDP (14 per cent in 1992) and FDI was 11 per cent of GDP (comparable to 1993 levels). Japan exported a higher proportion of its production during the interwar period than it does currently (Rodrik, 1997). The consequences of such high levels of integration were also debated. In his treatise, The Great Illusion (1910), Norman Angell predicted an end of warfare, especially between the highly integrated economies of Britain and Germany. This book’s popularity was unprecedented. It sold more than a million copies, quite a feat in the days when discount booksellers such as ‘amazon.com’ did not exist. Angell was knighted,

6 For an opposing view, see Bordo, Eichengreen and Kim (1998) as well as Bairoch and Kozul-Wright (1998). They contend that the breadth and the depth of integration is significantly greater in the 1990s, thereby posing real challenges to the de facto policy sovereignty of governments.
7 As many view globalisation serving US interests, 19th century scholars-statesmen including Hamilton and List believed that free trade and market integration served the interests of the British empire.
even awarded the Nobel Peace Prize (Beinart, 1997). As luck would have it, World War I broke out as Angell’s message appeared to gather steam, discrediting both the message and the messenger. The reader will observe similarities between Angell’s predictions and the New World Order notion that President Bush invoked to describe the post-cold war period where economic interests would triumph over ideology and politics.

Regional integration and interdependence research programmes also debated whether and how economic integration might constrain national governments. Functionalist theories sought to explain trends towards regional co-operation (Deutsch, 1957) – such as the formation of the European Coal and Steel Community (1952) and the European Economic Community (1956) – among the hitherto belligerent powers. With the creation of technical supranational organisations, scholars saw regional co-operation leading to the rise of transnational technical elites. The ‘ramifications’ (Mitrany, 1968) of technical co-operation in politics were predicted to lead to political integration, encouraging peaceful settlement of inter-country disputes. Neofunctionalists such as Haas (1975) critiqued functionalists’ neglect of domestic politics and contended that integration could take place only with the support of the political elites. Similar concerns about the political abilities of the Internet-obsessed technical elites and the political viability of globalisation are being voiced today.

Interdependence theories pointed that multiple linkages among countries lead to reciprocal effects and reciprocity connotes interdependence. They debated the extent to which integration with the global economy constrained governments; ‘obstinate or obsolete’ as Hoffmann (1966) put it. In contrast to the realists (Morgenthau, 1978), they focused on the importance of economics in international relations. International regimes and institutions – implicit or explicit principles, rules, norms, and decision making procedures around which the expectation of the actors converge in a given issue area (Krasner, 1983) – were identified as tools for constraining governments, enabling them to cope with interdependence.

Is the current phase of economic integration different in terms of its institutional challenges? Are governments more constrained in pursuing economic and social agendas? Globalisation differs from ‘complex interdependence’ (Keohane and Nye, 1977) in terms of the role and capacities of national governments in relation to market actors. Complex interdependence scholars challenged neorealists by highlighting the complex and reciprocal nature of linkages (in terms of ‘sensitivity’ and ‘vulnerability’) among countries. 8

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8 For example, Raymond Vernon’s treatise (1971), Sovereignty at Bay, made this argument. Kindleberger (1969, p. 207) even asserted that ‘the state is about through as an economic unit.’

9 In their reply to the interdependence scholars, Gilpin (1987) and Krasner (1976) provided a political explanation for the emergence of liberal institutions of international economic governance. They contended that instead of constraining, international regimes served the objectives of the dominant powers.
However, by continuing to subscribe to ‘methodological nationalism’ (Cerny, 1997), they did not question the state centredness of the Westphalian paradigm. In contrast, globalisation debates question the emphasis on Westphalian territoriality. With the ‘stateless’ MNEs emerging as the primary resource allocators, policy spaces are less defined by political jurisdictions.

\[ a. \text{ MNEs and Globalisation} \]

Multiple indicators reflect the MNEs’ key economic role in the contemporary world economy (UNCTAD, 1999): inward FDI stock has surged from $1 trillion in 1987 to $4.1 trillion in 1998;\(^{11}\) intra-company trade now exceeds arm’s-length trade ($5.3 trillion versus $4.8 trillion in 1993); MNEs’ value chains account for about 7 per cent of world GDP (5 per cent in the mid-1980s) and one-third of world exports (about one-quarter in the late 1980s).

How globalised are MNEs? Do they locate the critical functions – R&D, systems of innovation and corporate finance – in the parent country?\(^{12}\) If so, then globalisation is really the economic domination of the home countries via MNEs, a repeat of the East India Company model. Further, globalisation processes will only strengthen the Westphalian system because governments have incentives, perhaps even obligations, to defend and to promote domestic firms and home-based MNEs. After all, governments continue to actively engage in commercial diplomacy. An examination of governments’ strategies in GATT’s Uruguay Round, the MAI, and the Kyoto conference suggests that ensuring a fair deal for domestic firms remains a key item on governments’ agendas (Levy and Egan, 2000).

International Business literature has examined the subject of MNEs’ transnationality both at conceptual and empirical levels (Kobrin, 1991; Sullivan, 1994; Ramaswami, Kroeck and Renforth, 1996; and Makhija, Kim and Williamson, 1997). The World Investment Report (UNCTAD, 1998) presents a transnationality index that is the average of three ratios: foreign assets to total assets, foreign sales to total sales, and foreign employment to total employment.\(^{13}\) The 1996 levels of transnationality vary within and across industries (from 67.2 for food and beverages and 65.0 for chemicals and pharmaceuticals to 29.0 for

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\(^{10}\) Schwartz (2000) suggests that current globalisation processes are a continuation of a long term trend of global market integration that was interrupted by the Depression and World War II.

\(^{11}\) This paper follows the UNCTAD (1999) definition of FDI as the sum of equity flows, inter-company loans, and reinvested earnings. It does not include the funds raised by MNEs’ affiliates in domestic or international capital markets that sometimes exceed equity flows. Clearly, if these were to be included, funds controlled by MNEs would be substantially higher.

\(^{12}\) The subject of globalisation of R&D is much debated. Patel (1997) documents that the vast majority of inventions are developed by firms in their home country while Cantwell (1997) argues the opposite.

\(^{13}\) This index has been criticised on two grounds: it does not control for the size of the parent country, and for the spread of sales, assets, and employment across foreign countries.

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trading companies). The mean transnationality index for the top 100 MNEs increased from 51 (1995) to 54.8 (1996) indicating that MNEs are still rooted in home countries (Pauly and Reich, 1997; and Prahalad and Lieberthal, 1998).

In sum, this discussion suggests the following: (a) cross-border economic integration is not a new phenomenon; (b) the levels of cross-border linkages have increased dramatically though they exhibit significant variations across countries and regions; (c) MNEs have emerged as key agents of cross-border integration; (d) MNEs vary significantly in their levels of transnationality and most firms, especially the ones headquartered in large continental economies, can still be associated with specific countries. The next section examines the impact of globalisation on economic governance.

4. EFFECTS OF GLOBALISATION ON ECONOMIC GOVERNANCE

Governance is simply organising collective action. In the instrumental sense, governance entails establishing institutions; institutions being the rules of the game that permit, prescribe, or prohibit certain actions (Ostrom, 1986; and North, 1990). In contrast to institutions, organisations are physical actors having budgets, headcounts, and resources. To illustrate, the United Nations is an organisation while its rules and policies are institutions. Similarly, MNEs are organisations while markets are institutions.

By altering incentives, institutions facilitate collective action, enabling actors to pursue their individual and communal goals. If the benefits and the costs are asymmetrical across actors, institutional evolution and change could be conflictual. New or modified institutions could be either Hicks-Kaldor superior (generating net benefits at the aggregate level) or Hicks-Kaldor inferior (the losses of the ‘losers’ outweigh the benefits of the ‘winners’). Since institutions are political artefacts, it is important to examine how they evolve, whose preferences they reflect, and how they influence human behaviour.

An important debate centres around the impact of globalisation on the twin institutions of the Westphalian state and the welfare system. In the Westphalian system, the state is the major agency to supply collective goods and state-centric security considerations play a dominant role in international relations. The contractarian Hobbesian perspective views the emergence of states leading to

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14 Regimes and institutions are functional equivalents: facilitate collective action by encouraging information flows, by providing arenas for bargaining, and by establishing mechanisms for monitoring and enforcing contracts (Krasner, 1983; Keohane, 1984; and Young, 1986). Sociological theory, however, offers a non-contractual and non-utilitarian view of institutions. For a recent review, see Sandholtz (1999).

15 The Westphalian system is also under challenge from a resurgence of civil society as well as the increasing emphasis on the ‘third sector’ (Lipschutz, 1992; and Mathews, 1997).
improvements in citizens’ quality of life that was hitherto ‘solitary, poor, nasty, brutish, and short.’ Pigou (1932) saw governments necessary to counteract market failures, thereby increasing aggregate welfare. Marxists also provide an instrumental justification for the emergence of the state – to safeguard the collective interests of the ruling classes.

Though first introduced by Chancellor Otto von Bismark in the nineteenth century, the notion of a welfare state draws intellectual legitimacy from the Keynesian philosophy that markets are not self-regulatory, therefore requiring state interventions to provide social insurance and to even out business cycles. Ruggie’s (1982) notion of ‘embedded-liberalism’ provides a political justification for the welfare state as well. This suggests that for maintaining domestic peace, the costs imposed by liberalised trade on labour are to be offset by side-payments in the form of social safety nets such as unemployment insurance, old-age insurance, and welfare payments.

There are three broad perspectives regarding how globalisation may impact the Westphalian system and the welfare state (Prakash and Hart, 1999). First, the nation-state will wither away – de facto though not de jure. The reason is that the net costs of government failures (Wolf, 1979) exceed the net costs of market failures (Weimer and Vining, 1992) that governmental interventions are supposed to correct. The second view, in contrast, views business-as-usual for the state since the existing instruments of economic policy are sufficient to handle the challenges posed by globalisation. The net costs of market failures remain sufficiently high and outweigh the net costs of government failures. The third perspective is that the state will neither wither away nor remain unchanged. States will rearticulate themselves by shedding some political and economic functions and adopting new ones. Of course, whether and how they do it will vary. The relative weights of market and government failures will vary within and across countries. Further, though government failures could be addressed by the retreat of the state, governmental policies could be reconfigured to correct/reduce these failures. These perspectives are examined below.

a. Obsolete versus Holding Fort

Some suggest that the Westphalian system is on its last legs, and the world is heading towards some sort of a new political order that resembles the (non-state-centred) medieval period. Given that globalisation is inexorable and inevitable, the arrival of a ‘borderless world’ (Ohmae, 1991) is imminent. Governance institutions in this global village will be constituted at subnational and supranational levels and, consequently, citizens will have loyalties to multiple jurisdictions (Kobrin, 1999).

It is also contended that globalisation processes have led to the spread of democracy. Given that democracies almost never fight each other (Russett,
national security will be relegated to economic issues. Ohmae notes that:

Under cold war assumptions, government officials fall back on arguments that countries have to be prepared for emergencies – that is, war. Inefficient industries are subsidised in the name of national security. Meanwhile, Singapore and Hong Kong don’t worry about ifs. In theory Singapore can’t exist because it has no insurance, either in the form of military or strategic (read protected) industries. Yet, it enjoys current prosperity. I believe that the Singaporean solution is the right one, because in the global economy, economic linkage increases security (1991, pp. 13–14).

In contrast to the above perspective, others contest whether governments have become powerless compared to the MNEs and financial markets, and whether the ‘stateless corporation’ has indeed arrived. For them, the state-centred Westphalian model still holds, governments continue to remain powerful in the economic sphere, and the national origins of MNEs remain important for both business strategy and public policy (Tyson, 1991; Carnoy, Castells, Cohen and Cardoso, 1993; and Pauly and Reich, 1997).

Kudrle (1999) disputes that economic integration has narrowed the scope of effective policy instruments that states can employ to advance the welfare of their citizens. He debunks four common misperceptions: ‘Reinventing Government’ can be attributed to globalisation, devolution is a manifestation of globalisation, after-tax income inequality in industrialised countries has increased due to foreign trade, and deregulation has been forced by globalisation. He concludes that most of the challenges associated with globalisation admit to effective responses at the national level. And, others can often be dealt with by cross-national policy harmonisation.

Apropos relegating security issues to the background, the strife in the Balkans, the continuing stalemate in the Middle East, the increased tensions in the Far East, and the nuclear blasts in the Indian subcontinent suggest that security considerations remain important in international relations. The Westphalian state is alive and kicking.

\[b.\] The Rearticulated State

In contrast to the obsolete versus functional perspectives, some suggest a middle ground. Given the pressures from the processes of globalisation, states will not be able to do business-as-usual. They will not collapse either; rather, they will rearticulate by modifying their institutions and policies. Government failures

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16 The clash of civilisation thesis also suggests the continued importance of security issues. Huntington (1996), however, identifies the ‘civilisation,’ and not the nation-state, as his unit of analysis.
do not automatically imply that markets will function efficiently or vice-versa (World Bank, 1997). Further, though national security concerns will remain important in international relations, the notion of security itself will be reformulated and acquire new dimensions.

For the rearticulation to be successful in meeting the challenges of globalisation, state bureaucracies must have the incentives and the abilities to regenerate themselves. They must overcome the opposition from social actors interested in preserving the status quo. Further, they need to actively involve non-state actors (often with different preferences and endowments) in institutional design and implementation. As Evans (1997) suggests, states could develop capacities to co-produce collective goods with their citizens – a theme that has resonated in the Public Choice literature of the 1970s (Ostrom and Ostrom, 1977). He points out that in the post-World War II era, states took upon themselves more functions and responsibilities than they could handle. Thus, the attrition of the state is a corollary of the ‘capacity gap.’ He, however, notes that the capacity gap cannot be bridged by old strategies, particularly because of the hostile ideological climate.

States will perhaps delegate some of their functions upwards to supranational institutions as well as downwards to local governments. Thus, federalism and creating supranational institutions (regional and global) will go hand-in-hand. States will become structurally and functionally differentiated and a single level structural hegemony – statism, regionalism, or multilateralism – will not prevail (Cerny, 1999). The logic is that the Westphalian state is no longer the most efficient unit of aggregation for supplying various collective goods.

Which functions states will shed or adopt depends significantly on structural constraints (for example, commitments to international institutions such as the World Trade Organisation), domestic politics and the economic costs of not doing so. States are not alike in terms of their capacities and willingness to rearticulate themselves. Thus, an important area of future research is to develop a typology of states based on their internal and external attributes and predict what types of states are likely to undertake policies to rearticulate themselves.

5. POLICY CHALLENGES FOR THE REARTICULATED STATE

This paper takes the view that most governments have the incentives but only few may have the resources (material and institutional) to rearticulate themselves: the demand for rearticulation is high but the supply may not be forthcoming easily due to constraints within the domestic political economy. The international environment may also not provide much help, material or otherwise. Multilateral aid flows have decreased in absolute terms and there is a general ‘aid fatigue’ in developed countries. So, the hope lies in domestic reforms that would enable citizens to exploit opportunities created by global market integration.
Domestic challenges are manifold, however. Processes of globalisation will create ‘winners’ and ‘losers’ in the domestic political economy. In the US, the ratio of top executive to factory worker pay has dramatically increased over the last two decades: from 42 in 1980 to 419 to 1998 (Washington Post, 1999b). The Congressional Budget Office’s data suggests that the richest 1 per cent Americans (2.7 million individuals) account for 12.9 per cent of all income (7.3 per cent in 1977) and receive after-tax income comparable to the bottom 100 million (49 million in 1997) (New York Times, 1999). That foreign trade asymmetrically benefits factors of production (Rogowski, 1989; and Midford, 1993), sectors or industries (Magee, 1980), and firms (Milner, 1988) is well established: for example, factors employed intensively in import-competing industries lose, and factors employed intensively in exporting industries gain. In a pluralistic society, losers can be expected to oppose globalisation processes, and winners to support them. Public policy is an outcome of such conflicting pulls and pressures filtered through multiple institutions.

Political pluralism may also create incentives for re-emergence of primordial loyalties, making it difficult to institute change. In countries divided by caste, religious, tribal, and linguistic loyalties there are multiple veto points. A good example is India where caste has emerged as a potent (and in my opinion) destructive social institution due to electoral politics and has created multiple veto points to institutional change.

Clearly, the ‘rulers’ may not have incentives to usher in changes that facilitate economic growth (North, 1990). Even if the governments have the incentives, they may not have the material and/or institutional resources. Deficits in material resources can perhaps be bridged by tapping international markets. To successfully do so, international creditors and investors will require credible assurances regarding political and economic risks. This, in turn, may necessitate a ‘strong’ state that is capable of protecting property rights and is not captured by interest groups (Wallerstein, 1974; for a critique of Wallerstein’s notion, see Mastanduno, Lake and Ikenberry, 1989). States can be strong and weak across policy arenas depending on factors including the resources at the disposal of interest groups, their preference intensities, and institutional foundations of policy processes. Totalitarian states are not always strong and democracies not always weak. Governing coalitions in the former are often dependent on actors such as the army, the party, and the labour unions that may be harvesting significant rents, and therefore opposing institutional change.

17 Krugman (1994), however, argues that international trade accounts for only 20 per cent reduction in the earnings of low-skilled American workers. The main culprits are in the domestic economy – a slow growth in domestic productivity and slower increases in demand for unskilled labour relative to that of skilled labour.

18 For a review of literature on the relationship between regime type (democracy versus dictatorship) and economic growth, see Przeworski and Limongi (1993). They conclude that the literature does not provide conclusive answers, theoretical or empirical, about this relationship.
However, strong governments could expropriate wealth—a classic dilemma in the study of political economy (Weingast, 1993). Expropriation could involve outright confiscation (as in Idi Amin’s Uganda) or violating the terms, implicit or explicit, of contracts, thereby not allowing investors to profit from their investments (such as imposing capital controls in Malaysia). To soothe fears about expropriation, governments create credible institutions that weaken their expropriatory power. They could create an independent judiciary, for example, to serve as a protector of property rights.

In the light of the above discussion two generic policy challenges can be identified:

\[ a. \text{ Attracting MNEs} \]

Countries are in a race to become attractive locations for MNEs. Arguably, attracting MNEs is not the only route for economic development. Statist models (as in France) as well as the Keiretsu/Chaebol led industrialisation in Japan/South Korea demonstrate the possibilities of industrialising without relying on foreign MNEs. The structural conditions are different now, however. The new rules of international trade and investment constrain governments seeking to provide protection to domestic industries that France, Japan, and South Korea afforded in the 1950s and the 1960s. ‘National treatment’ of foreign firms is the battle cry. Second, high levels of R&D costs require firms to sell and procure globally. Import-substitution and protected home markets are clearly not appropriate for these tasks. Developing home MNE-based networks entails significant start-up costs. Thus, joining global value chain networks is a requisite for being competitive in international markets. Not surprisingly, the 1990s has witnessed a wave of cross-border consolidation, through outright M&As or through strategic alliances (as in the airlines industry).

Formulating coherent and politically feasible strategies to attract MNEs remains a challenging task. A key issue is: what can a country offer to MNEs that others cannot? In other words, what is the comparative advantage in relation to other countries for MNEs to locate their activities? While undertaking FDI, MNEs could have multiple objectives in mind: exploiting location-specific resources (resource-seeking: plantation MNEs in Latin America), lowering costs (efficiency seeking: software MNEs in India) and/or selling to the local market (market seeking:

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19 Rodrik (1999) is sceptical about FDI’s positive spillovers. He contends that correlation between FDI and economic growth is driven by reverse causality; that is, FDI tends to flow to countries that are more productive and developed.

20 India’s rise as the second largest exporter of software and the evolution of Bangalore as a mini-Silicon Valley is a testimony of how cheap yet skilled manpower can attract the software industry. Most of this efficiency-seeking FDI is export-oriented with Indian programmers employed as subcontractors whose wares were exported to some other country. This has created tremendous

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automobile industry in China) (UNCTAD, 1998). As Dunning’s (1993) Ownership-Location-Internalisation framework suggests, FDI flows take place if MNEs have ownership advantages that can be exploited in a given location only by establishing their own facilities (internalising within firm’s hierarchy as opposed to licensing technology to other firms). Lowering labour and environmental standards (the so-called races-to-the-bottom) potentially attract efficiency seeking FDI only. With declines in labour costs as a proportion of total costs, suppressed wages may not attract significant amounts of FDI. Even if they do, active scrutiny from citizen groups could impose significant costs on MNEs – the apparel and sportswear industries being prominent examples. Evidence also suggests that there is very little systematic migration of MNEs from developed to developing countries to economise on environmental costs.

Governments could also attract efficiency seeking and resource seeking FDI by creating appropriate ‘architectures-of-supply.’ To enhance the economic well beings of their citizens, states and their firms now increasingly compete for world market shares in key industries (Stopford and Strange, 1991). This occurs in the backdrop of increasing ‘technologisation’ of trade, that is, the increasing salience of high technology products in global trade. States can employ strategic trade and investment policies (STIPs) for developing domestic architectures-of-supply (Borrus and Hart, 1994) in critical technologies. Imperfect markets create a potential for super-normal profits and such interventions may shift these profits from foreign to home-based firms. Such architectures-of-supply provide home-based high-technology firms adequate and timely access to new technologies. Consequently, they could become a major ‘pull-factor’ for FDI (Porter, 1990). These architectures could be as simple as a reliable telecom network to a more complex system of state funding for R&D. President Mahathir Mohamad’s vision of a technology corridor is an example of such architectures. As the recent report of the US Presidential Advisory Committee pointed out, the key pillars of the contemporary economy – from microchips to the Internet – can be traced to fundamental research bankrolled by the government.

Architectures-of-supply can be viewed as subsets of industry-specific technology systems that reflect R&D intensities, industrial concentrations, property rights systems, and barriers to entry (Archibugi and Michie, 1997). Technology systems, in turn, are embedded in national innovation systems (NIS). 21 As numerous studies demonstrate, country-specific factors – institutional, cultural, political, and historical – together shape NIS (Nelson, 1993) and there is no ideal NIS suitable for all.

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The upshot of this discussion is that governments can devise multiple strategies to attract MNEs and to create architectures of supplies. Contrary to critics such as Ross Perot and Pat Buchanan, merely racing-to-the-bottom by lowering labour or environmental standards is clearly not the only/major strategy available to them.

**b. Reforming Domestic Institutions**

Globalisation processes could lead to governmental and market dysfunctionalities if extant institutions cannot efficiently respond to the challenges posed by new industries and reconfigured policy spaces. The types and levels of dysfunctionalities would vary across and within countries. At a generic level, however, governments need to focus on creating domestic institutions that attract MNEs and facilitate quick adaptation to the changing international environment. Such changes could be expected as well as unanticipated. Technological changes can be anticipated somewhat, hence planned for. Unanticipated changes include exogenous shocks, similar to the ones experienced by the East Asian economies in 1997.

Given capital’s exit option, adjustment costs invariably fall on unskilled and semi-skilled labour. MNEs demand flexibility to deploy labour resources. Three types of labour flexibility are required: reassigning to new tasks with or without retraining within a given location, reassigning to another location, and laying off. The managerial ability to undertake these policies is a function of national, sectoral, firm, and plant level institutions as well as the perceived strategic needs to do so. For example, in the wake of temporary economic downturn, managers may not lay off labour if rehiring and retraining costs are sufficiently high.

The issue of labour flexibility is complex for developing and industrialised countries. Economic problems of EU countries such as France are often attributed to, *inter alia*, inflexible and outdated labour laws. French labour laws penalise companies that allow their employees to work more than the legal weekly limit (Swardson, 1998). Can policies be devised to afford labour flexibility? Should they be devised? The post-World War II experience is instructive in this regard. As Ruggie has argued, the tremendous growth in foreign trade (the international liberal

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22 Though this essay emphasises the role of domestic institutions, it recognises the importance of other factors such as an established entrepreneurial class (or a diaspora) that can take advantage of such institutions. Such a class often becomes an important ally of MNEs that wish to undertake FDI. The role of overseas Chinese community in furthering China’s economic growth in the 1990s is noteworthy.

23 Skilled labour is also fairly mobile, perhaps even constituting some sort of an international ruling class.

24 I owe this point to Alistair Howard.
order) was made possible by making appropriate concessions in the domestic political economy in the form of social welfare provisions. The idea behind the ‘embedded liberalism’ compromise was to protect workers who would be displaced by the vagaries of the market. Thus, a collective social insurance financed by taxes was the necessary cost for labour flexibility. The collective nature of the insurance mitigated collective action dilemmas that might have arisen had the managers been given the opportunity to voluntarily join such schemes.

Data for the 1980s suggests that the welfare state has turned out to be resilient: the share of welfare payments as a proportion to GNP has not significantly reduced (Pierson, 1996). One reason is that the growth of the welfare state has transformed the politics of social policy – with concentrated and tangible losses but diffused and uncertain benefits, welfare cutbacks can be politically unrewarding. Thus, the politics of welfare state enhancement is quite different from that of welfare state retrenchment. Data also suggests that rich economies with significant exposure to external trade are strong welfare states (Cameron, 1978; and Rodrik, 1997). This is partly attributed to the increasing capacities of states to fund such redistributive policies as well as the need to placate the losers from free trade (Ruggie, 1982). Further, for any governance system to survive in the long run, it must build legitimacy (McGinnis, 1999). The existing governance institutions, particularly the state, may be better placed to provide such redistributive services than any new ones. However, such institutions must be made accountable. Better still, the potential recipients, especially in the unorganised sector, be given some sort of a ‘voice’ in the institutional structure. Otherwise, the established elites, including organised labour, will siphon off the funds earmarked for social insurance programmes (World Bank, 1997). An examination of India’s anti-poverty programmes of the 1980s (such as the Integrated Rural Development Programme) vividly demonstrates how organised elites, often at the local levels, can significantly reduce the effectiveness of such programmes.27

25 As Stephens, Huber and Ray (1999) demonstrate, the degree of roll-back has differed across regime types (Christian Democratic, Liberal, and Social Democratic) and entitlement types (such as pensions, healthcare, and public employment). Pensions were the most resilient to roll-backs while sickness pay, disability payments, and unemployment allowances fared the worst.

26 There is a gender gap in the support for the welfare state. Because women, as producers and consumers of welfare services, have benefited significantly from the expansion of the welfare state, they are its key defenders. Nordic women have opposed European integration primarily because of the fear that it would lead to rolling back of welfare provisions (Kitschelt, Lange, Marks and Stephens, 1999).

27 Unlike many others who are uncritically excited about the role of the civil society and community groups in public service delivery, I view this issue as being complex. Defining communities can be problematic in regions with ethnic, linguistic, and religious diversity. Further, some structures in the civil society can be very oppressive, often ossifying social inequities and dysfunctions. Since I do not see NGOs as different from other interest groups who pursue their respective agenda, I do not want to uncritically privilege the former over the latter.
Katzenstein (1985) has pointed out that corporatist structures giving ‘voice’ to labour, enabled small European economies that were highly dependent on foreign trade to rapidly adjust to the changing patterns of demand. Thus, it seems that institutions ensuring domestic equity help to create long-term conditions that protect international trade. Free traders need to ‘buy peace’ by assuring citizens that their economic interests will not be sacrificed at the altar of free trade. This is even more important today, given the wide-spread anxieties regarding the impact of globalisation on domestic institutions. Though opposition to free trade increases during recessions and economic doldrums, it is important to note that President Clinton was unable to persuade the Congress to grant him fast-track authority, notwithstanding a historically low unemployment rate in the United States. This is not surprising as a Wall Street Journal poll showed that 58 per cent of Americans believe that foreign trade is ‘bad for the U.S. economy because cheap imports hurt wages’ (Borosage, 1999).

In his recent book, The Third Way, Anthony Giddens (1998) argues for reconstructing the welfare state into a ‘social reinvestment state’ that provides resources to citizens for risk taking. The idea is to encourage entrepreneurship while providing partial insurance against risks. This structural transformation is important as firms increasingly seek to subcontract their activities rather than manufacture components in-house. As the traditional Fordist mode of production is dismantled, citizens need to rely on their own genius for employment. Robert Reich’s (1992) proposal of investment in human capital (as opposed to instituting industrial policies to support national champions) can be viewed as one manifestation of the social investment state where the state provides training to workers with different skills and at different points in their careers. However, skills imparted in business co-ordinated economies may be company-specific, thereby hampering labour mobility and employability. As long as these economies offered life-long employment, the nature of skills imparted was not a major issue. However, if such employment regime withers away, the usefulness of such training for labour becomes problematic. The Swedish approach is instructive on this subject. The government’s labour market policies absorb 7 per cent of the budget, 70 per cent of which goes towards training and placement programmes. The idea is that governmental policies should facilitate job creation at the high-wage level (UNDP, 1999, p. 91). Such training programmes can be implemented through bipartite

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28 In ‘business co-ordinated market economies’ as opposed to ‘liberal market economies,’ training and acquisition of skills is organised within companies and/or in public education systems with active involvement of both companies and unions (Kitschelt, Lange, Marks and Stephens, 1999). The challenges of imparting vocational training and establishing mechanisms for continual skill upgradation are therefore more severe in liberal market economies. Not surprisingly then, involvement of governments (federal and/or subnational) becomes critical in establishing such institutions.
partnerships with the private sector or tripartite partnerships that include workers’ organisations as well (Mitchell, 1998). Many such programmes are already in place in at least fourteen countries including the United States, the United Kingdom, Denmark, Spain, Japan, Malaysia, Chile and India. For example, Denmark’s adult vocational training programme, the AMU system, provides 1800 different educational plans covering a whole range of skills required in the labour market. Employer organisations and trade unions provide input to the government-instituted National Labour Market Authority about training content. Under the 1991 collective agreement between employer organisations and trade unions about 1 million of the 2.9 million private sector employees are entitled to one week of training every year (Olesen, 1997).

To summarise, this section argued that though governments need to devise policies to attract MNEs, indulging in races-to-the-bottom is not the only route, perhaps not even a desirable route. MNEs have multiple objectives in undertaking FDI and governments need to carefully assess their country’s strengths in this context. Second, to attract FDI, governments must afford labour flexibility. How they actually implement this will vary within and across countries. Labour flexibility can be made politically feasible by increasing the levels of social insurance to protect the well-being of displaced labour. Otherwise, there will be political backlash that could eventually undermine support for free trade and investment. Further, as the East Asian experience suggests, instead of a tradeoff, equity and growth go together (World Bank, 1992). An argument for equity does not imply governments should give a blank cheque to citizens, thereby creating moral hazard problems. I am making a case for empowering workers and other constituents that bear most costs of labour flexibility. This could involve extensive labour training programmes, job search programmes, adequate compensation and notice prior to laying off, and medical insurance in-between jobs and in the new jobs.

6. CONCLUSIONS

Undoubtedly, global market integration is structurally transforming the ways in which economic activity is organised in factor, input, and final product markets. As a consequence, new forms of market and government dysfunctions are emerging. With the rise of MNEs as key economic actors and the rapid growth in cross-border financial flows, national governments face new challenges. This paper identified three perspectives on how national governments may respond – retreat, hold fort, or rearticulate. Perhaps, these are better viewed as three categories of responses that governments could adopt across issue areas. Benefits and costs of various strategies need careful assessment. As Dani Rodrik observes:
Openness to the world economy can be a source of many economic benefits. But these are only potential benefits, to be realized in full only when the complementary policies and institutions are in place domestically. The claims made by the boosters of international economic integration are frequently inflated or downright false ... the relationship between growth rates and indicators of openness – levels of tariffs and non-tariff barriers or controls on capital flows – is weak at best (1999, p. 1).

Before embarking on new institutional adventures, policymakers must bear in mind that globalisation is neither inexorable nor irreversible. Institutional changes could result in self-fulfilling prophecies new economic blocs and international agreements to facilitate flows of goods, services, capital, and humans may lead to deeper forms of integration.

In addition to domestic political economy, how governments respond depends on international factors such as the country’s dependence on the international economy, its ability to pass on the costs of restructuring to other countries, and the availability of resources in the international arena. For example, many East Asian countries were fortunate to receive significant financial assistance from the IMF that enabled them to moderate interest rate hikes, thereby preventing even more serious recession. In addition, the vibrant US economy and the open trading system enabled them to partially export their way out of domestic recession. Similarly, many countries seriously affected by the oil price hikes in the 1970s were able to access funds from the commercial banks to meet balance-of-payment deficits. Banks were flushed with funds, the recycled petro-dollars, that were loaned to these countries. Thus access to international support reduces the resource gap – material, financial, and human – that impedes institutional changes, cushions the negative fallout from institutional changes, and provides resources for governments to compensate the losers. Whether governments sensibly use such resources is a different issue, however.

This paper has examined some issues pertaining to rearticulation of states. Governments are not alike, differing in their capacities and willingness to undertake institutional reforms. Some reforms may not show quick results, with lags longer than the electoral cycles. Thus successful rearticulation requires that firms, domestic and MNEs, believe that institutional reforms will continue irrespective of political changes. The nature of domestic socio-political institutions such as the relative autonomy of the state from domestic interests groups, the transparency of domestic decision making, and social and political cohesiveness critically influence firms’ perceptions of the endurance of institutional reforms.

Though this paper has focused on domestic institutional challenges, I recognise that establishing efficient and legitimate supranational institutions to govern cross-border flows is equally important.29 Globalisation processes negate the

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29 There is much discussion on the so-called ‘new architecture’ for global finance that includes establishing institutions that provide early warning signals about the macroeconomic health of
extant notions of territoriality which bedrock the Westphalian system. Internet flows are the most obvious examples highlighting the difficulties for establishing territorial boundaries in the cyberspace. International organisations (IOs) and regimes can perhaps help to govern such flows. However, as evidenced in Seattle and then in Washington, DC, citizen groups are opposing proposals to empower existing IOs or create new ones. Some argue that multilateralism, the basis of such organisations, is no longer viable to ensure co-operation, primarily because of multiplicity of actors. Some left-wing critics believe that most IOs are unsympathetic towards developing countries because MNEs and the industrialised countries dominate the existing IOs (World Bank, IMF, WTO) and the emerging regimes (MAI) (Chatterjee and Finger, 1994; and Shiva, 1997). Critics from both the left and the right point out that IOs are not adequately accountable. This ‘democratic deficit’ is accentuated by the physical and cultural distances between the transnational bureaucrats and the governed. IOs are also accused of suffering from ‘expertise deficit.’ Thus, there is a contention that supranational collective action requires private regimes, not the traditional inter-governmental IOs (Cutler, Haufler and Porter, 1999). Thus, the institutional challenges in the international arena to grapple with globalisation are quite complex.

As we are poised to enter the new millennium, countries face enormous challenges and unrealised opportunities. Economic globalisation is undoubtedly ushering in structural changes that will require careful analysis. The Internet is globalisation’s mascot and cyberspace the defining negation of the Westphalian territoriality. In spite of new opportunities, convergence in the levels of economic development, within and across countries, is not taking place. If at all, income and wealth inequalities are increasing. If long-term economic growth is predicated on income equality, this should be a cause for concern. The dependency and neo-colonialism rhetoric having lost its lustre, developing countries need to focus on reforming domestic institutions, upgrading human capital, and attracting MNEs on their own terms. This paper has outlined some ideas in this regard.

countries, serve as a lender of the last resort, and ensure transparent and common accounting standards. Though opposed by the US, many countries (France and Germany in particular) are also demanding mechanisms to regulate cross-border capital flows especially hedge funds that operate with very high leverages. The collapse of Long-Term Capital Management and its subsequent Fed-sponsored bailout adds credibility to such demands.

30 Interestingly, citizen groups have been criticised on the same grounds as supranational regimes. Mathews (1997, p. 64) notes:

For all their strengths, NGOs are special interests, albeit not motivated by personal profits. The best of them, the ablest and the most passionate, often suffer most from tunnel vision . . . A society in which the piling up of special interests replaces single strong voice for the common good is unlikely to fare well. Single-issue voters, as Americans know all too well, polarise and freeze public debates.
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