Globalization holds tremendous promise to improve human welfare but can also cause conflicts and crises as witnessed during 2007–09. How will competition for resources, employment, and growth shape economic policies among developed nations as they attempt to maintain productivity growth, social protections, and extensive political and cultural freedoms?

The processes associated with economic globalization—such as free trade, business outsourcing, capital mobility, and so on—generate considerable public apprehension because of the economic uncertainty they portend. But cross-national production supply chains have now become so extensive that the recession-induced decline in global trade is causing considerable economic distress in developed countries.

In contrast, emerging countries—especially Brazil, Russia, India, China, and South Korea—have experienced only modest declines in economic growth. As those nations continue to advance economically and output growth in developed nations recovers, the process of globalization will resume. But with the Doha round of multilateral trade negotiations stalled, bilateral and regional trade agreements may come to dominate that process. Regardless of how globalization progresses, policymakers in developed nations remain concerned about whether domestic output and employment growth can recover as rapidly as after recessions past. Those concerns are magnified by prospective population aging in developed countries.

Intensifying foreign competition and employment uncertainty could provoke calls by industry lobbyists and displaced workers for additional government protections. And worker migration toward developed nations will continue, spurred by wage differentials between developed and developing countries. Younger immigrants may eventually help developed nations to ease the economic challenge posed by population aging, but immigrants are often viewed as competing for jobs, adding to public welfare costs, and reducing social cohesion. This paper offers policy recommendations for developed nations to reduce globalization’s negative effects and, indeed, harness it for solving aging-related economic challenges.

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Introduction

Cross-national economic integration through trade has been ongoing for centuries but has accelerated significantly during the last two decades. Many people cite the consistent support of free trade and financial flows by the United States through its military umbrella and maintenance of dollar stability as key factors for promoting globalization. However, several other factors and events were also important: the fall of the Iron Curtain, the introduction of the North American Free Trade Agreement, the internal integration and expansion of the European Union, the introduction of the euro, the growth surge and opening of Chinese and Indian economies to world trade, and rapid advances in information technology during the 1980s and 1990s. These events successively led to a reorganization of production operations across many industries to save costs by employing cheaper offshore labor, utilizing economies of scale, and extending vertical integration by including foreign-based production processes—practices known as “business process outsourcing.”

Apart from increased trade in goods and services, globalization also involves migration by both labor and capital to areas and countries where wages and potential investment returns are higher. Workers in developing nations tend to seek better wages and living conditions in developed ones, but immigrants are often viewed by natives in developed nations as “stealing jobs,” upsetting cultural norms, and reducing social cohesion. In addition, firms that elect to make use of cheaper foreign labor by relocating plants offshore are criticized for out-migrating capital and outsourcing jobs to developing countries. Thus, economic adjustments associated with globalization are often decried as reducing workers’ economic security in developed countries and subjecting developing ones to “imperialist capitalist” exploitation. These views motivate and support tight immigration restrictions and capital controls, and increase political pressure for social and trade protections in many developed countries.

According to standard economic theory, however, globalization can improve citizens’ welfare in both developed and developing countries. In developing countries, expanding trade and capital flows permit increased specialization in production and expansion of employment among low-wage workers—their most abundant resource. Hence, at least theoretically, structural adjustments to trade liberalization policies should pose few problems for developing nations because positive economic growth would generate expanding economic opportunities for most citizens. Moreover, greater openness to foreign capital inflows could foster better financial, institutional, and corporate governance and economic policymaking frameworks in developing countries—the so-called “collateral benefits” of globalization.

In reality, however, globalization has produced winners and losers among low-wage workers in developing countries. Indeed, evidence from the 1980s and 1990s suggests that globalization in developing countries has mainly benefitted more highly skilled and educated workers rather than low-wage workers. This has created a mass perception that pro-globalization policies are intended to benefit particular population segments rather than the nation as a whole. Another problem is that financial liberalization (as distinct from trade liberalization) has induced mal-investment of capital inflows because of risk-mispricing by lending institutions, creating economic instability and crises.

For developed economies, competition from foreign producers is not a new phenomenon. The abandonment of the Bretton Woods fixed exchange rate regime during the early 1970s exposed both producers and consumers to currency fluctuations. For example, the reduction of U.S. inflation by Reagan-Volker monetary policies during the early 1980s caused a steep increase in the dollar’s international value, making foreign goods cheaper for Americans and American goods costlier for foreigners. Imports of Japanese cars, electron-
ics, and other goods generated large U.S. trade deficits and forced structural adjustments in the U.S. economy, which continued to move away from manufacturing and toward services during the 1980s and 1990s.

But the increased pace of globalization since then is feared for its potential to cause higher unemployment and wage stagnation or declines in developed economies. This could happen for three reasons: the out-migration of capital, in-migration of labor, and competition from low-wage foreign workers via their exports of cheaper consumer goods and services to developed nations. To avoid unemployment or significant income losses, workers in developed nations must further improve their skills and move to sectors with higher-value-added jobs. If displaced workers are not rapidly absorbed by other sectors, social unrest, demands for larger welfare payments, and demands for increased protectionism will emerge, which may slow the globalization process and prevent full realization of its potential economic benefits.

This has already happened in the wake of the deep recession of 2007–09. Lawmakers in developed nations are narrowly focused on achieving a quick economic recovery through interventions in goods, services, and labor markets. The short-term policy response to the recession has been to adopt large deficit-financed stimulus programs and targeted protectionist measures to spur an economic revival.3 These include bailouts of domestic manufacturers, “short-time” employment programs, and expenditure-switching “trade remedies” to boost domestic output and employment. The latter policies will slow the recovery of trade and capital flows and will slow globalization. Robust and sustainable economic growth can only be restored with the resumption of trade and capital flows—that is, by restoring the globalization process that has been temporarily stalled.

Although globalization increases the ability of nations and market participants to reduce their overall risk exposures—via firms diversifying their input sources and investors diversifying their investment portfolios—it also exposes them to the effects of other nations’ economic policies and offshore economic shocks, as the global financial and economic crisis of 2007–09 revealed in abundance. Besides managing the domestic effects, globalization also raises questions about international economic policy coordination, crisis management, and cross-national re-regulation of “systemically important” sectors such as financial services.

In addition, appropriate policy responses to globalization by developed countries must take into account the formidable demographic challenges that they already face. Their aging populations imply much larger future shares of unproductive citizens who must be supported. Can the benefits of globalization be harnessed to help meet those challenges? Which policies will help to maximize those benefits and promote both faster economic growth and income security? Now that the 2007–09 economic crisis appears to be ebbing, which policies are likely to emerge for regulating risks in financial markets and creating an appropriate “world economic order” for the 21st century?

This paper provides an overview of the current state of knowledge and thinking on these issues—mainly, but not exclusively, from the perspective of developed nations. It begins by looking at the basics of globalization and what it means for developed and developing nations and their populations. It then explores public concerns about how wages, employment, immigration, and communities are affected by globalization and considers the merits of alternative policy approaches. The paper then looks at the roles played by capital flows, trade imbalances, and financial liberalization. The penultimate section discusses the issue of aging populations and how globalization can be harnessed to mitigate the looming fiscal challenge it presents for developed nations. Finally, the paper considers the implications of the new world economic order that some analysts believe will emerge once the current global economic crisis has abated.
A Brief Tour of the Issues

The process of globalization has been ongoing for centuries, occurring in distinct waves. The first modern wave occurred after 1870 but ended as World War I began in 1914, followed by the Great Depression that prompted sharp increases in protectionism. During the first globalization phase, growth in world trade averaged 4 percent per year. Today, however, we are witnessing globalization at an unprecedented pace: world trade has grown at 11 percent per year since 1973, increasing from about 22 percent of world gross domestic product to 42 percent today. During the same period, annual capital flows have surged even faster, from 5 percent of world GDP to 21 percent today.

These two modern phases of globalization would probably have occurred more slowly without explicit promotion and protection under an “economic order.” Protection for trade routes, charters for private companies to engage in global trade, rules of law and property rights in colonies, and so on, were provided by Great Britain during the pre-1914 phase. In today’s phase, the United States provides a security umbrella, the dollar as a stable reserve currency, a strong pro-free-trade ideology, and a significant pro-globalization influence on the policies of international bodies for conflict resolution, trade rules, economic assistance, and so on.

After the 1980s, several developing economies dollarized or pegged their domestic currencies to the U.S. dollar or took other steps to stabilize their currencies. These measures promoted global financial integration by increasing investor confidence in the safety of their funds and in their ability to repatriate profits from abroad. A stable and strong dollar promoted non-U.S. countries to export more goods and services, which motivated them to support pro-globalization policies. Although the dollar’s strength created correspondingly large U.S. trade deficits, a strong U.S. economy and low unemployment after 1982 kept the lid on protests by U.S. exporters who were hurt by the dollar’s strength. The fact that foreign exporters and governments deposited their dollar earnings in U.S. securities—effectively investing the funds back in American companies or U.S. government debt—helped to sustain U.S. domestic investment, to increase demand for U.S. goods and services, and to maintain worker productivity despite a secular decline of U.S. national saving after the early 1980s.

Views about how globalization affects economic development have undergone a dramatic change. Four decades ago, globalization was blamed for uneven development across nations, benefitting already-rich nations at the expense of poor ones through industrial agglomeration—the concentration of productive enterprises in “North” (developed) countries, where they reaped the benefits of being near markets for intermediate and final goods. With the reduction of transport costs and innovations in information and communication technologies, the uneven development appears to be reversing itself. To the detriment of low-skilled workers in developed nations, more companies and industries find it profitable to relocate operations in “South” (developing) countries, which now have sizable markets and cheap labor and other inputs.

This worries policymakers in developed countries, even though the evidence of its potential harm is mixed: major developed economies such as the United States have experienced sizable capital inflows, and immigration into developed nations has not been restricted to low-skilled workers. Indeed, the recent spurt in globalization is associated with an increased divergence in labor productivity growth across nations, leading some analysts to believe that the earlier hypothesis of uneven international gains from globalization retains relevance.

Standard economic theory favors specialization in production and free trade. Given world prices of factors and goods, nations (especially small ones) benefit from moving away from their existing production configuration toward producing more of those goods that are cheaper to produce domestically rela-
tive to their world prices; that is, to reap the “gains from specialization.” If they simultaneously open their economies to world trade—exchanging goods produced at lower cost for ones that are cheaper to produce abroad—they can benefit from the “gains from trade.” Permitting both types of gains maximizes citizens’ welfare given the nation’s endowment of productive factors. Furthermore, opening the economy to foreign investment provides additional resources and technology, accelerating the development of natural and human resources, which eventually accelerates overall economic growth.

Thus, economic theory posits that open trade would benefit a nation’s more abundant productive resources. In developing countries, low- and intermediate-skilled workers are more abundant, while in the developed world, capital owners and high-skilled workers are the predominant resources. The losers would be their counterparts: high-skilled workers in developing countries and low-skilled workers in developed countries.8 However, although one would expect financial capital to flow from developed to developing nations—the latter with higher potential returns on investments—financial capital has flowed into the United States, on net. Economic theory provides no clear predictions about how the benefits of financial inflows would be distributed within nations, developed or developing. As discussed later, a nation’s abundant factor does not necessarily benefit from financial liberalization. The outcome depends on the mix of skills, technology, and capital intensity in production processes.

Who among the public favors free trade? Is this consistent with the expected winners and losers? Survey evidence confirms that the potential beneficiaries from globalization—high-skilled workers—favor increased globalization in developed countries. In developing countries, however, the evidence on attitudes toward globalization is mixed, partly because low-wage workers have so far benefitted only a little from globalization, and not without long delays. What is clear, however, is that most worker groups in developing countries do not favor a return to old economic policies of state control that limit employment-generating private entrepreneurial activities.9

Do policymakers favor free trade? Evidently so, especially among developed economies—as shown by the free trade zones in Europe and North America.10 Despite the fact that greater openness undercuts a government’s ability to finance larger budget expenditures (tax bases shrink faster in response to higher taxes), there is clear evidence that openness to trade is associated with larger-sized governments. Examples of such patterns are provided by Nordic countries that engage in free trade but maintain large social insurance programs.

One reason why free trade is associated with larger-sized governments is that openness to trade and financial flows exposes citizens to external economic shocks, potentially causing economic crises. However, there is little systematic evidence that financial globalization by itself leads to deeper and more costly economic crises. That is because, historically, most financial integration has occurred across developed countries with well-developed financial markets. Indeed, economic crises have been tamer and less frequent among developed nations during the current phase of globalization compared to the one before 1914.11 That suggests such nations have continued to develop better financial and other institutions to minimize the effects of offshore economic shocks. But how far do they yet have to go? It is noteworthy that although vulnerability to periodic economic crises has mostly been a feature of developing countries, the most recent crisis emanated from the United States and has affected developed and developing countries simultaneously.

The story seems to be different for emerging economies that lack well-developed financial sectors. Although trade globalization usually has a positive effect on emerging market economies, financial globalization may not. Financial globalization has historically been associated with greater economic volatility in recipient countries—especially small ones. As discussed in the section on capital flows, although allowing foreign direct and portfolio

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investment permits greater specialization in production and increases trade volumes, it also increases exposure to other countries’ exports, currency fluctuations, economic shocks, and policy changes. A sudden increase in foreign financial inflows can be destabilizing if domestic lending institutions fail to prevent increases in investment in risky domestic sectors and enterprises. Then, any onset of pessimistic economic expectations among the public has a larger potential for becoming self-fulfilling, leading to a crash. One study finds the likelihood of financial globalization–induced crashes to be higher when trade costs are high. This suggests that opening up financial sectors in developing nations would lead to less economic volatility (and lesser demands for social protections by the public) if it were preceded by trade liberalization.12

Finally, although globalization leads to greater demands for social insurance protection by loser groups—for example, low-wage workers in developed nations—it makes financing larger social insurance expenditures more difficult because trade and financial openness itself renders cross-country tax competition more intense. Taxing capital income to increase revenues would trigger capital flight, reducing capital per worker and, therefore, labor productivity and earnings. That means the burden of a tax imposed directly on capital income is shifted onto workers. Taxing high-wage workers instead would cause tax evasion and avoidance through less work. And it would induce skilled workers to emigrate, given the already high marginal taxes that they face in developed countries: such workers are generally more internationally mobile than low-wage workers and have more ways of disguising and shifting their incomes to non-taxed sources.

Thus, the factors demanding social protections the most—intermediate- and low-skilled workers—must either pay more taxes now (that is, self-insure) or transfer the tax burden on to future workers through higher explicit or implicit government debt. Alternatively, governments could limit exposure to offshore economic shocks by reducing the degree of trade and financial sector openness via protectionist economic policies.13 Thus, globalization presents a Catch-22 for developed economies: although cheaper imports enhance consumer welfare, low-wage workers could bear the brunt of the costs through less employment, stagnant wages, and the financial burden and associated distortions of additional social insurance provisions.

Thus, globalization holds implications for many economic issues such as wage growth, employment, immigration, job security, worker skill acquisition, capital flows, labor productivity, and economic volatility. The following sections discuss the policy implications of globalization in each of these areas.

Wages and Employment

Reality is at odds with the theoretical expectation that low-wage workers in developing countries would benefit from globalization. The experience of developing countries is mixed—intermediate-skilled workers have mainly benefitted from expanding business process outsourcing, while wages in some low-skilled sectors have stagnated or declined. In addition, high-skilled workers and entrepreneurs have also benefitted from access to foreign capital and export promotion policies. The resulting economic growth has therefore been associated with higher inequality, at least in the short term.14

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are “safer”—that is, less vulnerable to soon being outsourced.

There is robust evidence that foreign competition is positively related to innovation and vertical linkages with foreign firms. One study attributes the within-industry shift away from unskilled workers (in France) to an increase in the share of imported inputs from 9 percent in 1977 to 14 percent in 1993. Another study shows that which workers gain and which lose depends on inter-country differences in rates of saving and capital accumulation relative to their respective population growth rates. High-saving countries eventually enjoy higher capital intensity, enabling high-skilled workers to capture rents from employment. This implies that globalization redistributes such high-rent jobs, inducing greater cross-country inequality in labor productivity and wage levels. Empirical studies on the U.S. economy suggest that outsourcing low-skilled work abroad has resulted in a relative shift of employment demand toward high-skilled workers by between 15 and 33 percent across industries.

The conventional understanding is that globalization increases income inequality in the developing world. However, one study suggests that such growth in income inequality is an inter-country rather than a within-country phenomenon, and that the impact of globalization has been to reduce overall inter-country inequality by raising incomes of those developing countries that opened their economies to foreign trade and financial integration. Thus the appearance of greater income inequality from globalization arises because incomes of non-globalized countries have stagnated or declined.

The structural adjustments in labor markets implied by these changes can be very difficult for some worker groups and could take a long time to complete. Such ongoing adjustments generate higher frictional unemployment that can persist for decades. The continual downward pressure on wages, increasing specialization, and potentially higher output and consumption volatility from increased exposure to external economic shocks implies greater economic uncertainty facing workers. Indeed, there is clear evidence that worker perceptions of economic insecurity are heightened in industries with more foreign direct investment activity.

It is not surprising, therefore, that the increased globalization should be accompanied by calls to expand social insurance protections for workers and limit the pace of globalization through protectionist policies. Some observers advocate enhanced social insurance support on moral grounds. Given the danger of government creep and ever-increasing generosity of social protections at taxpayer expense, proposals for expanding such protections against the undesirable effects of globalization should be subject to rigorous scrutiny by weighing costs against benefits: that is, whether the income security they purchase is worth the costly distortions to output, employment, and consumption that they bring about from increases in taxes for financing them. Demonstrating that the benefits of enhanced social protections would exceed the costs of funding them is usually very difficult, but such considerations are usually ignored in the policymaking process.

### Immigration

Some observers are concerned that greater globalization will be accompanied by immigration of low-wage workers into developed economies. However, it is not the absolute levels of wages in developed and developing countries that is relevant, but differentials between them at different skill levels. In developed countries, wage premiums associated with higher education and skills have increased rapidly during the last three decades. That would suggest inter-country wage differentials would be highest for those with intermediate and high skills. Indeed, the evidence suggests Mexican migrants to the United States are more educated on average and occupy the middle and upper portions of the income distribution.
wage distribution in Mexico, confirming that conjecture.\textsuperscript{22}

Furthermore, in both the United States and Europe (especially Germany), immigration is not found to adversely affect natives’ wages and employment because the two worker groups are not close substitutes in employment. Rather, new immigrants are similar to and compete with earlier immigrants. Many studies have suggested that immigration leads to lower wages for native workers. However, a recent study that adopts a more comprehensive and dynamic method in evaluating the issue finds a large \textit{positive} impact of immigration on the wages of nonimmigrant workers in the United States.\textsuperscript{23}

Another issue is that immigrants impose costs on federal, state, and local welfare programs. Indeed, the payment of a “replacement wage” (e.g., traditional welfare payments) for which both natives and immigrants qualify without working builds immigration pressure and simultaneously generates more unemployment by reducing the overall demand for workers and reducing their willingness to work.\textsuperscript{24}

If developed nations elect to provide some form of income support (this paper is agnostic as to the wisdom of that choice), then they should remove the perverse incentive against labor market participation by transitioning—in a deficit-neutral manner—to a “wage subsidy” program for native and immigrant workers patterned on the U.S. Earned Income Tax Credit. The drawback, of course, is that gradually phasing out the subsidies at higher wage levels introduces a corresponding work disincentive. However, because wage subsidies are focused on workers rather than on welfare recipients, they increase total employment and, most likely, output as well in the economy, as compared to welfare benefits that are not contingent on employment.

One proposal for regulating the number of immigrants entering developed countries is to levy a head tax on immigrants—graduated by skill or qualification levels. This would enable developed countries to finance wage subsidies or other types of social insurance to native low-wage workers. However, global competition for skilled workers is likely to become more intense with growing needs among developed nations to support their aging populations. Nations that seek limits on immigration through a head tax are likely to lose better-qualified immigrants to other countries. Besides, such a tax would not necessarily attract high-human-capital workers due to borrowing constraints—because most of the wealth of such immigrants is tied up in their future earning capacity. Rather, it would attract already wealthy but not necessarily highly educated immigrants. Furthermore, although this policy is intended to attract high-skilled workers, it runs contrary to the “ability to pay” principle of public economics—a graduated head tax favoring high-human-capital immigrants imposes higher costs on low-skilled immigrants who would lose opportunities to acquire skills and become more productive over time.

The Management of “Community Effects”

Ill-conceived policies in developed economies—such as awarding welfare benefits unrelated to employment—can result in higher unemployment among citizens \textit{and} more immigration, with many new immigrants ending up unemployed. These policies compound the problems already facing immigrants, such as language barriers and insufficient education. Those are the two biggest obstacles that prevent them from becoming economically self-sufficient. Two-thirds of low-wage U.S. immigrant workers are not proficient in English, 30 percent have not completed high school, and 18 percent have less than a ninth-grade education.\textsuperscript{25} In Europe, 40 percent of immigrants originate from another European Union (EU27) country, whereas the rest originate in near equal parts from Asia, Africa, and America.\textsuperscript{26} The diversity of immigrants in Europe generates an entirely new set of issues pertaining to
social and cultural segregation and low economic mobility because of language barriers. Difficulties in finding jobs and alienation from the social mainstream can lead both immigrant and domestic low-wage workers to become involved in black markets and crime. Policy reforms should therefore aim to create an economic environment for attracting high-skilled foreign-born workers and encouraging quicker assimilation of low-skilled immigrants into the national economic and cultural mainstream. The latter is a key element for improving immigrants' economic productivity, especially across their successive generations. Indeed, some analysts argue that in view of developed nations’ prospective need for young workers in key non-tradable service sectors such as health care, better stewardship of such “community effects” is an urgent public policy concern. Similar to the wage subsidy program above, if developed nations choose to publicly provide job training, education, and youth programs, then those programs should be reformed so as to lessen perverse incentives and ease the negative effects of globalization. However, as discussed below, there are serious questions about the benefit of such programs, even if they undergo reform.

**Job-Training Programs**

Although most measures of human capital consider just the level of formal schooling, training on the job is just as important for determining workers’ skill levels. Indeed, the importance of such training is likely to increase in developed countries as rapid technological progress accelerates skill-obsolescence and competition from foreign workers intensifies the need to move to higher-value-added jobs that are less vulnerable to outsourcing. Hence, upgrading skills continuously during one’s career is likely to gain importance for workers in developed nations in order to minimize unemployment spells and avoid earnings declines. The increase in intra-cohort skills-based wage differences since the 1980s has also raised the importance of upgrading low-wage workers’ skills.

What is the best way to increase worker skills? Under competitive labor markets, firm owners and managers have poor incentives to train workers because of the risk of them quitting soon after acquiring new skills. That seems to call for government-run job training programs. But independent government programs are generally unsuccessful in increasing workers’ productivity and wages because such training is divorced from productive activity. Should the government subsidize or regulate firms so as to promote on-the-job training? The answer based on recent studies seems to be “no.”

Under the more usual noncompetitive labor market conditions (created by transactions costs, asymmetric information about workers’ existing skills, inability to observe the degree of shirking on the job, and so on), firms can extract rents by setting wages below workers’ productivity levels. If more rents can be extracted from higher-skilled workers, firms have an incentive to train workers, even in general rather than just firm-specific skills. This directly undermines the case for government job-training subsidies. Government subsidies would also be ineffective because within-firm training levels are difficult to observe.

Thus, some analysts suggest regulating the amount of on-the-job training that workers must receive—perhaps by setting minimum criteria—say, hours or dollars spent per less-educated and low-skilled workers on training. However, such regulation is also unlikely to prove effective: recent studies suggest that wage differences explained by differences in schooling and workplace experience are only slightly reduced when the amount of job training is accounted for. And if government job-training regulations become too draconian, they can distort the amount of training offered by firms or increase the gap between worker compensation and productivity, leading to suboptimal outcomes, not only for worker training but also employment. Thus, recent evidence does not, on balance, support government subsidies or regulations to increase job training by firms.

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However, if developed nations choose to adopt public policies that support job training, those policies should emphasize skill acquisition in future growth sectors such as health care and elder care. For example, U.S. government policies toward community colleges during the 1980s and 1990s appear to have successfully induced curricula geared toward changing local labor markets.30

Wage Subsidies

The earlier discussion suggested that, if developed nations elect to provide some form of income support, replacing welfare payments with wage subsidies would remove work disincentives created by the former for workers with low skills. Could wage subsidies also promote skill acquisition by low-wage workers? The outcome depends on how skills are generally acquired. If labor force attachments alone are sufficient for skill acquisition (learning by doing), wage subsidies would result in more skill acquisition by encouraging more work.31 However, if working and skill acquisition are rivalrous—more work implies less time spent on skill acquisition—then wage subsidies could reduce skill acquisition. These effects probably vary at different skill levels and change as workers progress in their careers.

Hence the total impact of wage subsidies on skill acquisition is likely to be uncertain. Studies on this issue support the “learning by doing” method of acquiring skills—implying that wage subsidies could result in more skill acquisition by lower-wage workers directly, by encouraging greater labor force participation and more work by those already in the labor force.32 Thus, on balance, replacing traditional welfare payments with wage subsidies such as the Earned Income Tax Credit program in the United States removes a disincentive for low-wage workers to work and gain skill. A caveat, as one study suggests, is that because wage subsidies increase the opportunity costs of acquiring skills at low wage levels but reduces those costs at wage levels where the subsidy is phased out, those subsidies would retard skill acquisition by low-wage workers but encourage it for intermediate-wage workers—thereby increasing earnings inequality over time.

Primary and Secondary Education and Youth Programs

Finally, there is an intergenerational component to generating positive community effects among low-wage workers and immigrants. Promoting greater labor-force attachments among adult workers helps in transmitting skills, civic values, and a work ethic to their children. Complementary institutions for fostering better assimilation of migrants and low-wage families over time and for their successive generations are effective, integrated, and competitive primary and secondary school systems for children.

Second-generation immigrants often lag behind their native counterparts in primary and secondary school. School choice has added competition in the U.S. school system, forcing educators to turn out children who can either enter higher education or start out strong in the workforce no matter their background. Recent research shows that competition between schools (whether public, private, or charter) fosters innovation in teaching methods to effectively impart new skills that a changing labor market requires.33 Competition will continue to promote innovation in schooling, resulting in new methods for assimilating immigrant cultures and teaching in settings with growing diversity. Currently, in some communities, charter schools are using both Spanish and English to better assimilate recently immigrated populations.

Recent evidence on government programs points to only partial effectiveness of school-to-work programs in increasing the skill levels of youth—for whom traditional adult job training programs also fail.34 In Germany, the school-to-work programs take the form of apprenticeship systems in different industries; in Japan they operate through contractual arrangements between schools and employers; in the United States, the 1994 School-to-Work Opportunities Act operated until No Child Left Behind removed it in 2001. Such programs, which are more prevalent in Europe
than in the United States, target high school and college graduates, integrating youth employment, job training, and information about labor market opportunities. The faster transition from school graduation to employment fosters stable labor-force attachments at higher wages. Unfortunately, there is no evidence on how long the positive short-term effects persist. In addition, time devoted to these programs implies time spent away from academic preparation for further education that could boost career wages significantly.35

Another facet could be student loans systems (including loan repayment scheduling) that reward the completion of schooling and training, but some current programs in the United States, such as the GI bill, reward people for merely going to school rather than for doing well and completing school.

Finally, policies that induce higher rates of school dropouts—such as minimum wage laws and the provision of generous welfare benefits unrelated to employment—should be revised.36 Policymakers need to be careful to strike the right balance between encouraging work and encouraging the pursuit of more training, especially among younger workers. Too much emphasis on the former could degrade the latter objective. Indeed, in the United States the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (better known as welfare reform) induced many former welfare recipients to begin working, but one study estimates that it also reduced the probability of college enrollment by 20 percent among unmarried females living in low-educated non-two-parent households.37

Capital Flows

The export-oriented growth policies of China and other developing economies and the two-decade-strong consumption binge in the United States and other developed nations led many developed economies to experience massive trade deficits. At its peak, the U.S. international trade deficit equaled $760 billion in 2008. However, trade deficit figures offset gross imports and exports of goods, services, and earnings each year. Taking the ratio of the sum of imports and exports to GDP, which fully reflects the U.S. economy’s exposure to foreign trade, produces the figure of 40 percent in 2008. And even that large number is dwarfed by corresponding ones for major European economies.

Trade imbalances correspond directly with capital flow imbalances that restore “balance” to each country’s international transaction accounts. Large U.S. trade deficits mean that world capital moves to the United States, on net. Much of it is attributed to continued investment by the Chinese government of its trade surpluses in U.S.-denominated securities. However, in terms of gross financial flows, most foreign investments in the United States are accounted for by capital flows from Europe, not from emerging markets: of the total Organization for Economic Co-operation and Development investment flows of $33 trillion in 2007, $16 trillion were directed to the United States. Among the major European economies in 2008, Italy, France, Spain, and the United Kingdom exhibited sizable trade deficits, but Germany and Sweden had large export surpluses and corresponding net capital outflows.

Who Is Engaged in Financial Integration?

Thus the availability of cheap imports from developing countries had the normal effect of increasing consumption and reducing saving rates among developed countries, and increasing net capital flows toward the largest developed countries—mainly the United States. Thus, in contrast to the theoretical expectation that capital would flow from developed to developing countries with cheap labor and growing product markets, capital moved in the opposite direction, on net, during the 1990s and 2000s. Moreover, financial globalization is primarily a North-North phenomenon, enabling citizens of developed nations to better diversify their

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assets. Gross capital flows from North to South relative to total capital are far smaller—just 15 percent of total global flows, although they have grown rapidly from their 1980s share of 5 percent.

Although economists agree about the potential benefits of trade liberalization, they differ on those of financial liberalization. Financial liberalization is just as difficult to implement for developing countries today as it was during the pre-1914 globalization phase. Lacking mature financial sectors, emerging nations are unable to float their currencies if they wish to attract foreign capital because exchange rate volatility would reduce foreign investment inflows. Hence, many choose to peg their currencies to developed country currencies—especially to the U.S. dollar.\(^{38}\)

### Financial Integration’s Economic Effects—What are the Pathways?

Prominent economists such as Joseph Stiglitz and Jagdish Bhagwati believe that financial liberalizations by developing countries would most likely lead to financial collapse and that the “claims of enormous benefits from free capital mobility are not persuasive.”\(^{39}\) The issue hinges not upon whether financial globalization is inherently beneficial or not, but on whether it can be implemented correctly in those countries.

Although greater economic and financial integration permits diversification from narrow production bases, it also induces greater specialization in production and makes countries susceptible to external economic shocks. What are the pathways by which financial flows can lead to increased economic volatility?

First, the empirical evidence on the impact of greater financial openness on national output growth is mixed: several studies find little empirical evidence that fluctuations in national output (and output growth) become more pronounced with greater financial openness.\(^{40}\) However, studies on the short-term inflation/output gap tradeoff—the amount by which output growth must be reduced below potential, on average, to achieve a specific percentage point reduction in inflation—suggest adverse output growth effects from financial liberalization. That is, the sacrifice in output growth required to achieve a given decline in inflation has increased, making output growth more volatile after financial liberalizations.\(^{41}\) Thus, it remains unsettled whether the fluctuations in output growth increase or decrease as a nation opens itself to freer trade and international financial integration.

Second, consumption volatility (fluctuations in consumption growth) should theoretically decline with greater openness to foreign capital inflows. Being averse to sudden declines in their consumption and living standards, most people try to smooth them when faced with negative income shocks. They do so by borrowing when income is temporarily low and saving the extra income when it is temporarily high. Thus, larger foreign capital inflows should allow risk-averse citizens to increase their ability to borrow and maintain smoother consumption profiles over time, despite volatility in income and output. The evidence, however, shows that greater financial openness is associated with even larger volatility of total national consumption (and consumption growth). That is, economic and financial integration does not appear to confer the benefit of improved risk-sharing and consumption-smoothing as economic theory predicts. This is consistent with findings that—given uncertainty over the likelihood that a country would default on its debt—globalization opens some asset markets but closes others, leading to imperfections in risk-sharing within and across countries.\(^{42}\) For example, channels that provided credit to domestic households and firms before financial liberalization may be reorganized when liberalization opens other investment opportunities so that some sectors and consumers experience credit shortages and are forced to downsize or consume less.

Third, the evidence suggests that financial integration induces stronger synchronicity of income and consumption growth across countries, generating more coordinated busi-
ness cycles across developed and developing countries.

Recent studies on the links between a nation’s financial openness and output growth (not output growth volatility) find a positive association, even after accounting for indirect effects such as globalization-induced improvements in macroeconomic policies, corporate governance, and so on. However, the direction of causation—whether globalization induces faster economic growth in a country or whether global capital flows are attracted to countries that already exhibit signs of emergent growth based on good economic and political institutions—remains difficult to decipher. One study that examines the connections between finance, economic growth, and capital market integration over the long term concludes that output growth and globalization are both led by prior development of a nation’s domestic financial sector. A well-developed financial sector directly fosters economic growth but also fosters financial integration with foreign institutions seeking to allocate capital efficiently.

Obstacles to Continuing Financial Globalization in Developing Countries

As mentioned earlier, higher volatility of consumption growth (and perhaps also output growth) associated with greater globaliza-
tion stimulates demand for greater government protections through larger social insurance programs—welfare, unemployment protections, social security, health benefits, and so on. But some analysts point out that financial integration and trade openness are more pervasive today than during the pre-1914 globalization era, yet we do not witness comparably severe financial instability and political pressures for trade restrictions as were common then because of institutional advantages such as better macro-stabilization policies, social welfare systems, and stronger countervailing interests among high-skilled workers and capital owners. Admittedly these views are still evolving; many recent studies do not take into account the current economic crisis. But if macro/monetary policies are successful in stabilizing world economies relatively soon, such views may retain currency.

For developing countries, although financial deepening increases the access of the poor to credit, dysfunctional legal systems and unenforceable property rights reduce the amount of available collateral and compound the credit market problems of adverse selection and moral hazard to limit the benefits of increased foreign capital inflows. The key culprits are corruption or “financial repression” from government officials and incumbent financial firms through political connections that siphon away large chunks of financial investments for personal use.

The channels by which financial liberalization can lead to crises are twofold: by inducing mal-investment by banks and other lending agencies, and by generating a fiscal shock. The first channel usually occurs because of risk mispricing by domestic banks. In part, this occurs because capital market liberalization leads to expectations of higher asset prices, lower cost of capital, and higher incomes in developing countries, which induces investors to take on more risky projects. Subsequent investment losses turn lending booms into busts, starving even viable industries of capital. If a financial panic ensues from widespread bank failures, the loss of output and employment can be quite large. Alternatively, if the government faces a large fiscal imbalance and cannot finance its debt—partly because liberalizations involve reduction or elimination of revenues from tariffs—it often exhorts or forces banks to buy more government paper. If investors subsequently lose confidence in the government’s ability to repay its debts, and they attempt to sell their holdings of government securities en masse, the ensuing decline in the value of government bonds and increases in interest rates creates a large hole on the asset side of bank balance sheets. That can lead to a decline in banks’ viability, a banking panic and, again, a decline in credit availability to viable firms. These factors prevent the world from effectively being “flat” (that is, with lower barriers)
where capital flows are concerned. This lack of flatness has been documented for East European nations and Russia. Poor corporate governance and high political risks pose barriers to obtaining the full benefits of financial globalization. Hence, the role of 21st century financial sector reforms designed to reduce risk exposures of financial firms can be approached in two ways: The first, which will likely be the main focus of the G-20 nations, is preventing international investors—mostly large businesses, pension and mutual funds, investment banks, and so on—from assuming unwarranted risks in their international investment portfolios.

A better approach would be to encourage developing nations to improve their systems of corporate governance, reduce ownership concentrations that encourage policies inimical to shareholder interests, improve public and corporate accounting systems, and promote better political and bureaucratic institutions to minimize corruption. Such measures are more likely to reduce investment risks compared to simply constraining investors’ options. Indeed, the benefits of the latter measures are likely to accrue to both developing and developed countries, the former enjoying smaller risks of capital-inflow-induced crises, and the latter gaining from broader investment options with lower risks.

Population Aging in Developed Countries: How Globalization Can Help

According to the 2009 Aging Report of the European Commission, the old-age population dependency ratio will increase from 25 percent today to more than 50 percent by 2050. That is, instead of four workers (aged 15–64) for each retiree (aged 65+), there will be just two among the EU27 by 2050. Spain, Italy, Ireland, and Slovenia are projected to experience extreme increases in old-age dependency ratios of between 57 and 60 percent by 2050, implying 1.5 workers per person aged 65 and older.

Part of the reason for the projected increase in age-dependency ratios is continued low European birth rates. The number of births per 1,000 females per year has declined from about 2.3 in 1970 to 1.8 in 1990, and to about 1.5 today. Demographers project European birth rates to increase only slightly through 2050. Another factor is increasing longevity: male and female life expectancies at birth are projected to increase by 7.1 and 5.8 years respectively. The looming shortage of young workers for generating adequate economic output for supporting a massive increase in older populations ought to be a first-order concern of policymakers in developed economies.

Assuming a strictly pay-as-you-go social insurance system (inclusive of medical care for retirees), simple calculations under standard productivity and demographic assumptions show how much social insurance taxes must increase to maintain retirees’ living standards when the worker-to-retiree ratio declines. The calculations reported here for EU27 countries as a group are based on demographic and economic projections calibrated according to two European Commission monographs.

Under these assumptions, just maintaining European retirees’ living standards at their 2010 levels would require an increase in the payroll tax rate from 15 percent to 22 percent, an increase of almost 50 percent. Alternatively, if the payroll tax rate were maintained at 15 percent throughout, retiree living standards would decline by 2050 to just 88 percent of their 2010 level. These two alternatives capture in simple terms the dimensions of the economic challenge for Europe as a whole because of an aging population. Note, however, that the foregoing understates the true size of the challenge because it does not take account of the projected faster growth of health care costs per person (because of population aging) compared to productivity growth in Europe.

Increased immigration could provide an alternative to higher taxes, with immigrant laborers providing more revenue to Europe’s public retirement programs. However, the
increase in immigrants necessary to hold the payroll tax rate at roughly its current level is unlikely to be politically acceptable: under one scenario, worker immigration would have to be increased by 1.0 percent of the total population immediately, and the flow of additional immigrants would have to grow at 8 percent per year through 2050. Under this scenario, the payroll tax rate for maintaining retiree living standards would have to increase to 17.3 percent by the early 2030s, but would then decline back to 15 percent by 2050. Alternatively, this increase in immigration would mean that retiree living standards would need only decline 4 percent from their 2010 levels through the mid-2030s, but then recover back to 2010 levels by 2050.53

Under parallel calculations, the aging problem appears to be even more urgent in the United States than in the EU27 because many among the latter have much younger populations. Although the higher projected U.S. birth rate means that the domestic population of workers increases at a faster pace, the retiree population increases even faster, especially through 2030. The United States has a worker-to-beneficiary ratio of about 3.0 today (as opposed to 4.0 for the EU27), but that declines to about 2.0 by 2030 (rather than by 2050 for the EU27). The rate of decline slows beyond 2030 in the United States because, with the baby-boomers retired, only increasing human longevity continues to depress the worker-to-beneficiary ratio. However, the social insurance system in the United States is less generous, with social insurance contributions at only 7.0 percent of GDP today.

Keeping all except demographic parameters the same and repeating the calculations as above shows that the U.S. social insurance contribution rate would need to increase to 15 percent by 2030 and then decline back to about 8.0 percent by 2050. Thus the United States would need to double the social insurance contribution rate by the end of two more decades in order to maintain retiree living standards at today’s levels. Again, the caveat about rapidly rising health care expenditures applies to the United States, perhaps even more strongly compared to Europe.

Thus, maintaining living standards of retirees but at the same time preventing payroll taxes from increasing rapidly (and permanently) in developed economies is a challenge that must be approached by alternative means. One way would be to harness the forces of globalization to better exploit the cheaper factors, resources, and development potentials in emerging markets. Indeed, some analysts hypothesize that vast pools of unemployed workers in developing countries can easily augment the developed world’s labor supply without relocating.54

However, making full use of these resources would require that the current South-to-North direction of capital flows be reversed and existing global imbalances in trade and investment flows be reduced. But the success of this strategy will require considerable improvements in business conditions, economic policymaking, corporate governance, and political stability in developing countries. Such reforms would clearly benefit those countries because, as discussed earlier, reforming financial and trade institutions would enable them to reap the benefits of openness—more investment, faster output growth, and higher living standards—without hindrance by the previously experienced shortcomings of economic volatility and crises.55 Notwithstanding the fact that the current crisis emanated from risk mispricing and mal-investments in the United States, which will probably trigger regulatory changes, leaders contemplating the nature of the new world economic order for the 21st century should continue to prioritize the developmental objectives of financial sectors in emerging markets.

New World Economic Order

The recent economic crisis has led to a sharp decline in international trade volumes and, despite lip service to eschew protectionist policies, many nations have adopted a variety of targeted anti-competitive policies.
The pre-crisis economic order was marked by continued negotiations of trade and financial liberalization within the context of the World Trade Organization’s Doha round. However, the emergence of the so-called BRICK nations (Brazil, Russia, India, China, and South Korea) as economic powerhouses—with increased negotiating power vis-à-vis developed nations—has stalled progress on multilateral trade rules under the Doha round. Another feature of the pre-crisis order was the dollar’s role as a global reserve currency, enabling the United States to maintain low borrowing rates, reap better trade terms, and accrue seignorage benefits. Although the crisis has interrupted globalization, nascent economic recoveries in developed nations and continued economic development of BRICK nations means that the process will eventually resume. Finally, the pre-crisis economic order was marked by global imbalances as financial flows moved primarily toward North countries, chiefly the United States.

United States as Hegemonic Defender of Open Markets

The pre-recession (2007–09) international economic order was that of the United States promoting and protecting international trade and financial integration, almost by default as it has been the only superpower since the late 1980s. The dollar’s relative stability in international markets, despite the emergence of the euro as an alternative currency and despite the accumulation of massive current account deficits during the 1980s and 1990s, is the result of a purely domestic objective of maintaining price stability after the debilitating inflationary period of the late 1960s and 1970s. This made the dollar attractive as an international reserve currency that many high-saving nations (China, oil exporters, Germany, etc.) used as a “store of value.” Those nations’ policies of investing trade surpluses in dollar-denominated financial assets supported the United States’ other domestic policy goals of maintaining free trade and financial openness by sustaining domestic investment and helping to maintain low unemployment despite low U.S. national saving.

The influence of developed nations (not just the United States) on the policies of international lending and regulatory institutions such as the World Trade Organization, International Monetary Fund, and World Bank promoted trade agreements and provided conditional assistance to nations experiencing foreign exchange shortfalls during economic crises. The assistance was subject to nations introducing austere fiscal, monetary, and exchange rate policies for restoring their economies to health. But those policies also promoted moral hazard among private individual and institutional investors, inducing greater risk-taking on international investments. Thus the economic incentives created by the institutional setup of the earlier economic order may have initiated a series of economic crises of which the one that began with the financial panic of 2007–08 is but the latest example.

The fact that the latest economic crisis began in the U.S. subprime housing sector suggests inappropriate regulation (rather than nonregulation) of U.S. and global financial institutions, but also hubris on the part of key policymakers about their ability to prevent a financial sector meltdown from spreading to the real economy. This crisis has raised concerns about appropriate macroprudential regulation of financial enterprises to contain their leverage ratios and risk exposures. But recent G-20 declarations notwithstanding, there appears to be no agreement about how such international “super-regulations” and “peer-reviews” should be designed and conducted in order to maintain open trade and continued growth in financial integration. The confusion is understandable given that the goals of containing risk exposures while continuing an incipient economic recovery and extending global financial integration are fundamentally contradictory.

Toward a New Economic Order?

Because imposing tighter international financial regulations may slow global recovery
from the current crisis, the new international economic order will take some time to emerge. The overt change following a severe financial sector collapse and the recession-induced decline in trade volumes has been the emergence of the G-20 group of nations as the steward of the global economy. However, the emergent order may remain quite similar to the pre-crisis economic order if the United States is successful in containing inflationary pressures and the dollar's exchange value remains unimpaired. That requires a timely withdrawal of extraordinary monetary infusions undertaken in 2008 to aid the U.S. and global economic recovery. In addition, reforms to eliminate massive fiscal imbalances in developed countries will be necessary to prevent taxes from escalating and maintain the younger generations' incentives to continue investing in human and physical capital. Maintaining tax rates as low as possible is clearly a prerequisite for maintaining future productivity growth and meeting emergent challenges on many fronts: population aging, energy conservation, climate change, rising health care costs, and so on. However, skepticism is growing about whether all of the daunting economic policy challenges can be met in a timely manner.

At the microeconomic level as well, the post-crisis economic order is unlikely to stop the erosion of economic security for workers in developed nations—indeed, quite the opposite. If the new regulatory framework being debated successfully preserves the process of global economic integration, workers in the developed world will continue to experience heightened job insecurity and competition from foreign workers. They would be forced to adapt by acquiring new skills and being more mobile. Thus, policymakers in developed nations will face increasing political pressures to reduce these uncertainties via expanded social protections.

The economic crisis of 2007–09 has provoked different responses from different countries. Most have introduced economic stimulus packages to extend unemployment assistance, expand public projects, support investment, and provide assistance to financial institutions to enable resumption of lending activities. Although these supports should be removed as economies recover, they may not be fully reversed as the above-mentioned economic pressures from globalization become more intense and unemployment rates remain high.

Thus, forces that would interrupt globalization and those that would promote it are both present: The recent financial crisis has weakened the developed world economies, promoted “beggar-thy-neighbor” policies that benefited some nations at the expense of others, and eroded support for continued globalization. But regional interests may promote globalization in a fragmented form as countries seek to maximize the advantages of international trade and integration without any global power to enforce international laws, norms, and institutions. However, such a world economic order involves considerable uncertainty and could ultimately turn out to be unstable. Distaste for the consequences of a breakdown of the international economic order—which transpired after 1914 in terms of economic and physical destruction from two world wars—may provide sufficient momentum to allow the U.S.-led order to continue for a few more decades. However, no nation appears capable of stepping into the U.S. role as the United States did when Great Britain was economically spent after World War II. The only candidates are Europe, China, and India, but they are each either not interested or economically and militarily not capable of successfully assuming the role of global hegemon.

**Summary and Conclusion**

G-20 officials are likely to be concerned about the need for reforms to better anticipate and defend against future economic crises, restore balance to global financial flows, and introduce mechanisms for a smoother and more fool-proof process of risk determination to regulate cross-border financial flows and investments. Can and will such controls be
introduced appropriately? Or will regulators overshoot and lengthen the time of recovering from the current crisis and end up stifling long-term economic growth?

G-20 officials focused on designing an economic and financial regulatory order during several recent conclaves. Their September 2009 conclave in Pittsburgh, Pennsylvania, released a 58-point resolution aimed at strengthening financial regulations to ensure greater stability, openness, and transparency of financial institutions’ transactions and introduce periodic peer reviews and “early warning systems” to check if systemic risks are heightened.59

The resolution clearly indicates that G-20 officials are likely to focus on financial sector regulations because the last recession was triggered by poor investment decisions by the largest multinational financial institutions. But the next crisis is unlikely to repeat the mistakes of the current one. Changes in country profiles, of endowed resources, skills, workforce compositions, and so on are likely to occur, indeed, more rapidly than in the past. G-20 lawmakers should, therefore, also consider ancillary objectives, given prospective developmental needs of different countries.

The key issue facing developed economies is future population aging. The key issue for emerging economies is maximizing the use of their resource bases while minimizing volatility from openness to global trade and capital flows. Both objectives appear to be complementary rather than contradictory and should induce participants to accelerate the process of globalization.

Several other areas should also be addressed:

On immigration. The first Bretton Woods system adopted immigration limits to serve national welfare state objectives and satisfy political preferences in democratic developed countries. Some analysts recommend that the next world economic order should achieve a “feasible globalization” via multilateral visa schemes to temporarily expand entry into the advanced nations of a mix of skilled and unskilled workers from developing nations.60 However, others believe that with the advent of new technologies, the physical relocation of a large number of workers to developed countries is not necessary. A reversal of capital flows, from North to South, would be necessary to employ those workers, increase their incomes, and generate greater output for sustaining aging populations in developed countries as well—a win-win result from increased globalization.61 Such a scheme would likely increase incomes significantly despite a relatively small increase in cross-border worker migration.

On social insurance. If developed nations elect to provide support for low-wage workers, that support should be based on policies that do not disincentivize employment and output. Welfare benefits without consideration of employment effects should be rejected in favor of wage subsidies. The latter would increase employment and possibly output, on net, but only if wage subsidies are phased out earlier along the income scale so as to minimize the work disincentives among intermediate skill workers. A second consideration is greater human capital acquisition through improved education and worker training; better assimilation of immigrant and low-wage populations into the national and cultural mainstream, and transmission of a good work ethic and civic values to the next generation. Policies for improving and sustaining such “community effects” would render prospective economic challenges of developed countries easier to meet.

On capital flows. The new economic order appears likely to focus on subjecting private financial institutions to more stringent regulations so as to reduce their risk exposures. But that would constrain global capital flows, whereas the need is to expand them—and not just in the short-term to hasten recovery from the current recession. The key for expanding capital flows, especially toward “South” countries, is reforming emerging countries’ financial systems: better corporate governance, less corruption, and growth-oriented macro-economic policies. These reforms are in the interests of both developed and developing economies as the gains would flow to both. Indeed, the goal of expanding world financial flows,
especially within the South and from North to South, is consistent with the vision expressed at the Pittsburgh G-20 summit—of a shift away from dependence on the United States as the “consumer of last resort,” toward greater participation by developing economies wherein consumers with access to financial resources can enjoy better and more stable living standards.

Other than the United States, no country or group of nations appears interested or is capable of steering the global economy back to normalcy and promoting further global economic integration. But whether the United States can successfully pursue such a course will depend on whether it can maintain a strong domestic economy. The financial crisis has increased skepticism about whether the United States can avoid weakening the dollar through higher domestic inflation. And doubts about political will among U.S. lawmakers to soon reduce unfunded social spending commitments to manageable size are growing. Surmounting both challenges early is essential for maintaining economic vitality through low taxes and preserve progress achieved through globalization during the last five decades.

Notes

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8. Globalization benefits all workers, on net, because it reduces the prices of goods and services through cheaper imports. Therefore, although globalization can make some workers worse off relative to others, the collective absolute welfare of the loser groups could, in principle, be improved.


10. Note that many so-called free trade agreements include protectionist provisions for maintaining subsidies to certain domestic industries and worker groups such as agriculture, steel, mining, and so on.


27. Phelps, pp. 54–58.


31. Note that income effects of wage subsidies generally discourage work effort at higher wage levels.

32. James J. Heckman, Lance Lochner, and Ricardo Cossa, “Learning-by-Doing vs. On-the-Job Training: Using Variation Induced by the EITC to Distinguish between Models of Skill Formation,” NBER Working Paper 9083 (July 2002). The study cautions that the average effect of a wage subsidy on work and skill acquisition responses could mask considerable heterogeneity across worker groups. However, low-wage workers would generally work more and thereby acquire skills.


51. “Paying for the Grey: The 2009 Aging Report,” European Economy (July 2008); and “Public Finances in EMU,” European Economy (April 2008), both from the directorate general for economic and financial affairs.

52. Prospective population growth is set to 0.3 percent per year (including current immigration). However, the worker population is assumed to grow at negative 0.1 percent per year, whereas the population of retirees, initially set at just 25 percent of the working population, grows at 1.6 percent per year. These growth rates deliver an old-age dependency ratio of 0.50 by 2050. The growth rate of the capital stock is set to 0.7 percent per year; capital’s share in output is set to be 35 percent; total-factor productivity growth is set to 1.1 percent per year; and it is assumed that 75 percent of capital is owned by the country’s retirees, the rest being owned by domestic workers and foreigners. Capital returns help to sustain retiree living standards, although with a growing number of retirees, the amount of capital per retiree would also decline under a fixed growth rate of the capital stock. The Social Security payroll tax rate is assumed to be 15 percent in 2010—calibrated according to the share of social contributions in GDP averaged over 27 EU countries.

53. The medium-term increase in the payroll tax rate and decline in retiree living standards occurs because the worker-to-beneficiary ratio continues to decline for a few years after 2010 despite faster immigration. It takes more than three decades for additional immigration and the associated increase in the returns to capital to become significant enough to fully offset the effects of a declining worker-to-beneficiary ratio on retiree living standards.


55. Indeed, historical evidence in the area of labor regulations shows that although domestic pressures gave rise to a latent appeal for labor regulations, nations acquiesced to these demands only when their major trading partners had previously passed comparable pieces of legislation. The outcome was a level playing field in labor laws across trading partners. Such evidence of robust complementarities between trade and regulation stands in...
opposition to the frequent claim, espoused in the late 19th century and echoed in the current wave of globalization, that competitive forces drive labor standards down in a race to the bottom. A similar development may be feasible in other sectors as well, driven by the need to expand access resources and markets located abroad. See Michael Huberman and Christopher M. Meissner, “Riding the Wave of Trade: Explaining the Rise of Labor Regulation in the Golden Age of Globalization,” NBER Working Paper no. 15374 (September 2009).

56. The qualification is motivated by the ongoing debate among political economists about the nature of the United States as an imperialist power in seeking the glories of “empire.” Many American commentators on the left and the right argue against the United States pursuing goals similar to those of Great Britain during the 19th and early 20th centuries—to avoid sacrificing liberty at home for the sake of power abroad. See Niall Ferguson, Empire (New York: Basic Books, 2002).


58. This point was also made by Deepak Lal in a speech at the Metropolitan Club, Washington DC, December 14, 2009.


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