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Comparative Institutional and Policy Advantage:

The Scope for Divergence within European Economic Integration

◆ **Robert J. Franzese, Jr**

University of Michigan, USA

◆ **James M. Mosher**

Ohio University, USA

ABSTRACT

Many expect globalization and regional economic integration to force domestic institutions and policies to converge toward some efficiency-mandated minimalism. Applying basic trade theory to national institutional and policy systems clarifies, however, that the greater force is tax competition (broadly conceived), as abetted by ideology and transmitted and magnified by international financial mobility. Trade rather furthers institutional and policy diversity; and international finance per se tends to reinforce that. Tax competition for global capital, contrarily, does create fiscal pressures, but wholly independently of the efficiency of taxation or tax-financed public activity. However, the political integration that accompanies European economic integration provides a policy-making forum for surmounting the collective action problem of tax competition, sometimes turning economic globalization opponents into political Europeanization proponents. The analysis also highlights three broader conclusions. Export or output growth or specialization in particular sectors suggests only comparative, not necessarily absolute advantage. Trade and, less surely, capital integration tend to reinforce domestic equilibria that sustain existing networks regardless of their

KEY WORDS

- comparative advantage
- economic integration
- convergence
- fiscal and regulatory policy
- institutions

efficiency. Economic integration partly offsets short-run costs of inferior networks, further dampening any efficiency-based pressures for convergence.

Introduction: basic trade theory and popular fears and hopes regarding economic integration

Popular fears of globalization, most dramatically evidenced recently in Seattle and Genoa, have long hindered the European Union's economic integration agenda. Opponents fear, proponents hope, and both expect some vague combination of advancing freedom of international trade and financial, cultural, and intellectual exchange will force European political-economic institutions and fiscal and regulatory policies to converge toward some efficiency-mandated minimalism. Exposing European economies to ever-greater internal and external competition, many argue, will force firms to cut training programs and worker involvement, governments to curtail costly social (health, education, welfare, etc.) spending and to balance budgets, and citizens to mold preferences to some Americanized low-cost, low-quality standard in food, entertainment, and other consumption.¹

A basic trade theory conception of the economic performance effects of national institutional and policy systems, however, argues strongly against many such fears and hopes. Trade supports national institutional, policy, and perhaps even cultural diversity. Financial integration has a more mixed impact, reinforcing trade's pro-diversity effect but also magnifying race-to-the-bottom effects of tax competition, broadly conceived. This may produce the expected fiscal constraints of Europeanization, and the mobility of financial capital likely magnifies this effect, but trade per se actually relaxes fiscal constraints on European governments, and capital mobility augments that too. Moreover, such tax competition constraints and their capital mobility enhancement occur regardless of the objective efficiency of taxation or of the public activities that it finances. Thus, whether economic integration should be rightly feared or welcomed from a social welfare view is ideally an empirical but more likely an ideological question. The European Union, however, combines economic and political integration, and this differentiates *Europeanization* from *globalization*. In this regard, the EU can be a policy-making forum for surmounting the collective action problem underlying the tax competition effect. When European policy-makers leverage their wider jurisdictional control in the EU effectively, as in recent moves toward a Social Charter governing work relations, opponents of economic globalization become proponents of political Europeanization and vice versa, as seen for example in British wariness of political Europeanization producing more such action.

This section next overviews the basic logic behind these claims. Ensuing sections elaborate and demonstrate the logic graphically. The conclusion discusses implications for Europeanization threats to national policy, institutional, and, more tentatively, cultural diversity within the EU.

International trade tends to preserve and further national institutional, policy, and perhaps even cultural diversity because national institutional and policy networks shape productive capacities, efficiently or inefficiently but also *differently* across economic sectors. Thus, along with technology and factor endowments, national fiscal and regulatory policies and institutions shape production possibility frontiers and, with them, the comparative advantages that determine national production and exports. Trade spurs production specialization according to comparative advantage (a core lesson of trade theory), which bolsters rather than undermines the diversification of institutional and policy configuration. Trade also expands the economy (another core lesson), i.e. the tax base, which eases governments' fiscal constraints. Meanwhile, trade also severs domestic consumption from production (another core lesson) and so may facilitate satisfaction of diverse cultural preferences – a kind of Tiebout (1956) effect. Especially accompanied by intellectual and cultural exchange, trade could even expand those cultural preferences. In fact, the consumption so facilitated could include sustenance of 'inefficient' production systems (say, traditional agriculture) or greater social welfare, equality, etc. Trade, in short, cannot logically be the source of either fears or hopes regarding Europeanization.²

Insofar as international finance seeks to invest in profitable and growing economic activity, it only reinforces trade's pro-diversification effects. However, financiers also aim to minimize tax and regulatory burdens on investment returns, inducing competition between EU members that does tighten their fiscal constraints.³ Moreover, the basis for the transmission of capital mobility and magnification of this fiscal constraint is largely intellectual or ideological. If owners of mobile capital *believe* some institutional and policy network to be inefficient (e.g. 'Europe is over-taxed and over-regulated'), then even efficient institutional, regulatory, and fiscal diversification suffers financial disadvantages. In fact, these capital-mobility-augmented tax competition and ideological effects occur fully independently of the objective efficiency, i.e. of the social welfare properties, of the taxation or regulation and any public activities or goods they finance or secure. Thus, the welfare implications of any fiscal or institutional constraints arising from economic Europeanization are, ideally, an empirical question, but, as shown below, an exceedingly difficult one, which likely implies that the answers that will motivate policy will be highly ideological.

Europeanization differs crucially from globalization, however, in that the

EU combines political and economic integration. If valid bases for expectations regarding economic integration rest on ideologically abetted tax competition, then effective political integration can reverse them. That is, the strategic situation of individual governments in competing for mobile capital creates fiscal constraints, so political integration can alter the story. The wider political jurisdiction of the EU enables it to harmonize tax and regulatory costs, for example, which would emasculate at least intra-European competition for capital. Thus, political integration in the EU creates a policy-making forum for surmounting the collective action problem that underlies the tax competition effect, which, if used effectively for this purpose, could convert opponents of economic globalization into proponents of political Europeanization, and vice versa.

The following sections develop these theoretical propositions using simple graphical models of international trade. The analysis will stress three conclusions that previous work has often missed. First, trade specialization in some sector (*ceteris paribus*) suggests only that a nation's institutional and policy network is comparatively, and not necessarily absolutely, better than others' in fostering that sector's production. Indeed, even if a nation exports and produces some goods strongly, its national network could be Pareto dominated, i.e. weakly inferior in all goods, including the ones strongly produced or exported. This severely complicates any inference of policy or institutional quality from economic, especially sectoral, performance, even if one has appropriately controlled for technology and endowments. Second, growing trade and financial integration alters the costs and benefits to various domestic interests of both inferior and superior national systems of institutions and policies and so may upset or, more likely, reinforce the domestic political equilibria that sustain them (this is more likely for trade; less so for financial integration). Third, rising trade and financial exposure likely reduces short-run incentives for beneficial institutional and policy reforms by offsetting the costs of inferior national networks. Thus, the EU internal and external free trade agendas more likely favor institutional and policy divergence than convergence, and that is efficient, yet free trade is unlikely to raise political-economic pressures for such improvement and could even strengthen (especially short-run) support for inferior systems.

Varieties of capitalism: effects of national institutional and policy systems

All capitalist societies rely preponderantly on private ownership of the means of production and on markets to organize economic interaction. However, recent scholarly discussions of the varieties of capitalism (for example,

Anglo-Saxon, Rheinisch capitalism, Japan Inc.⁴) stress that, this common base notwithstanding, different market-capitalist societies exhibit markedly distinct national institutional and policy frameworks that condition their economic and political performance in myriad, importantly different, ways. Recent social scientific and journalistic literature addresses this variety in national frameworks in at least three contexts. First, many stress that, because institutions and policy affect economic outcomes and vary cross-nationally, varieties of capitalism produce differences in national economic performance.⁵ Second, some argue further that increasing globalization will increasingly force nations to converge on one set of institutional and policy arrangements and, in particular, a unique set of Pareto-improving arrangements.⁶ Third, others stress instead that the differences across varieties of capitalism can affect countries' advantages in trade, and thus alter patterns of product specialization across nations (Soskice, 1999; Sorge, 1991). For example, the UK specializes in knowledge-intensive production (banking and other services, biotechnology, etc.), and Germany specializes in high-quality, high-diversity sectors: diversified, quality production, or DQP (complex machine tools, upscale automobiles, etc.). This product specialization appears to exceed that which factor endowments and classical trade theory alone could explain. Some link this apparent UK (German) advantage in knowledge-intensive (skill-intensive) goods at least in part to differences in national institutional and policy frameworks (Hall and Soskice, 2001).

Whether they emphasize performance, convergence, or specialization, analysts stressing varieties of capitalism agree that institutional and policy systems shape economic activity within nations (and, in particular, multiple aspects of national systems interact) to produce certain economic advantages or disadvantages. Although the precise meaning of economic advantage varies across analyses, a common conceptualization is that one national institutional and policy system is better, for some industries or in aggregate, than another system if countries with the one engage in more production of certain kinds than those with the other. Yet, anticipating later arguments, obviously no country can produce relatively more of all goods whatever (dis)advantages their institutions and policies confer; rather, all countries will make relatively more of some goods and export them and relatively less of other goods and import them. This implicit conflation of two variants of institutional/policy advantage – comparative and absolute or competitive advantage – fosters such confusion in the literature and among those fearing and hoping for convergence. Basic trade theory can sharpen these conceptions of how institutions and policies affect economic performance, but first we must clarify the concepts of national institutional and policy systems and better economic performance used here.

A country is defined as absolutely better than others are at producing

some good if it can produce more at equal factor input cost; i.e. it has higher total factor cost productivity. A country is globally absolutely better – i.e. its production system is *Pareto superior* and *Pareto dominates* other countries' systems – if it can produce more of any combination of goods with the same technology and factor input. A country could be better at producing some good for many reasons. It could be better at producing food or capital goods, for example, if it is relatively more abundant in land or capital because, by supply and demand, the intense inputs would be relatively inexpensive (assuming limited factor mobility). Thus, factor endowments critically shape national production advantages. Technological differences, too, could make one country absolutely better in some productive activities. Indeed, neo-classical economics typically limits its focus to technology and factor endowments. Expand this now to consider how nations' institutional and policy configurations shape their sectoral patterns of productivity, in effect assuming *ceteris paribus* on technological and factor endowment fronts.

Among national institutions and policies strongly affecting economic performance, scholars have emphasized those in the financial and monetary, education and training, industrial relations, inter-company governance,⁷ legal, property rights, and, of course, fiscal systems (e.g. Hall and Soskice, 2001). The policy and institutional regulation of each subsystem creates multiple economic advantages and disadvantages. For example, financial system arrangements might facilitate certain types of loans, promoting some kinds of investment, but also discourage non-housing savings and hamper other kinds of loans and investment. The education system may produce a highly trained general workforce but few advanced graduates or research scientists. Payroll or capital taxes create, respectively, employment or investment disincentives that relatively hamper labor- or capital-intensive production. These many national institutions and policies and their effects deserve careful individual study, but this analysis will aggregate ruthlessly. Here, national institutions and policies refer to *all* of a nation's political-economic institutions and policies, and their economic effect refers to the *net* effect of *all* institutions and policies. The key aspect for present purposes is simply that policy and institutional arrangements affect national productive capacities and, critically, do so differently across types of productive activities (sectors).

The economic effects of institutions occur along two broad causal pathways. First, institutions can shape economic policies and policy-making (Hall, 1986). For example, concentrating authority in politicians directly elected from and responsive to national constituencies might yield less distributive spending than dividing authority among multiple representatives responsible to many subnational constituencies. In myriad such ways, institutions affect

economic policies, and policies affect economic performance. Second, at a more decentralized and micro level, institutions can directly shape the incentives facing economic actors in their market activity; that is, they can directly alter nations' economic production functions (Hall and Soskice, 2001). For example, British legal systems, derived from common law, seem to support production based on cooperative contractor-subcontractor relationships less well than that based on more competitive, adversarial relationships, in comparison with the German legal system (Casper, 1995).

New institutional economics stresses the impact of institutions on transaction costs as a determinant of economic performance (North and Thomas, 1973; North, 1981; Williamson, 1985). Other authors stress degrees to which firms and/or workers organize into collectivities capable of unified action, which can change what economic actions are optimal (Olson, 1965, 1982; Goldthorpe, 1984).⁸ 'Institutions affect the performance of the economy by their effect on the costs of exchange and production' (North, 1990: 5). Institutions are, therefore, a form of soft technology, not only affecting aggregate economic performance, but also altering how various inputs are most efficiently combined to produce different goods and thus differentially affecting various economic activities. In other words, institutions affect aggregate performance *differently* across sectors. For example, suppose legal system safeguards for contracts and property rights were weakened. Productive-but-risky exchange and, with it, aggregate efficiency would decline. Firms would also substitute other activities for risky exchange as far as possible because the optimal combination of sub-processes in production had changed. Workers and consumers would similarly substitute imperfectly for any procedures involving risky exchange. Critically, though, some productive activities rely more heavily upon risky exchange, so economic actors can substitute less well for them. Thus, the efficiency loss from weakening property rights varies across economic sectors.

More important still for present purposes, economic policies of all types similarly have aggregate effects that differ across sectors. For example, higher capital tax may discourage investment, but some sectors (capital-intensive ones) suffer more from this than others; or, more positively, public investment in basic research may spur technological, organizational, and other advancements, but some industries rely more on these research products than do others. Proponents and opponents of Europeanization seem to neglect the fact that national policies and institutions affect different types of economic activities differently, and that this has implications for comparative advantage.

Basic trade theory and comparative advantage from institutions and policies

The first insight from basic trade theory is that, when two countries trade, one will focus efforts on producing some goods and the other on other goods, they will trade to satisfy their domestic demands, and both will benefit thereby. In short, trade induces specialization among, and produces gains for, all parties. The second basic insight is that trade induces each country to specialize into production of goods in which it enjoys comparative advantage and so to export them, and to specialize out of production of goods in which it suffers comparative disadvantage and so to import them. Absolute (dis)advantage is less relevant. Obviously, if England is absolutely better at making cloth and Spain absolutely better at making wine, then England could make cloth and Spain wine, they could trade, and both would benefit. Such absolute advantage, however, is not determinative. Even if, for example, Spain is absolutely more productive in both, trade produces specialization and gains. The direction of trade, the allocation of specialization, and the presence of gains are determined by productivity in activity 1 relative to activity 2 in country A relative to the same ratio in B (assuming, for simplicity only, two goods, two countries, and different production possibility frontiers). Thus, for example, if the ratio of England's productivity in cloth to its productivity in wine exceeds Spain's productivity ratio in cloth to wine, then trade induces England (Spain) to specialize in and export cloth (wine), and they both gain by this transaction, all regardless of their respective absolute productivities.

Standard trade theory emphasizes factor endowments and technology as sources of comparative advantage, but if institutions and policies affect economic performance, as argued above, then they will also affect countries' advantages, both absolute and comparative. Consider now a two-good (machine tools, banking services), two-country (UK, Germany) graphical model of production, consumption, and trade to illustrate such comparative and absolute institutional and policy advantages. We use the labels UK and Germany here for concreteness only and do not intend any theoretical or empirical claim about these two countries or industries. Assume all factor endowment, technological, and other conditions equal to isolate institutions and policies. As argued above, institutions influence factor and technological accumulation, but, in this simple, static model, assume the countries begin with equal factor endowments. In a dynamic model, which awaits development, institutions would have additional, future effects as the current effects alter factor endowment and technological conditions.

Figure 1 shows the combinations of machine tools and banking services

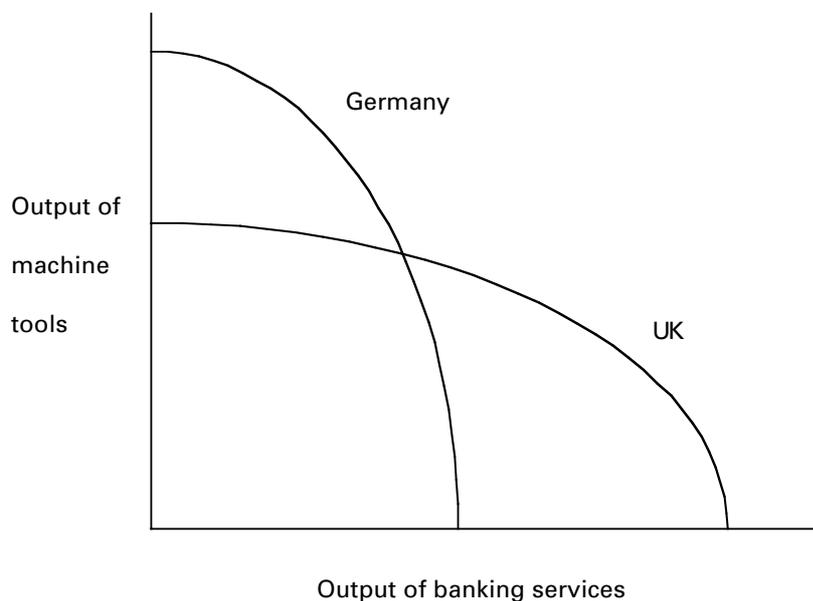


Figure 1 Absolute institutional advantage in one sector.

the UK can produce using its factor endowment with its technologies, institutions, and policies – its production possibility frontier (PPF). As production shifts from banking to machine tools, resources must relocate. Since the first reallocated will be those most effective in machine tools and least in banking services, the curve initially rises steeply from the x -axis and flattens as more resources, increasingly well suited to banking and poorly suited to machine tools, shift to machine tools (diminishing returns). UK technologies, institutions, and policies determine its PPF's curvature, i.e. the marginal cost of machine tools in terms of banking services and vice versa, while UK resources, technologies, institutions, and policies all determine its distance from the origin, i.e. total productive capacity (briefly, wealth).

Figure 1 also shows Germany's PPF, which, by assumption, differs only because its institutions and policies differ. The example assumes the German national system is less favorable to banking service than to machine tool production. Thus, Germany must sacrifice many more machine tools than the UK to make an equal amount of banking services; i.e. the marginal cost of banking services in terms of machine tools is higher in Germany. Note also that, with all resources allocated to one activity, the UK can make more banking services than Germany and Germany more machine tools than the UK. Resources and technologies are equal, so this precisely illustrates absolute

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institutional and policy advantage in machine tools for Germany and in banking services for the UK. Paralleling the simple England–Spain, wine–cloth example above, Germany is absolutely better in machine tools and worse in banking services than the UK, so obviously trade induces Germany to specialize in machine tools and the UK to specialize in banking services, and both gain.

More interesting are cases where one country's institutions and policies are strictly superior and the other's inferior in both goods' production. Figure 2 shows the UK absolutely more productive in banking services, as above, but now also absolutely more productive in machine tools. Using the same resources and technologies, this UK can produce any combination of banking services and machine tools better than this Germany can. With equal technologies and endowments assumed, the example thus illustrates strict Pareto dominance of UK institutions and policies. Perhaps this UK's lower capital tax rates induce more saving and more efficient capital allocation than this Germany's policies, with the efficiency gain larger in banking services than in machine tools.

Now suppose the two countries trade. When, as in Figure 1, the UK's and Germany's institutions and policies produced absolute advantage in banking and in machine tools respectively, the UK produced more banking

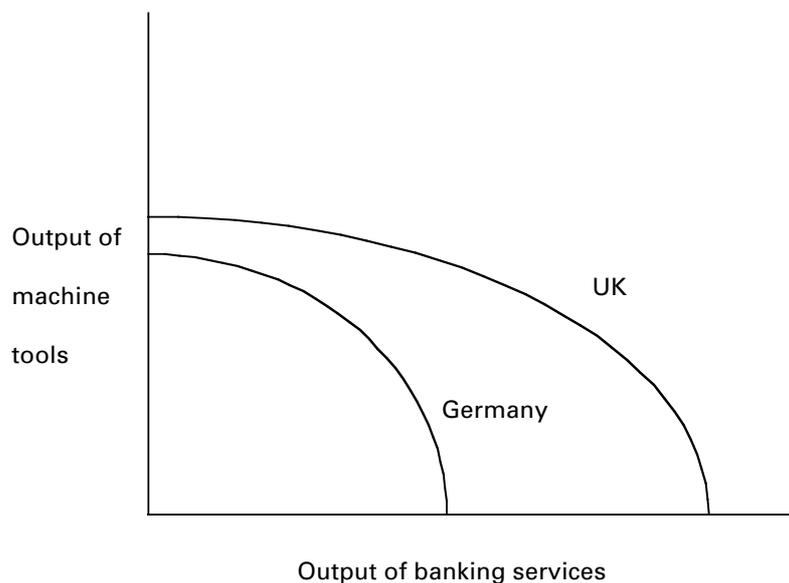


Figure 2 Strictly inferior (superior) institutions.

IC_{Ga} and IC_{Ua} respectively: the ICs tangent to their PPFs. Under autarky, then, Germany (UK) produces and consumes the bundle labeled A_G (A_U). The tangents also determine domestic, autarky relative prices of banking services and machine tools: p_{Ga} and p_{Ua} . Note that machine tools are less costly in terms of banking services in Germany, and vice versa in the UK, $p_{Ga} > p_{Ua}$, reflecting the countries' comparative advantages. Now, with trade, the relative price of banking services and machine tools must equalize at one world price, p_w (net of transport and related costs). p_w lies between p_{Ga} and p_{Ua} here because there are only two countries, but nothing substantive depends on that. At p_w , Germany could produce more machine tools, sell them, and buy banking services, while the UK does the opposite, to consume on a higher IC. Trade thus enables Germany (UK) to produce T_{PG} (T_{PU}) but to consume T_{CG} (T_{CU}); it induces Germany (UK) to specialize in machine tools (banking services), export them, and import banking services (machine tools), and both countries benefit.

Analytically, one key point illustrated in Figure 3 is that mere evidence of trade or production specialization or even of growth does not suffice to determine absolute institutional/policy advantage in production generally or sectorally. Observing specialization and sectoral growth as trade expands, even assuming all else correctly controlled, implies only comparative, and not necessarily absolute, advantage. Scholars often seem to ignore the distinction. Examples of leaps from evidence of growth or specialization to conclusions of absolute advantages abound. The term 'absolute advantage' may not appear, but the inference that some area's specialization and strong performance in some good's production indicates that the area has special facility in such production is clear. This special facility is then linked to local, regional, or national institutions or policies (or cultural characteristics), often without attention to possible resource or technological advantages (comparative or absolute) that could also explain such specialization. For example, analyses of the Third Italy, which specializes in fashion goods and customized machine tools using flexible specialization techniques, attribute this success to institutions and policies in that region giving absolute advantage:

Four coincident factors were crucial to this innovative turn [i.e. successful expansion of flexible specialization production]: the Italian extended family; the view of artisan work as a distinct type of economic activity; the existence of merchant traditions connecting the Italian provinces to world markets; and the willingness of municipal and regional governments (often allied to the labor movement) to help create the infrastructure that the firms required but could not themselves provide. (Piore and Sabel, 1984: 227)

Given trade, the evidence cited – concentration and extensive production,

growth, and exports of fashion and other goods using flexible specialization production techniques – establishes only that Italy is, minimally, less bad at producing fashion goods and machine tools than other goods compared with other countries (even assuming technology and endowments alone cannot explain the observation). Perhaps Italian familial, artisan, and merchant traditions and government willingness to provide infrastructure (i.e. economic policy) indeed make Italy absolutely better than other countries at producing fashion goods, etc., but evidence of growth and specialization alone cannot establish that. As importantly for later discussion, Figure 3 also demonstrates that absolute *disadvantage*, such as inferior economic policies might confer, and on which proponents and opponents have so focused, will also modify comparative advantage. In fact, Figure 3 illustrates the identity of German Pareto inferiority with UK Pareto superiority. Likewise, Italian traditions, institutions, and policies could be globally economically inefficient, but simply less detrimental to flexible specialization than other modes of production, to induce the same Tuscan glories.

Finally, Figure 3 highlights also that trade frees domestic consumption from production. The simple fact that consumption opportunity-sets are larger with than without trade implies that trade allows better fulfillment of social preference functions (obtaining higher indifference curves). This may suggest that, stretching the point, trade can also foster cultural diversity if societies wish it. Not only do trading countries expand production in their comparatively advantaged industries, which are therefore probably established and traditional, but consumers are free to consume more in any combination. Figure 3 shows UK and Germany consuming more of both goods, but, for differently shaped societal preferences (ICs), trade could as easily allow them to consume more of the domestically produced good than they would have without trade if it were highly desired for cultural (or any other) reasons.

This section has graphically illustrated a simple two-good, two-country model from basic trade theory to clarify the distinction between absolute and comparative advantage, accomplishing three tasks en route. First, it demonstrated a procedure – graphing national PPFs that isolate institutional differences by adjusting for resources and technology and applying basic trade theory – by which one can, in principle, compare the production effects of different national institutions and policies. Second, it identified the (exactly) two possible configurations of advantage. A country's policies and institutions could provide absolute advantage in both goods' production (that is, its institutions and policies could Pareto dominate). In this case, either country can enjoy comparative advantage in either good. Alternatively, each country's institutions and policies could create absolute advantage in one good; in which case, comparative and absolute advantage align.⁹ Third, it established

(a) that trade frees consumption from domestic production, (b) that trade induces countries to specialize production where they enjoy comparative, not absolute, advantage, and (c) that, therefore, production or export specialization (or expansion) provides evidence only of comparative, and not necessarily of absolute, advantage in production.

Pareto-dominated systems, trade, politics, and divergence

Next, we use this model to explore the role of domestic institutions and policy in shaping the impact of increasing globalization generally and, in particular, to consider whether and how the EU's free trade advances might foster or retard European institutional and policy convergence or divergence. In particular, does freer trade tighten fiscal constraints on member governments, forcing them to jettison divergent, 'inefficient' economic policies or institutions? In this exploration, we invoke only the more interesting case in which one country's system Pareto-dominates the other's system; extension to the other case is trivial. As in Frieden and Rogowski (1996), define globalization as an 'exogenous easing of international exchange,' which, for expositional simplicity, one can consider by starkly comparing the situation of two countries that do not trade with that of the same two trading freely. Finally, consider initially only globalization of trade in goods, and not in capital, which we consider more briefly later.

As noted, proponents hope and opponents fear that the EU's free trade agenda, by increasing the exposure of national economies to competition, will eventually produce convergence of member country institutions and policies on some 'efficient' minimum. Inferior institutions and policies, the argument goes, retard economic performance, creating ever-mounting political pressure to alter the offending arrangements if domestic producers saddled with these inferior arrangements must compete with less encumbered producers abroad. As shown above, however, inefficient policies and institutions nonetheless confer comparative advantages, and note now also that rising trade exposure will therefore increase returns to those sectors comparatively advantaged and expand the economy (tax base). Still, the Germany in our Figures 2 and 3 achieves less output, wealth, tax base, and social welfare than it could with more efficient institutions and policies. How do such societies persistently retain distinct domestic institutions and policies, even if they are absolutely inferior?

First, countries with different relative land, labor, human capital, and physical capital endowments may require different technologies, including

the soft technology of institutions and policies, to combine these inputs most efficiently. Distinct institutions and policies might then reflect efficient responses to varying resource and technology endowments (Hall and Soskice, 2001). Second, relatedly, some more active public policies and institutional regulation could be efficient, as, e.g., Garrett (1998) argued. In either case, basic trade theory and standard globalization logic hardly imply convergence; divergence would persist or expand as countries further specialize institutions and policies to exploit comparative advantage. Third, perhaps neither more active nor less active policy and regulation Pareto dominate. If they are near equally efficient in aggregate, yet have very different distributional effects, sustaining diversity requires only that currently advantaged groups retain political control (Boix, 1998; Iversen, 1999; Franzese, 2002). In all these cases, policies and institutions are not inefficient, so the question above and standard convergence logic (that integration squeezes inefficient institutions and policies) just do not apply. It is likely, though, that at least some persistent institutions and policies are Pareto dominated, so we explore the harder case of strictly inferior institutions and policies below.

Path dependency is one plausible source of persistent inferiority; i.e. the transition costs involved in adjusting national institutional and policy configurations to Pareto-superior arrangements might hinder or prohibit such adjustments (North, 1990: ch. 11; Anderson et al., 1988; Arthur, 1989, 1990, 1994). However, path dependency is usually limited, and the standard globalization argument claims only *eventual* convergence. Because the loss from any inefficiency in national institutions or policies would compound over time as current output is reinvested to grow into future output, disparity between inferior and superior systems would become increasingly apparent over time. Transition costs, therefore, must be extremely large relative to inefficiencies for the retention of inefficient institutions and policies to be near permanently economically optimal by this logic. Thus, although such economic path dependency likely plays some role in maintaining policy and institutional diversity, political-economic sources of path dependency would seem more central.

Institutions and, *a fortiori*, policies rest on the social and political coalitions that support them (Hall, 1986). Thus, cross-country variation in the distribution of political power among various interest groups, however that may be determined, implies different equilibrium national institutional and policy configurations, and the match between configurations that are economically most efficient and those that are sustainable politically can be weak. Thus, to the degree that the current winning coalition cannot be reliably compensated for accepting replacement of the institutions and policies favoring it, inferior national networks can persist indefinitely. Finding sufficient

compensatory schemes may become easier as losses from inefficiency mount, but they need not, because potential gainers from institutional adjustment often find effective collective action more difficult than those benefiting from existing networks (Olson, 1965, 1982) – an Olsonian path dependency.

Either sort of path dependency could sustain divergent policy and institutional networks, including economically inferior ones, given prohibitive transition or compensation costs. A final sort emerges from adding the simplest politics to the simple trade models elaborated previously.

The standard argument that globalization fosters convergence is inspired by proven free market doctrine that competition tends to excise inefficiency, and by a basic result for trade theory that, with free trade and certain other conditions, factor (land, labor, capital) prices equalize. This analysis contests neither doctrine – such pathways for globalization pressures toward institution/policy improvement likely exist – but institutions and policies are both factors of production and part of the technology that determines the shape of production functions. In the latter capacity, as noted, equally well-proven doctrine implies that trade induces specialization and so will spur economically efficient divergence. As demonstrated next, adding political considerations implies that globalization could foster economically inefficient policy and institutional persistence, and convergence or, more likely, divergence.

Consider first a nation with inferior institutions and policies that does not trade. The inferior system will involve extra-normal rents and deadweight losses. Assume that these rents and losses accrue such that the political forces supporting the present system exceed those opposing them, so the national system is in political equilibrium initially. Now, opening to trade increases competition but also raises (lowers) returns to factors in which the nation is comparatively (dis)advantaged: the Stolper–Samuelson theorem. Whether this weakens support for inferior systems depends on how such exposure alters and reallocates rents and losses. Increasing exposure could magnify deadweight costs on those previously benefiting from the inferior institutions, weakening them or changing some into opponents. It could also increase costs on current opponents, perhaps thereby enabling more effective collective action against the previously winning coalition. One or both of these possibilities must implicitly underlie the standard argument.

Notice the highly political mechanism here: the shifting rents and costs from the existing system that exposure induces ultimately must alter winning coalitions to undermine the current equilibrium. The political shifts induced by trade exposure, however, more likely *strengthen* coalitions behind inferior institutions and policies. In Figure 3, for example, Germany's inferior system – its only difference from the UK – certainly reduced its aggregate wealth (Germany's PPF lies entirely within the UK's), but it also created a

comparative advantage in machine tools. With this comparative advantage, trade exposure would increase returns to agents deriving their income from, and factors used intensively in, that industry. (This implication is common to Ricardo–Viner specific factors and Stolper–Samuelson mobile factors trade models.) This would likely strengthen any coalition based on machine tools (that is, on its specific or intensely used factors) relative to any banking-system-based opponents, and the former are far more likely than the latter to support the existing national system given its relative favoring of machine tools (see, for example, Rogowski, 1990, 1998). Adding political considerations, then, trade seems more likely to reinforce institutional or policy divergence than to induce convergence.

To clarify, if a country with inferior institutions and policies were to replace them with superior ones; its aggregate society would benefit. However, trade exposure per se more likely weakens than strengthens both economic and political incentives for replacing inferior systems. The sources of trade pressure for institutional and policy improvements are the potential gains they might bring certain domestic political actors and the political actions these might motivate them to take. Against this force weigh the potential losses (smaller in aggregate, but much larger individually) of those currently gaining rents from the existing inferior system and the actions these might motivate them to take.¹⁰ Increasing trade exposure alters both in multiple ways, with the net impact ambiguous but more likely anti- than pro-reform. Ultimately, any pro-reform pressures arise because domestic actors perceive gaps between their current and some hypothetical alternative system, perhaps exemplified in other countries. Thus, globalization of information and ideas, and of ideology, seems a more likely transmission mechanism for institutional and policy convergence than trade (a point elaborated later).

In this regard, notice also that trade exposure per se actually reduces pressures toward policy and institutional improvement precisely because it increases the net wealth of societies. To illustrate, consider Figure 3 one last time. Germany's inferior system allows it to produce combinations of banking services and machine tools along PPF_G . Given this PPF, and absent trade, it achieves its maximal national welfare, IC_{G^*} , by producing and consuming at A_G . If German actors recognize that better arrangements exist, such as those allowing the UK to reach PPF_U , they might well press for the necessary changes, although the political considerations discussed above imply not even this is assured. However, opening to trade allows Germany to increase machine tool production and reduce banking service production to T_{PG} , and trade with the UK to consume at T_{CG} , thus achieving higher aggregate welfare along IC_{G^*} , and lowering the costs of its inferior system. In this way, increasing

trade exposure per se may actually *reduce* pressure for institutional and policy improvement. Phrased differently, institutional/policy improvement and trade liberalization are more substitutes than complements.

Notice, finally, that if Germany improved its national institutions and policies fully to match the UK and they had identical preferences, then gains from trade (and trade) would vanish. In Germany, the greater aggregate efficiency would compensate, but the UK would actually suffer relative to when Germany had an inferior system! This example exaggerates because it assumes away all sources of gains from trade except the institutional and policy differences, including preference (cultural) heterogeneity, but it also illustrates nations' mixed incentives regarding international institutional and policy convergence, even on improvements, because divergence produces gains from trade.

Thus, trade exposure has two effects on the persistence and reform of inferior institutions and policy: (1) it redistributes the costs of inferior systems, which might lead to the formation of a new winning coalition behind reform but, more likely, reinforces existing political equilibria; (2) it partially offsets the aggregate costs of inferior systems by expanding the gains from trade, which partly stem from such differences. Plus, as others have argued before, (3) some institutional and policy diversity may reflect efficient responses to factor and technological endowments; (4) multiple non-Pareto-inferior systems, with varying distributional effects, are economically and politically sustainable; and (5) economic transition costs induce path dependency for existing national systems. For all these reasons, increasing trade exposure is unlikely to induce international convergence in institutions or policy. Moreover, because trade exposure spurs the growth of comparatively advantaged sectors and of total output (the tax base), trade per se produces no fiscal pressures on government either. Finally, stretching the point, trade may even facilitate greater fulfillment of cultural diversity in consumption preferences and likely reinforces any cultural preferences reflected in production techniques (such as traditional agriculture).

The EU's internal and external free trade agenda is, in short, fully exonerated from both opponents' fears and proponents' hopes; expanding trade per se likely aids and abets member country institutional and policy diversity, relaxes member government fiscal constraints, and succors cultural diversity reflected in consumption and production. Opponents and proponents cannot correctly found on trade their hopes or fears that the EU's internal and external free trade agenda will constrain government policy and domestic institutions to converge on some frugal minimalism, so one must ask next whether they can more logically credit or blame international capital mobility.

Long-term and short-term capital mobility, tax competition, and ideology

Capital mobility, in this context, refers to investment flows across national jurisdictions, that is, into and out of diverse national systems of institutions and policies. In studying the effects of such capital flows, scholars generally distinguish the flow of direct, i.e. foreign direct investment or FDI (long-term), from that of portfolio investment, i.e. financial or monetary flows (short-term). This discussion begins by identifying the motivations behind and thus the determinants of any kind of investment: rate of return, risk (and term structure), and tax liability. Whether the financial integration aspects of the EU agenda produce forces for policy and institutional convergence or tighten fiscal constraints on member governments, therefore, hinges on the effect of financial integration on the economic or political strategic conditions that produces these terms.

The analysis has already shown in fact, that comparative advantage secures the potential to produce returns, that is, to foster the profitability and growth that produces total capital appreciation (dividends, share price appreciation, interest, etc.). The resources that relocate toward the sector comparatively advantaged by domestic institutions and policies do so precisely to pursue these returns. Comparatively advantaged sectors thus offer competitive return/risk bundles by definition. Regardless of the aggregate efficiency of the economy, trade expansion assures that resources, now including international financial resources, are reallocated toward comparative advantage. In Figure 3, for example, both UK and German resources flow from German banking and UK machine tools into German machine tools and UK banking. In other words, insofar as capital flows seek investment in profitable and growing productive activities, financial integration augments the pro-diversification and fiscal-constraint-easing forces from trade.

However, the after-tax-return aspect of investment motivation and individual governments' strategic positions complicate this monolithic story. Regardless of whether the tax system¹¹ or any of the public activities it finances contribute to comparative or to any absolute efficiency, individual tax authorities always have a marginal incentive to lower taxes to attract mobile capital. Even if some taxes enhance the aggregate efficiency or comparative advantage of some economy, another government could draw capital from those valuable investments by lowering its taxes on investment. A sufficiently low relative tax rate would draw massive capital inflows that would actually increase the undercutting state's revenues. With perfectly mobile capital, the 'over'-charging states now must cut taxes or forfeit all their capital, but then each individual state has an incentive to cut again. Many analysts

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assume that zero tax rates restrain this race to the bottom, but, actually, governments can subsidize capital inflows up to their ability to generate other revenues, including borrowing up to their no-Ponzi constraint, and they have every incentive to do so under perfect capital mobility.

Again, such tax competition occurs regardless of any absolute or comparative advantage to which taxation or tax-financed activity contributes. This extreme Bertrand competition result requires perfect capital mobility, but rising mobility generally increases tax competition pressures. Moreover, similar competitive pressures from portfolio investment threaten institutional (and cultural) diversity as well insofar as public policy diversity secures them. In a sense, the comparative advantages that diversity of national institutions, policies, and culture provide are a public good to the EU member states. Trade and foreign direct investment essentially raise the value of this public good and increase the productivity of resources in providing it, respectively, but portfolio investment raises the individual costs and incentives against any cooperative attempts to provide it.

Ideology, lastly, likely augments this competitive pressure because, as argued above, any pressure from return-seeking investment toward true policy and institutional reform, i.e. toward Pareto-efficiency-improving policy and institutional change, can only arise from economic and political actors' *expectations* regarding efficient policies and institutions. As also shown throughout, disentangling comparative advantage from absolute Pareto dominance in open economies is very difficult logically and almost impossible empirically. Thus, all actors' expectations will likely almost fully reflect their ideology. This includes investors, of course, but their actions on these expectations can be more self-fulfilling. If financiers believe 'Europe is over-taxed and over-regulated', then they will demand higher current returns for their expected lower growth and/or higher risk, and that will in fact tend to retard growth and increase risk, and that will in fact tend to constrain European governments and depress diversity, which, by the arguments above, would actually be globally inefficient.¹²

Therefore, opponents' fears and proponents' hopes that globalization will constrain governments' fiscal maneuverability and force policy, institutional, and perhaps even cultural diversity toward some frugal minimalism may be well founded on tax and regulatory competition grounds, but this frugal minimalism need bear no relation to any efficiency-mandated improvements. Moreover, the increasing political integration that accompanies European economic integration differentiates Europeanization from globalization and may counter some of these competitive pressures. If the strategic situation of individual governments competing for mobile capital can create fiscal constraints and convergence pressures, then political integration critically alters

the situation. Policy-making at a wider European level can effectively surmount its member governments' collective action problem reflected in their tax and regulatory competition. For example, the EU could harmonize tax and regulatory costs across its wider political jurisdiction, which would emasculate at least intra-European competition for capital. If European policy-makers use this forum for collective action for such purposes, economic globalization opponents become political Europeanization proponents, and vice versa. For example, in recent moves toward a Social Charter, EU policy-makers leveraged their wider jurisdictional control effectively, and economic globalization opponents indeed became political Europeanization proponents, and vice versa, as seen for example in British wariness of political Europeanization producing more such action.

Conclusion

This paper has expounded on comparative institutional and policy advantage to demonstrate several theoretical and substantive points. First, trade, production, and/or export specialization is evidence of only comparative advantage and therefore cannot establish that one system of institutions and policies is absolutely better than another, in general or for those areas of specialization. Second, increasing trade exposure alters the amount and allocation of (extra-normal) gains and (deadweight) losses from (Pareto-inferior) systems among domestic groups. This may upset existing political equilibria behind that system but more likely reinforces them and so entails no pressures toward domestic institutional or policy improvement and fosters more international divergence than convergence. Third, increasing trade exposure also reduces the aggregate economic incentives toward domestic institutional reform by offsetting the costs of inferior institutions with gains from trade. Fourth, increasing trade exposure may even abet cultural diversity by reinforcing locally dominant modes of production and by freeing domestic consumption to pursue its distinct preferences even more intensely. Fifth, increasing trade exposure relaxes rather than tightens fiscal constraints on governments, at least in the short term, because it increases the tax base (total output). Sixth, capital mobility reinforces all of this insofar as investors seek profitable, growing productive activities in which to invest (loosely, foreign direct investment). However, seventh, individual governments' competitive situation implies Bertrand competition over tax rates on liquid capital (loosely, portfolio investment), constrained only by their ability to generate other revenues or to borrow and by the imperfect mobility of capital. This is true, eighth, regardless of the efficiency properties of such taxation or any activities

it supports, including the comparative or absolute advantages conferred by policy and institutional diversity. However, ninth, the political integration that accompanies European economic integration distinguishes Europeanization from globalization and enables European leaders so-minded to surmount the collective action problem that underlies the tax and regulatory competition effect, at least regarding intra-European competition. This converts anti-economic-globalization into pro-political-Europeanization partisans, and vice versa. Finally, tenth, any pressure toward institutional and policy improvement, therefore, can arise only from political and economic actors' expectations of alternative systems' Pareto superiority, which, given trade and the law of comparative advantage, is extremely difficult to discern logically or empirically. Such expectations therefore likely contain large ideological components, but some actors' ideological expectations will be somewhat self-fulfilling even if, actually, they were globally inefficient.

In sum, proponents' hopes and opponents' fears regarding the EU's free trade agenda forcing convergence on some brutal institutional, policy, and cultural minimalism are ultimately unfounded. Logically, trade expansion per se is not only fully exonerated, but likely in fact champions diversity of all three kinds. Rising financial integration has more mixed effects. Freeing capital flows to pursue growing, profitable investments only reinforces trade's pro-diversity and budget-constraint-relaxing tendency, but freeing capital flows to hold tax rate auctions across member state jurisdictions ultimately constrains fiscal activity and hampers diversity, and wholly without regard to whether the activity or diversity is efficient. Of course, freeing capital to flow for one and not the other purpose would be difficult or impossible, but political coordination across national jurisdictions, such as characterizes Europeanization but not globalization, can diminish the degree to which tax and regulatory competition occurs. Thus, grounds for any expectation that the EU's broader economic integration agenda will squash institutional and cultural diversity and policy maneuverability lie in the tax competition effects of highly mobile capital. However, whether institutional and policy diversity is correctly feared or sought on social welfare grounds (the desirability of cultural diversity can be assumed) is an empirical matter, although, being such a difficult one, it more likely will remain debated in ideological terms.

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Notes

- 1 Unlike journalistic and popular accounts, recent academic treatments, such as Oatley (1997), Boix (1998), Garrett (1998), Clark (2002), and Franzese (2002), expect certain types of divergence to persist under trade and financial integration; they argue this and show how different policies and institutions are economically efficient or politically stable under differing conditions. Many of these arguments have great theoretical merit and strong supporting evidence, but basic trade theory shows that aggregate efficiency is unnecessary to explain divergence, that continued divergence does not imply efficiency, and that convergence need not be efficiency improving.
- 2 Recent advances in trade theory that emphasize intra-industry trade induced by economies of scale or density, etc., only strengthen this logic. Intra-industry trade captures scale economies by segregating the production process, or by producing more subtly or quality differentiated goods, across different locations, yet comparative advantage remains central to the allocation of processes or types in production. In fact, scale or density economies *magnify* the specialization response to even very small differences in relative productivities across types of activities.
- 3 In this context, tax competition should be understood very broadly. The competition is in the average or total excess burden from public activity, which extends beyond taxes to include costs incurred in following public regulations. It is critical here not to confuse the average or total aspect of regulatory and tax competition with the comparative advantage impacts of these taxes and regulations having different, relative effects across sectors of production.
- 4 Albert (1993); Shonfield (1969) [1965]; Hall and Soskice (2001); Soskice (1999); Piore and Sabel (1984); Streeck (1992); Hollingsworth and Boyer (1997); Campbell et al. (1991); Brown et al. (1996); Dorman (1995); Sorge and Streeck (1988); Womack et al. (1990); Hollingsworth et al. (1994); Crouch and Streeck (1997); Boyer and Drache (1996); Berger and Dore (1996); Kitschelt et al. (1999); Maurice et al. (1980); and Maurice et al. (1986).
- 5 Ibid.
- 6 Ibid.
- 7 This item refers to how inter-firm relationships are structured and function and emphasizes the degree to which market or network relationships dominate. See also Soskice (1999).
- 8 Note that such institutional effects alter rates of production/accumulation of labor, physical and human capital, and technology. Thus, institutions affect economic performance, in part at least, through their effects on variables

traditionally viewed as purely economic, which can radically alter our understanding of institutions and economic performance. For example, students of the East Asian Miracle have disputed whether (a) some East Asian institutional model improved productivity or (b) greater inputs of labor, capital, and human capital explain the Miracle (Krugman, 1994), which many take to imply that institutions played little role. However, if East Asian institutions affected the increases in labor and physical and human capital inputs, then they were clearly important even if they appear insignificant controlling for factor growth.

- 9 To see that these are and exhaust the possibilities, call country 1 (2) productivity in good A (B): a_1, b_1, a_2, b_2 . Absolute advantage in A and B for 1 implies $a_1 > a_2$ and $b_1 > b_2$, which implies nothing about comparative advantage: $a_1/b_1 \geq a_2/b_2$. Absolute advantage in A (B) for 1 (2), however, implies $a_1 > a_2$ and $b_1 < b_2$, which implies $a_1/b_1 > a_2/b_2$.
- 10 Becker (1983) argues similarly but focuses only on policies and only indirectly considers the impact of these domestic political forces on economic performance.
- 11 Recall that we construe 'taxes' broadly to include regulatory costs and that competition effects regard average costs, which we must keep analytically distinct from tax and regulation's relative cost effects.
- 12 Baghwati, Krugman, Rodrik, Stiglitz, Sachs, and others have all argued along similar lines that foreign direct investment is but portfolio investment and does not necessarily enhance social welfare.

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About the authors

Robert J. Franzese, Jr is Assistant Professor of Political Science at the University of Michigan, Ann Arbor, MI 48106-1248, USA.

Fax: (+001) 734 764 3341

E-mail: franzese@umich.edu

James M. Mosher is Assistant Professor of Political Science at Ohio University, OH 45701, USA

Tel: (+001) 740 593 4383

Fax: (+001) 740 593 0394

E-mail: mosherj@ohio.edu

