Trade Globalization, Politics, and the Choice of Policies and Institutions: Three Varieties of Institutional Divergence[1]

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I. Introduction

Much recent research in political economy has focused on how globalization might affect the politics of institutional and policy choice (Drezner, 2001; Garrett, 1998b; for the effects on the state, see Strange, 1996; Weiss, 1998). Research examining whether globalization will contribute to convergence of national institutional arrangements or policies is the preeminent example of this type of work. In this paper, we use an extension of basic trade theory that reveals the links between trade globalization, politics, and institutional/policy choice (except trade policy) to examine the impact of trade globalization on three varieties of institutional divergence.[2] In the analysis, we place particular emphasis on examining institutional divergence caused by political coalitional politics. *We focus our analysis on the role of trade globalization*, one aspect of globalization, and argue that each aspect of globalization needs to be investigated individually (On the effects of financial globalization, see Andrews, 1994, Gill and Law 1993; and McKenzie and Lee, 1991; Kurzer, 1994; Kahler, ND). Our analysis challenges the general assumption of those examining globalization that globalization can be expected to exert a common pressure for convergence. This is an assumption shared by scholars expecting convergence (Cerny, 1997) and even by scholars expecting continuing divergence (Garrett, 1998a; Kitschelt et al., 1999; Berger and Dore, 1996).

Our conclusion is that trade globalization should not be expected to create a general, common pressure for institutional/policy change, and because it does not generate a general, common pressure for institutional change, it does not contribute to institutional convergence. To the contrary, trade globalization can be expected to broadly reinforce institutional/policy diversity. Thus, the impact of trade globalization is exactly opposite that generally assumed in the literature. In some circumstances, trade globalization may change

the outcome of domestic politics contributing to institutional change but not in manner to create a common pattern of institutional change leading to institutional convergence.

One important point of our analysis is that because globalization is a bundle of different processes it is important to trace out the impact of each individual aspect of globalization. Research on globalization is often weak because it fails to analyze globalization as a bundle of different processes that may as easily have contradictory effects as reinforcing effects.

A second point of our analysis is that it is necessary to examine why countries maintain divergent institutions before one can explore how any aspect of globalization might lead to institutional/policy change and/or convergence. Analyses of convergence without a theory of institutional divergence are deficient.

In our analysis, we explore three sources of institutional divergence, but we emphasize the role of distributive coalition politics as the most important source of institutional divergence. Many scholars have emphasized the role of coalition politics in shaping institutional choice (Esping-Andersen, 1990; Rowgoski, 1990; Gerschenkron, 1943; and many others). Our contribution to this style of analysis is twofold. First, we provide neo-classical micro-foundations why these coalitional dynamics that are the fundamental core of politics are not overridden by trade globalization but rather continue to remain fundamental. Second, we specify how trade globalization can affect the coalition politics behind institutional and policy choice.

The conclusion that trade globalization will not produce any common pattern of institutional (or policy) convergence is a general result of our analysis and applies to all national institutional arrangements. However, scholars examining the fate of welfare states in advanced industrialized countries will be particularly interested by the results of our study

(Geyer, 1998; Huber and Stephens, 2001). Some have assumed that globalization will undermine large redistributive welfare states because welfare states can generate economic inefficiencies. Our results suggest that trade globalization does not create common pressures to rollback welfare states. In fact, trade globalization should usually reinforce political support for large welfare states because the negative economic impact of large welfare states is reduced with trade globalization. The fact that large welfare states are commonly associated with highly open economies such as Sweden and the Netherlands reflects the fact that trade globalization does not undermine large welfare states and, in fact, can reinforce them (Cameron, 1978).

Finally, before proceeding we comment on three aspects of our analysis. First, it is important to recognize that our study of the impact of trade globalization shows that domestic politics is the key factor shaping institutional choice and policy choice and is not overridden by trade globalization. Second, our analysis is based on actors making rational choices to maximize their material interests. We expect a significant portion of the variation in political action regarding institutional and policy choice to be shaped by this without expecting this to explain all variation in political behavior. Other factors such as bounded rationality, interests other than material interests, asymmetrical valuation of benefits and costs, group behavior, norm-driven behavior, etc. also affect human action and would be part of an entirely complete analysis. Third, the definition of economic performance we use focuses on aggregate economy-wide economic efficiency. When we use phrases like institutions in country A are absolutely better or superior than country B's institutions, one should read that to mean that institutions in country A are absolutely better or superior than country B's institutions in terms of economic efficiency alone. One could alternatively judge institutional and policy performance more broadly and consider issues of distributional

equality. Our definition of performance as economic efficiency does not preclude meta-consideration of distributional issues, and we support such examination and believe our analysis to be a useful contribution to such meta-analysis.

II. Theories of Institutional and Policy Convergence and Theories of Institutional and Policy Non-Convergence

Our conclusion that trade globalization should not be expected to lead to institutional convergence challenges two views of globalization's effect on domestic institutional/policy choice. The first group we wish to challenge sees globalization creating irresistible pressures for institutional change that domestic actors cannot resist and sees this change leading to significant institutional convergence. The sophisticated form of this argument recognizes that complete convergence will not occur but rather argues that substantial, albeit incomplete, convergence will occur. The second group we wish to challenge has had more influence on scholarly discussion. This second group accepts that globalization can create pressure for institutional convergence but argues either that the pressure can be blocked or altered by other factors or the pressure is overstated. In this paper, we challenge the original assumption of both groups of a common international pressure for convergence when it comes trade globalization.

The first group we wish to challenge sees domestic institutions that produce economic inefficiencies like the welfare state or strong industrial relations systems that benefit labor being under tremendous pressure. One scholar who could be placed in this group is Philip Cerny. He sees globalization causing the state to shift its role from a "welfare state" to a "competition state," which actively dismantles economically inefficient institutions, resulting in, at least, partial convergence. Cerny (1997, p. 251) writes:

> Although embedded state forms, contrasting modes of state intervention and differing

state/society arrangements persist, such models are feasible in the medium term only where they constitute relatively efficient alternative modes of adaptation to economic and political globalization. At the same time, however, **pressures for homogenization are likely to continue to erode these different models where they prove to be economically inefficient** in world markets and therefore unattractive to state and market actors [emphasis added].

The second group we wish to challenge accepts that globalization creates pressures for institutional convergence but sees either a variety of counterforces that block this pressure or counterforces that transform this pressure so that it has a different impact in different places, or see the extent of globalization being overstated. Among the factors cited as blocking or transforming globalization convergence pressures or leading to an overstatement of these pressures are varying domestic political arrangements/political configurations, institutional functional equivalents, historical legacies/path dependency, the limited extent of global competition, and the continued existence of niche markets.[3] Because of the influence of this second group we examine more closely three influential contributions, those by Geoffrey Garrett (1998a) in his book *Partisan Politics in the Global Economy*, by Herbert Kitschelt, Peter Lange, Gary Marks, and John D. Stephens (1999) in the concluding chapter of their edited volume *Continuity and Change in Contemporary Capitalism*, and by Suzanne Berger and Ronald Dore in the introductory chapter of their edited volume *National Diversity and Global Capitalism*.

Geoffrey Garrett (1998a, p. 130) argues that in spite of globalization there still exists a distinct and viable "leftist alternative to free market capitalism." Such an alternative is viable if it contains these four elements: 1) redistribution that favors the large segment of the population vulnerable to the vicissitudes of global markets; 2) social democratic spending policies that contribute to better economic performance (such as investments in human capital and infrastructure); 3) encompassing labor market institutions that restrain workers

from taking advantage of the market-cushioning policies (restrain free-riding and overcome collective action problems); and 4) political, economic and social stability coupled with high productivity of labor to "provide an attractive home for investors in the uncertain and volatile international economy."

Kitschelt et al. (1999, p. 440) argue "that convergence of modern political economies on a uniquely superior model of markets and collective decision-making institutions is theoretically and empirically implausible for at least five reasons." The five reasons are: 1) international competition is imperfect and there are niche markets sheltered from international exposure; 2) "the effects of economic internationalization on domestic economies will differ depending on the prior mix of economic factors and resultant economies of scale," which means that institutions evolve on path dependent pathways that block convergence; 3) variation in ideas and bounded rationality means that "common international competitive pressures are likely to be perceived differently" and therefore responded to differently; 4) "the pervasiveness of international economic pressures as a source of convergence is determined by the willingness and capacity of individual governments and regional regimes to liberalize," which means that politics can block and alter such liberalization; and 5) "perhaps most critically, the impact of international competition on domestic policy and institutions is refracted by the domestic status quo – that is, by the relative strength and organizational capacity of" the various domestic political actors.

Finally, Berger and Dore (1996) describe in the introduction to their edited volume *National Diversity and Global Capitalism* that one group of authors in the volume do not expect the institutions of capitalism to converge in spite of globalization. This group advances four reasons: 1) the global market is not perfect enough to enforce complete convergence because

of information and power asymmetries, different social infrastructure; the effects of scale and the existence of market niches; 2) the functional equivalence of production systems; 3) the tightness of fit in national systems of production (a form of path dependency argument); and 4) political resistance to convergence.

Although these three contributions in the second group differ in some respects, they each accept that there are "common international competitive pressures." They only differ in what explains why this common pressure does not lead to institutional convergence, whether that pressure is blocked, altered, addressed with functional substitutes, or weaker than imagined.

Our challenge to the "globalization will lead to convergence group" and the "globalization can be and will be resisted group" is that the assumption that globalization creates broad general pressures for institutional convergence is incorrect for the trade globalization aspect of globalization. In fact, to the contrary, the net incentives for changing national institutional arrangements actually decline with an increase in trade openness. This occurs because opening to trade reduces the deadweight costs of inferior institutions. Phrased differently, within some range, institutional reform and trade liberalization are more substitutes than complements.

Although trade globalization does not increase net incentives for changing national institutional arrangements and does not put the economy in the aggregate under greater economic stress, our analysis does show that trade globalization can change the distribution of the benefits and costs of institutions thereby potentially altering actors' preferences over institutions. The first possible outcome of this process and the one more likely is that trade globalization, by redistributing incentives, will interact with domestic politics to reinforce political support for the existing set of national institutional arrangements. The second

possible outcome is that the political equilibrium within a society maintaining current national institutional arrangements is undermined by trade globalization and leads to institutional change. But this institutional change need not lead to institutional convergence. The new political winning coalition will likely not prefer the first-best set of national institutional arrangements, which would lead to institutional convergence. The new winning coalition will more likely prefer a different set of institutional arrangements that are economically sub-optimal but which provide a new set of distributive benefits to the new winning coalition. Thus, although our analysis suggests some circumstances that might lead to institutional change, there is no reason for there to be a pattern of change leading to convergence. Both parts of our analysis reject the notion of a common pressure pushing for institutional convergence coming from trade globalization.

It is important to emphasize how our analysis differs from the analysis of those who see the impact of globalization being blocked or transformed because we come to similar conclusions about the unlikelihood of convergence. First, our analysis differs from arguments that see institutions needing to provide some alternative contribution to economic performance to be viable in the face of globalization ala Geoffrey Garrett. We show that institutions that are just plain bad for economic performance are not put under pressure from trade globalization; in fact they are under reduced pressure with trade globalization. There is no need to produce functional equivalence or alternative economic advantages for economically inefficient institutions to be viable in the face of trade globalization.

Second, our analysis differs from arguments that see globalization as being blocked or resisted by domestic political action. It is true that we see distributional politics as the primary cause for the existence of economically inferior institutions, so we are very sensitive to the role of politics in shaping institutional choice (and policy choice).[4] This may lead the

reader to see us making identical arguments as these other authors. The arguments are related but different in important ways. The conception of blocking globalization envisions a common international pressure that is resisted by domestic interests. We show that there is never any commonness to the pressure coming from trade globalization pushing for institutional (or policy) convergence. The only common impact of trade globalization is to reduce pressure for institutional/policy change. In our analysis, political action enters to explain original institutional divergence occurs not to explain how a common pressure for convergence is resisted.

Third, our analysis has much similarity to the argument that sees globalization being refracted by domestic politics because we show that domestic politics shapes how trade globalization affects the politics of institutional choice. But "refracting" as a metaphor still implies some commonality to the pressure coming from trade globalization that is then transformed by domestic politics. We show that politics does not step in after trade globalization begins to impact domestic institutions. Distributional politics shapes the original institutional divergence that causes globalization to have a different impact in different countries in the first place. The impact of domestic politics is more fundamental and more primordial than the way the current metaphor of "refraction" is used. A more accurate description is that domestic politics refracts institutions before there is even an issue of trade globalization and this pre-existing refraction produces differential effects of trade globalization across states.

Although our challenge to the widespread notion of a common pressure for institutional convergence coming from globalization is limited to the trade globalization aspect, it is important to show that at least one aspect of globalization is not consistent with the current general perception. This challenge is important regardless of what one concludes

about other aspects of globalization.

III. Adapting Trade Theory to Account for Institutions and Outlining Explanations for Institutional Diversity

Our analysis begins with two tasks. The first task is to outline a mechanism that accounts for how national institutional arrangements affect production. The second task is to describe the various reasons why countries would maintain different institutions or policies.

Production Possibility Frontiers as a Mechanisms to Account for the Impact of Institutions on Economic Performance

Among the national institutions affecting economic performance that scholars of political economy have identified as important are: the financial system, the education system, the training system, the industrial relations system, the inter-company governance systems, the legal system, the property-rights system, the tax system, and the welfare state (see, *e.g.*, Hall and Soskice, 2001).[5] Similarly, political institutions, such as electoral rules, constitutional arrangements, Federalism/Centralization, can directly or indirectly shape economic performance. Although these individual institutions deserve careful individual analysis, for present purposes we aggregate their effects. In our abstract framework, we explore the *"net effect of national institutions on the economy."* including *all* of a nation's institutions that affect economic performance.

The net impact of all institutions on production can be described using the graphing of Production Possibility Frontiers.[6] Figure 1 shows the various combinations of goods that can be produced in two countries. In our graphical representation, we use the labels Canada and the US instead of country A and country B and machine tools and computers instead of good A and good B for illustrative purposes only; the situation is purely hypothetical. For the

purposes of our analysis, we assume that all factor-endowments, technology, and other conditions are equal in the two countries, thereby isolating the impact of institutional advantages and disadvantages, as these are the only differences between the two countries.

<u>Figure 1</u>: **Strictly Inferior (Superior) Institutions**
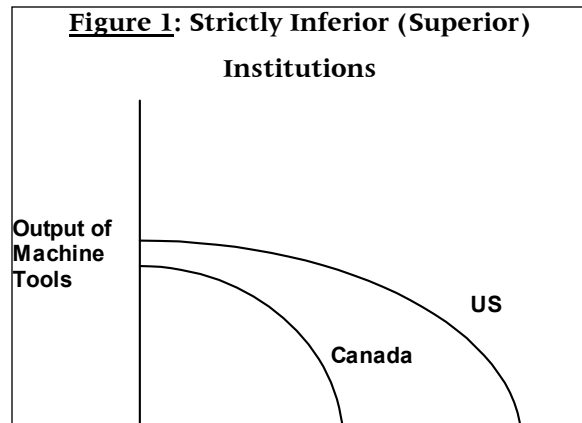
In figure 1, Canada is assumed to have national institutions less favorable than the United States for the production of computers and the production of machine-tools. Using the same resources and technologies as Canada, the US is better at making any combination of computers and machine tools than Canada. This advantage stems only from institutional differences across the two, since by assumption both countries have identical factor endowments and technology, so the illustrated case shows strict Pareto dominance of US institutions over Canadian institutions, i.e., the US has economically superior institutions and Canada's are inferior.

The illustrated situation allows for any institutional difference (or combination of institutional differences) between the US and Canada to be the explanation for why Canada is less efficient than the US in producing computers and machine tools. But the reader can imagine that the reason is that Canada has a large welfare state that places large costs on both the computer industry and the machine tool industry. This is one of many reasons but can stand in as a representative of all the other potential reasons.

The graphing of PPF's allows us to account for the impact of inferior institutions in Canada on economic performance compared to the US and later ask how trade globalization affects institutional choice in Canada. We have chosen to represent Canada as being inferior in the production of both computers and machine tools and later examine how trade

globalization affects its institutional choice because current scholarly discussion expects that trade globalization would induce a country with pareto-dominated, inferior institutions to be put under pressure to abandon them in favor of superior institutions. If trade globalization, thus, led all countries to adopt superior institutions, it would lead to institutional convergence. We examine the pareto-dominated situation because it is the most salient in examining the question of institutional convergence due to trade globalization. (The situation where each country has an absolute advantage in the production of one good is more relevant to considering the link between cross-national diversity of institutional arrangements and world aggregate welfare, which we plan to pursue elsewhere.)

Outlining Explanations for Institutional Diversity

We now explore why countries would maintain different institutional arrangements or policies. Most research on institutional convergence ignores the issue of why institutional diversity exists in the first place. The implicit assumption is, or must be, that it is unnecessary to know the origin of institutional diversity to understand how globalization affects that diversity. Our analysis shows this to be a faulty assumption, at least, for trade globalization and we suspect more broadly.

Here, we examine three reasons that would lead two countries to adopt different institutional arrangements or policies (summarized in table 1): 1) economically optimal institutional adaptation to differing relative factor inputs used in production, 2) economic path dependency[7], and 3) political divergence.[8] These three reasons are the most relevant ones for examining how trade globalization will affect the politics of institutional choice but do not exhaust the reasons why two countries might choose different institutions.[9]

One difference among the three possible explanations is that in the first one differing institutional/policy choice is an optimal response to circumstances (in particular, differing

relative endowments and operating under autarky). Therefore, the first one cannot explain the maintenance of sub-optimal institutions/policies.   In contrast, the second two possibilities can explain the more interesting situation where a country chooses to maintain economically sub-optimal institutions/policies that are pareto-dominated by other institutional/policy choices.

Economically optimal institutions as response to differing production capital/labor ratios

The first reason two countries would adopt differing national institutional arrangements is rooted in the use of differing relative labor/capital ratios in the production of at least one good. This can occur when two countries differ in relative factor endowments and are producing under autarky (we are relaxing for the moment the assumption of identical factor endowments but keeping the assumption of identical technology). Countries operating under autarky with differing relative labor and capital endowments (or more generally differing relative land, labor, human and physical capital endowments) will produce, under almost all circumstances, using differing capital/labor ratios for at least one good and likely both goods. The reason is quite straightforward. A country with a lot of capital and very little labor will produce computers and machine tools using a higher ratio of capital to labor in both sectors (or under unusual circumstances in one sector). Conversely, a country with very little capital and a lot of labor will produce using a lower ratio of capital to labor in both sectors (or under unusual circumstances in one sector). These differing capital/labor ratios would likely require different institutions to combine these production inputs most efficiently. Divergent institutional arrangements would then reflect optimal responses to varying resource endowments but on the same common institutionally/technologically defined production functions.[10]

Opening to free trade radically changes the situation sketched above. Basic trade

theory concludes that, under certain conditions, a free-trade-induced alteration in production choices will cause capital/labor ratios for each good to converge. Free trade eliminates the impact of differing original relative factor endowments on the capital/labor ratios used in production. To the extent that diversity in optimal institutional arrangements is driven by producing using differing capital/labor ratios, each country will now prefer identical institutional arrangements because each produces using identical capital/labor ratios in each sector.[11]

This first analysis can explain why we should expect that "optimal" institutional divergence due to differences in production factor ratios caused by differences in relative factor endowments will disappear as production factor ratios converge under trade globalization.[12] In this case, the impact of trade globalization on institutional choice is clear: **Trade globalization leads to convergence of implemented institutional arrangements.** Even if all the assumptions of basic trade theory are not met and full relative factor ratio convergence does not occur, opening to trade is likely to lead to significant relative factor ratio convergence. This partial relative factor ratio convergence will provide a reason for partial institutional/policy convergence.

An example of this first cause of institutional diversity would be two countries one with a large amount of capital and a limited amount of labor and another with abundant labor but limited amounts of capital and each having access to similar amounts of coal. Under autarky, each will mine coal combining different amounts of capital and labor. The capital surplus country will mine coal with sophisticated machinery likely requiring a more skilled workforce. The labor surplus country will mine coal using a limited amount of machinery and a lot of brute force supplied by low-skill labor. Because of these different production processes each country would be best served by differing vocational training

institutions (and other institutional differences) and therefore if they choose based on which institutions are economically optimal, they will choose differing institutions. If these two countries open to trade, workers and capital will shift around across sectors so that each country uses identical factor ratios in coal mining. With identical capital/labor ratios, each country will have identical skill requirements for labor. As a result, they now have reason to prefer identical vocational training institutions (and identical types of other institutions).

This first cause of institutional diversity can explain why two countries would choose different institutions, even when they choose the economically optimal institution. This first scenario also provides a situation with unambiguous micro-foundations for expecting institutional convergence with trade globalization. Although a significant amount of existing institutional variation is certainly at least partially due to optimal adaptation of institutions to varying characteristics of production, we suspect that much existing institutional variation is not optimal institutional adaptation but related to the choosing of sub-optimal institutions, in others words, the choosing of economically inferior institutions as illustrated in figure 1. Consequently, the more interesting question--and we believe more important question--is what effect will trade globalization have when countries make sub-optimal choices over institutional arrangements, especially when the choice of sub-optimal institutions is driven by politics.

We now explore two reasons that can explain the more interesting case where a country limits itself to a set of institutional arrangements that produce inferior outcomes in the production of both goods. We return to the assumption that both countries have identical factor endowments (and technology) and that they only differ in the institutions they chose.

Economic Path Dependency

One reason a country would maintain economically inferior institutions is increasing returns leading to *economic path dependency* (Pierson, 2000).[13] If institutions are subject to increasing returns, then the choice of a particular institutional path in the past will shape evolution in the future and make switching from one path to another costly. When institutions are subject to path dependency it could occur that a country at one moment in time would be better off in terms of static economic efficiency with another set of institutions if they suddenly and costlessly appeared.[14] However, transition costs involved in adjusting national institutional networks to pareto-superior configurations might be so large as to hinder or prohibit a switch to the set of "statically" superior institutions (North, 1990, Chpt. 11; and Hall and Taylor, 1996). In this case, a country will choose to retain institutions that are statically inferior. The effect of increasing returns is to prevent countries from having equal access to all possible institutional arrangements because the costs of institutions to a country vary depending upon history.

One example of how economic path dependency might lead a country to keep an economically inferior institution even if economically superior institutions existed would be if we assume first that the US would be better off with a high speed rail system today. Second, we assume the US does not build one because the cost of building a high speed rail system from scratch is higher than it would have been if the US had kept a more significant rail system in the 50s, 60s, 70s, 80s and 90s. In other words, from the perspective of the present, it would have been a good idea for the US in the past to have chosen to keep the rail system so that today the US would have the basis to build a high-speed rail network. Further imagine that it would have been equally beneficial for the US at the time of choice in the 50s to keep a rail system or to have gotten rid of it. This last assumption means the choice between the two paths was random and not driven by any question of efficiency, so that if

the choice were repeated a hundred times we could expect the US to choose to keep the rail half the time.[15]   Two reasons of the many possible that could explain why the US was indifferent to the choice at the time although one choice is clearly better for the US in the present are: First, the US of the past did not foresee a world of high-speed rail and the economic advantages it would create, i.e., an unforeseen technological shock, thus giving it no possible way to foresee that it should have kept the rail network in the past even though at the time the choice between them seemed to be a toss up (technological shock). Second, the US of the past discounted the foreseeable gains in the future of being able to build a high-speed rail on a regular rail network so that at the time of choice the US was indifferent but by the time the present rolled around the US was no longer indifferent (discounting of the future). [In effect, we have described the situation where errors(random choices) have permanent effects that can mean that a countries has inferior institutions from the perspective of the present.][16] This example shows the US with inferior institutions that are too expensive to replace and exist only because of a random choice in the past.

The extent to which institutions are subject to economic path dependence that blocks switching from inferior institutions to superior institutions is still subject to much debate (Pierson, 2000). However, there are reasons to believe that significantly inferior institutions are not likely to survive for long periods of time, although moderately inferior institutions might persist for long periods. Because the loss from any inefficiency in national institutional networks would compound over time as current output is reinvested to grow into future output, disparity between inferior and superior configurations would compound over time. Transition costs, therefore, must be extremely large and/or discounting high relative to institutional inefficiencies for retaining inefficient institutions to be economically optimal in the long run. In the case of the high speed rail example, if the gains in the US by

building high speed rail over the current situation are large enough, then the US will build one even if it has to pay more because of not have maintained a rail network in the 50s to the 90s. [This argument basically says that some errors(random choices) can persist but only ones that do not diverge too far from the optimal path.] Thus, while we attribute some importance to such *economic* path dependency in maintaining currently sub-optimal institutions, we stress politics as the reason for the persistence of inferior institutions.

Distributional Politics

The third reason that can explain why a country might maintain divergent institutions/policies (and the second reason why they would maintain inferior institutions) is distributional politics (see figure 3). Institutions, especially formal institutions, and 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 and variation in coalitional groupings can produce different political equilibria supporting different national institutional networks. It is quite likely that the correlation between sets of institutions that are economically most efficient and those that can be maintained politically is imperfect because political coalitions support institutions based on the interaction of the institutions' efficiency and distributional impact and not economic efficiency alone (Becker, 1983). *Thus, to the degree that current winning-coalitions cannot be reliably and sufficiently compensated for accepting replacement of the current inferior institutions that provide distributional benefits to them, these inferior institutions can persist indefinitely.* Finding sufficient compensatory schemes to convince the winning coalition to accept replacement of inferior institutions, or building a winning coalition behind the replacement of inferior institutions, may become easier as losses from inefficiency mount, but this need not be the case.

To explore how trade globalization affects a political equilibrium that maintains

inferior institutions, we need to describe the nature of a political equilibrium behind inferior institutions in a nation that does not trade and then examine how trade might or might not change that equilibrium (see figure 3). The inferior institutions with distributive consequences will involve extra-normal rents going to the members of the winning coalition and deadweight losses. Assume that the rents and losses are distributed such that the political forces with a net gain, who are supportive of the current inferior institutions, are stronger than those opposing those institutions. As a result the nation and its institutions are initially in political equilibrium. There are a large variety of possible mechanisms for explaining how benefits are distributed between the winning and losing coalitions so as to support a political equilibrium behind inferior institutions, but to illustrate one example look again at figure 1.[17] What political coalition in Canada might support the inferior institutions represented in the figure over the superior institutions of the US (continuing to assume that Canada is not trading with the US)? One potential answer is a coalition of workers. To show this, we need to examine who benefits and why. Canada's inferior institutions cause both the production of computers and the production of machine tools to be harmed (this is indicated by the fact that Canada's PPF lies entirely within the US's PPF.). This leads to deadweight losses for Canadian society. However, the production of computers is harmed more than the production of machine tools. This will lead demand to shift towards machine tools. Over the short-term, this will increase returns to the specific factors used in the production of machine tools, in other words, to the capitalists and workers engaged in machine tool production. Over the long term, this will increase the returns to the factor of production that is more intensively used in the production of machine tools. Now assume that machine tool production uses labor more intensively and that computer production uses capital more intensively. If the shift in returns towards labor due to the alteration in the

demand for machine tools relative to computers is greater than any deadweight costs that labor must incur, then labor will favor Canada's inferior institutions over the US's superior institutions.[18] If labor has more political power than capital, then it will impose these inferior institutions on Canada. These institutions will be in political equilibrium. Again, this is one possibility but illustrates why a winning political coalition would impose inferior institutions on a country.

III. Trade Globalization and Economically Sub-Optimal (Pareto Dominated) Institutions/Policies

We have now outlined three reasons why countries would choose different institutions/policies. We showed that if countries choose different institutions for the first reason—optimal institutional adaptations to differing relative factor ratios used in production, then trade globalization would lead to convergence as countries produce using convergent relative factor ratios. We now explore the more interesting case of the impact of trade globalization on countries that have chosen economically sub-optimal institutions. Before presenting our analysis, we first review why some scholars have to this point believed that trade globalization might lead to institutional convergence or generated pressures pushing for institutional convergence.

Scholars have believed that trade globalization will lead to the abandonment of economically inferior institutions based on the following scenario. When a country with an institutional feature that harms competitiveness faces increased trade globalization that country will lose market share. Facing the loss of markets for its products, a country will be put under pressure to abandon its inferior institutions. Among the pressures are increases in unemployment, the closing of businesses, etc. A typical example of this scenario is that the welfare state because it causes economic inefficiencies when faced with trade globalization

will lead to a loss of market share for a country.[19] Faced with the collapse of demand for their products when facing increased international competition, domestic political actors will be forced to abandon the welfare state. Thus, economic rationality will dominate any concerns for generating greater equality or protecting the weaker members of society.

We provide micro-foundations showing why this imagined scenario regarding trade globalization leading to institutional convergence, although intuitively appealing, is based on an incorrect understanding of how trade globalization affects the domestic economy and domestic politics, and why we should expect that trade globalization will not to lead to institutional convergence.

The logic behind our argument is based on a simple insight from basic trade theory. It is suggested in the argument above that if a country has inferior institutions and trade globalization increases international competition, then a country will lose international market share. The loss of national income and the loss of jobs will force politicians to abandon such inferior institutions. What is missing in this analysis is a recognition that if a country is losing international market share in one good due to trade globalization it will in the long run simultaneously be gaining market share in another good over the long in order to balance trade. A country will not and cannot lose international market share in all goods indefinitely. This is, of course, because all countries will have a comparative advantage in at least one good, no matter how inferior a country's institutions are. While a country with inferior institutions may lose international market share in a whole host of goods due to trade globalization, it will gain market share in at least one good. *As we show below, this loss of international market share in some goods combined with a gain in national market share for at least one good will leave a country with inferior institutions with a net gain in national welfare.* A country with a net gain in national welfare due to globalization is not under any aggregate pressure to

abandon its inferior institutions.

To demonstrate this point fully we now adapt the two-good, two-country graphical model of production and trade from basic trade theory to incorporate the role of institutions using the mechanism of PPF's to account for the impact of institutions on production. We define consumption preferences for each country by adding national indifference curves (IC's) so that production (P) and consumption (C) choices of each country can be fully specified under autarky and trade respectively (figure 2). Each indifference curve (IC) shows the combinations of computers and machine tools a nation equally prefers to consume. Indifference curves (IC's) lying farther from the origin represent combinations of computers and machine tools that a nation prefers to more interior IC combinations. IC's farther from the origin represent the consumption of more computers and/or more machine tools so that the consuming nation has a higher utility. We take the set of national indifference curves as identical in both Canada and the US, with each indifference curve having an identical shape, only varying in their distance from the origin (any appearance in the graphs to the contrary is unintentional). We assume that each country has identical sets of indifference curves so that production and trade choices are not driven by differing consumption preferences but only by differing institutional arrangements that affect production.

In our analysis, we follow Frieden and Rogowski (1996) in defining globalization as an "exogenous easing of international exchange," which, for expositional simplicity, we model by starkly comparing the situation of two countries that do not trade, autarky, to that of the same two trading freely. We consider only the globalization of trade in goods, and take capital and labor to be wholly immobile.

The production possibility frontier (PPF_C), indifference curves (IC_C) production outcomes (P_C), consumption outcomes (C_C), and relative prices (p_C) representing Canada

have a C subscript. Those for the US have a US subscript. Outcomes under autarky have an "a" subscript, e.g. C_{Ca}, Canada's consumption outcome under autarky. Outcomes with fully open trade have a "t" subscript. Since with fully open trade relative prices are identical, relative prices (p_{Wt}) under trade are identical in Canada and the US and are identified with a subscript Wt (world relative prices under trade).

Summarizing the results of basic trade theory, we identify the production outcomes (P) and the consumption outcomes (C) under autarky (a) and with trade (t). First, note that autarky (absence of trade) implies that Canada and the US can produce and consume only on their national PPF. Doing so, the best they can do is consume on IC_{Ca} and IC_{USa} respectively, the IC's tangent to their PPF's. Under autarky Canada produces and consumes at P/C_{Ca}, the US at P/C_{USa}.

Now, we will explore outcomes in Canada and the US with free trade. With fully free trade, Canada will produce more machine tools than it will consume, and exchange the surplus machine tools with the US for computers, i.e., produce at P_{Ct} but consume at C_{Ct}. Conversely, the US will produce more computers than it will consume, and exchange the surplus computers with Canada for machine tools, i.e., produce at P_{USt} but consume at C_{USt}. With trade, both Canada and the US can consume a greater combination of computers and machine tools (C_{Ct} and C_{USt}) than they can under autarky (C_{Ca} and C_{USa}). In other words, each country consumes on an indifference curve further from the origin with trade than under autarky, and each prefers to consume on an indifference curve further from the origin. Therefore, trade induces Canada and the US to follow their comparative advantage and to specialize in machine tool production and computer production respectively. Differences in comparative advantage are entirely created by the existence of different institutions in Canada and the US because we have assumed identical factor endowments and technology.

The countries exchange surpluses; and both countries benefit. This is the standard result of basic trade theory.
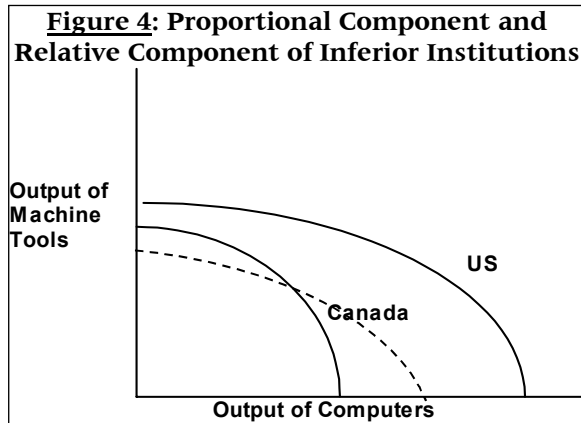
The impact of trade on Canada with its inferior institutions is not to reduce Canada's aggregate welfare but rather to increase its aggregate welfare; it can consume more with trade and inferior institutions (C_{Ct}) than it can with autarky and inferior institutions (C_{Ca}). Trade actually lowers the costs of its inferior institutions. Thus, increasing trade exposure *per se* can reduce the pressure for institutional improvement that arises from social actors having to pay the deadweight costs of inferior institution because the deadweight costs are lower under trade than under autarky. Phrased differently, within some range, institutional reform and trade liberalization are more substitutes than complements.

The costs of Canada's economically inferior institutions are lower under trade because it is producing fewer goods in the sector most harmed by its inferior institutions (computers) and producing more goods in the sector least harmed by its inferior institutions (machine tools).

The extent to which trade with other countries can reduce the impact of inferior institutions depends upon how the inferior institutions affect the shape of the production possibility frontier in relation the other trading country. If the inferior institutions were to bring the production possibility frontier proportionally inward towards the origin, in other words, the shape of the production possibility frontier were the same as the other country's only closer to the origin and still assuming that the same set of identically shaped indifference curves, then no trade between the two countries would be induced. Both countries would produce and consume on their own production possibility frontier on the same ray extending outward from the origin. Relative prices would be the same in both countries. In this scenario, trade is not necessary to have relative prices converge to a single

world relative price. Thus, trade can reduce the costs of inferior institutions only to the extent the inferior institutions change the shape of the production possibility frontier.

One can decompose the effects of inferior institutions on the production possibility frontier into a "proportional component" and a "relative component". In figure 4, the proportional component of Canada's inferior institutions compared to the US is illustrated by the dashed line. The relative component would be the difference between the dashed line and the solid line for Canada. The component of national institutional arrangements that affect the production of all goods proportionally does not have any trade effects. For example, if the negative effects of welfare state arrangements were to proportionally affect the production of all goods, then these proportionally balanced negative effects of welfare state arrangements would have no trade effects between the country with inferior institutions and that with superior institutions.

Figure 4: Proportional Component and Relative Component of Inferior Institutions

Output of Machine Tools

US

Canada

Output of Computers

To see how trade with the whole world would affect the domestic politics of a country choosing inferior institutions--where the whole world may have countries with different levels of technology and different relative factor endowments, one would compare the production possibility frontier of the country with inferior institutions to the aggregate production possibility frontier of the rest of the world and examine the proportional difference and the relative difference. Only the relative difference would allow trade to reduce the negative impact of inferior institutions. All proportional differences would induce no trade and therefore would have no impact on domestic political choice. In fact, trade globalization would have no interaction whatsoever with a welfare state that were entirely

composed of proportionally balanced effects across sectors relative to the production possibility frontier of the rest of the world. Only the relative component allows for the possibility for trade reducing the costs of inferior institutions and interaction effects with trade.

This means that to the extent that inferior institutions differentially affect sectors, trade globalization can reduce their negative impact. The extent to which inferior institutions proportionally disadvantage sectors trade globalization will have no impact. Thus, at worst in this case, trade globalization will have no impact on a society with inferior institutions. At best, it will reduce the deadweight costs of inferior institutions.

It also means that if a society prefers national institutions that have desirable distributional consequences but negative economic efficiency consequences, then the only impact of trade globalization in the aggregate is at minimum to reduce the costs due to negative economic efficiency. This result is opposite the assumption in the literature that trade globalization will impose costs on a society with economically inferior institutions that somehow must be resisted before these institutions can survive.

Notice what this says about the fall of Communism in the Soviet Union. If the Soviet Empire had been more open to trade, its inferior economic system might have been more sustainable in economic terms. Similarly, with China's opening to trade its system should be more sustainable in economic terms and therefore more likely to survive even if economically inferior. (Of course, opening to trade might also increase the transmission of ideas that, in turn, could undermine Communism. But in purely economic efficiency terms, opening to trade should help economically inferior Communist systems survive.)

Now knowing that trade globalization at best will increase the net welfare of a society with inferior institutions and at worse have no effect, we can begin to identify how trade

globalization will affect institutional choice. In the case when economically inferior institutions exist because of economic path dependency, trade globalization will make the replacement of economically inferior institutions less likely. To understand the reason requires remembering that inferior institutions were not replaced under autarky because the gains for replacing inferior institutions were already less than the transition costs. With trade globalization the negative impact of inferior institutions is reduced, so there will be even fewer gains to be made to justify the transition costs. With fewer potential gains to justify the transition costs, inferior institutions due to economic path dependency will be more entrenched under trade globalization than under autarky.

We now analyze the effect of trade globalization on inferior institutions that exist because they are supported by a distributional coalition.[20] We separate the analysis into two parts. First, we analyze the aggregate, society-wide effects of trade globalization, and then we analyze the effects of trade globalization on the winning coalition and the losing coalition.

We have argued that inferior institutions are likely to persist in a nation because there exists a political coalition strong enough to impose these inferior institutions on a nation, and the institutions are in a political equilibrium. A political coalition would only rationally do this for reasons of material interest if its gains from imposing the inferior institutions were greater than the deadweight costs generated by the inferior institutions that it is forced to pay. Since trade improves the aggregate welfare of a society with inferior institutions, there are fewer deadweight costs that any social actor must pay. Trade globalization reduces the aggregate incentives to replace inferior institutions, thereby reducing aggregate pressure to change inferior institutions. Thus, just as with economically path dependent inferior institutions, trade globalization can reinforce a preference for inferior institutions because it

reduces the deadweight costs of inferior institutions (see table 2).

An important implication of this analysis is that the reduction of deadweight costs due to trade globalization affects the trade-offs that exist when political choices are made. Arthur Okun (1975) in his book *Equality and Efficiency: The Big Trade-off* described such a trade-off between equality and efficiency. Because trade globalization can reduce the deadweight costs of economically inferior institutions, it makes those trade-offs easier, although it cannot eliminate them.

While it is clear that reduced deadweight costs can contribute to the maintenance of inferior institutions, survival of politically imposed inferior institutions ultimately depends on the continued willingness and ability of the winning coalition to maintain the inferior institutions. This willingness and ability can be affected by trade globalization to the extent that trade globalization changes the distribution of the benefits and costs produced by the inferior institutions (see figure 5). Redistributing the benefits and costs produced by inferior institutions can change the coalition dynamics and lead to the political equilibrium supporting inferior institutions/policies to be undermined. Because trade globalization reduces the deadweight costs at the same time that the benefits and costs of inferior institutions/policies are redistributed, the redistribution of benefits and costs must leave the total benefits minus total costs of inferior institution higher with trade globalization by the amount of reduced deadweight costs.

To explore how trade globalization would affect the political equilibrium behind inferior institutions/policies, we examine how trade globalization affects the preferences of societal actors over institutions. There are four possible ways that trade globalization might alter the distributional impact of inferior institutions and thereby affect the coalitional dynamics (see table 2).

First, because there are fewer deadweight costs, both the winning coalition and the losing coalition might see economic gains from trade globalization. This pattern is unlikely to alter the political equilibrium in support of inferior institutions because it does not increase the incentives of any actor to seek change. This is probably the most likely outcome of trade globalization in the long run after the economy has adjusted, so we should expect trade globalization to most commonly and in the long run lead to the reinforcement of the political equilibrium that supports inferior institutions. An example of this type of change would be if trade globalization reduced the efficiency penalty created by a large welfare state. As a result, payments to the beneficiaries of the welfare state could be increased and the taxes used to pay for the large welfare state could be simultaneously decreased. One can see that such a pattern of change gives all the actors reduced incentives to change the large welfare state. This doesn't mean that those who pay for the large welfare state are not still unhappy at some level but they are less unhappy because taxes decline.

In a second possibility, trade might further increase the economic gains being made by the winning political coalition from the imposition of the inferior institutions and further increases the economics losses of the political losing coalition. This would increase the incentives of the political winning coalition to keep the current inferior institutions, and, to this point, we have assumed that that the political winning coalition has the power to impose inferior institutions on a society. The increase in losses of the losing coalition would also increase the incentives of the losing coalition to replace the inferior institutions. It may be that there is a tipping point at which high enough losses by the losing coalition might be great enough to overcome past obstacles to gaining political power. For example, the losing coalition might be politically weak because of collective action problems, but increasing economic losses may be enough for the political losing coalition (or some element of the

political losing coalition) to overcome collective action problems (possibly by forming a pressure group or a new party). Overcoming political action problems may then be enough for the losing political coalition to become the winning coalition. Thus, if trade globalization increases the gains of the political winners and places further losses on the political losers, we should expect no change in the political equilibrium behind inferior institutions, unless there is a tipping point.

However, if there is institutional change because there is a tipping point that leads the losing coalition to become the winning coalition, there is no reason to expect this new winning coalition to choose the absolute best institutions in terms of economic efficiency. Under two conditions, this new winning coalition has as much incentive as the old winning coalition to chose institutions that provide distributional benefits even if they are not economically optimal. The first condition is that there exist a set of institutions and/or policies that produce greater benefits to the new winning coalition than the economically optimal set of institutions. This is almost certainly always true. The second condition is that the new winning coalition cannot be reliably compensated for replacing these sub-optimal institutions with distributional benefits with optimal institutions without those distributional benefits. This is the same condition that led to institutional divergence in the first place. Choosing new but economically sub-optimal institutions leads to institutional change but not to institutional convergence on optimal institutions as the globalization convergence thesis would require.[21]

An example of this second scenario would be a percentage tax on capital returns that hits labor intensive industries less hard than capital-intensive industries and the money from this tax is transferred to labor. Opening to trade with a country with identical factor endowments and technology but no capital tax would shift (further shift) production to

labor intensive industries increasing net returns to labor and further reducing net returns to capital. Labor would get more of its returns directly in pay and less from tax transfer but it would still be better off. Capital would get lower net returns even taking into account that it would be paying less in taxes. This would increase labor's incentive to keep the capital tax. But it would also increase capital's incentive to get rid of the capital tax. If labor had been able politically to maintain the capital tax only because capital had fewer votes and had been unable to organize an effective system of bribing politicians to over come the disadvantage in votes because of collective action problems, the increased losses on capital might be enough so that some of the larger capitalists now had enough individual incentives to form a small club and bribe politicians to get rid of the capital tax. Once capitalists have the capacity to pay off politicians, they have an incentive not to chose the most economically efficient institutional arrangement of no taxes but have an incentive to tax labor and have the revenue transferred to them, an economically sub-optimal outcome, but one that provides capitalists with distributive benefits.

The third possible effect of trade on the distribution of gains is that the gains earned by the winning coalition may be less than without trade and the political losers reap all the benefit of the reduction in deadweight costs plus some of their its earlier distributional losses to the winning coalition are returned to it. If the economic gains of the winning coalition after trade are now less than the remaining (and reduced) deadweight costs of the inferior institution, then the winning coalition as a whole would now have an incentive to replace the inferior institutions with other institutions, although these other institutions still might not be the economically optimal institutions but merely different economically inferior institutions.

An example of this third scenario would be a tax on products from labor-intensive

industries with the money from this tax is transferred to labor. We assume the revenue from the tax is greater than the reduced returns to labor as production is shifted to more capital-intensive industries due to the tax. Opening to trade with a country with identical factor endowments and technology would further shift production from labor intensive to capital-intensive industries. This would reduce the returns to labor and reduce the revenue from the tax on labor-intensive production. The combination of reduced labor returns and reduced tax transfers might make the tax on labor-intensive production no longer profitable for labor. Labor would then prefer to abolish such a tax leading to institutional change. However, labor's best option would be to switch to a tax on capital returns instead of choosing the most economically efficient institutional arrangement of no taxes.

The fourth possible effect of opening to trade is a variation of the third one. In this scenario changes in the distribution of gains reduce the economic gains earned by some element of the political winning coalition below the deadweight costs that that element of the political winning coalition must pay so that that element of the winning coalition now would join the losers in wishing to replace current inferior institutions. This change in coalition dynamics might be enough to form a new political winning coalition for institutional change. Although in this scenario trade globalization would create a new winning coalition in favor of institutional change, this new winning coalition need not favor superior institutions but again would likely favor a new set of inferior institutions now benefiting a different winning coalition.

An example of this fourth scenario would be a percentage tax on capital returns that hits labor intensive industries less hard than capital intensive industries and the money from this tax is transferred to labor, but we now also assume that labor in capital intensive industries has made investments in human capital that are only valuable in capital intensive

industries, imagine steelworkers. Opening to trade with a country with identical factor endowments and technology but no capital tax would shift (further shift) production to labor intensive industries. Labor as a whole would benefit from this further shift in production to labor intensive industries, but steelworkers could lose as their human capital investment as steel making skills are devalued. This might change steelworkers' preferences over the imposition of a capital tax even if the revenue of that tax is shifted to all labor. Steelworkers would have an incentive to form a cross-class coalition with capital to replace the tax on capital with new institutions.[22] With control of the political system, this new winning coalition would benefit most not by setting up the economically most efficient system of no taxes but would benefit most by constructing a system of taxes that has distributional benefits for capital and steelworkers together that outweigh any deadweight costs they have to pay. Again, the emergence of a new winning coalition is unlikely to lead to convergence on institutions that are economically absolutely the most superior.

As we have shown, there are four possible scenarios in which trade globalization might affect the distribution of benefits and costs generated by institutions/policies and thereby interact with domestic politics to affect institutional choice. In most of these four possible scenarios, trade globalization reinforces the political equilibrium behind inferior institutions reinforcing institutional divergence, but under some circumstances trade globalization could alter the distribution of benefits and costs so as to undermine the current political equilibrium. Knowing how trade will affect the political equilibrium behind inferior institutions requires identifying the exact incentives that allowed a winning political coalition to form behind inferior institutions, identifying how that winning coalition was able to impose its preferences on society, and identifying precisely how trade changes the incentives of each element of the winning coalition and each element of the losing coalition.

But one can still say three general things. First, trade globalization should not be expected to lead to a common pattern of institutional convergence, because the effect of trade globalization on institutional choice is dependent on the domestic political behind economically inferior institutions that vary from country to country. Second, the most common outcome is likely to be that trade globalization reinforces the existing political equilibrium behind inferior institutions. The reasons are because the deadweight costs are reduced with trade globalization leaving more gains to be distributed to support the existing political equilibrium and because the most common patterns of changes in distributional outcome induced by trade globalization are likely to either reinforce the existing political equilibrium or not be enough to undermine the political equilibrium. Finally, even if trade globalization undermines the political equilibrium behind current sub-optimal institutions, the new winning coalition is just as likely to choose a different set of sub-optimal institutions that provides distributive benefits as to choose convergent optimal institutions. So even if trade globalization leads to institutional change it need not lead to convergence on optimal institutions but more likely merely a different set of inferior institutions.

There is one final point about our analysis in this article. Reaching our conclusions relied upon basic trade theory. Among the assumptions that basic trade theory makes are balanced trade, competitive perfect markets, all goods are traded, and declining returns. These are assumptions that are not always entirely applicable in the real world. Thus, the conclusions we draw using basic trade theory should be seen as a step in producing some insights into the links between trade globalization, politics, and institutional/policy choice, but there is potential for further research based on more complex forms of trade theory, such as strategic trade theory. Nonetheless, it is fairly clear that using more complicated forms of trade theory will not dramatically alter the conclusions we reach. In particular, it is relatively

clear that more complicated forms of trade theory will not lead one to expect a common pattern of institutional convergence but rather that the pattern of institutional divergence as it is shaped by domestic politics is even more complicated than basic trade theory will predict.

IV. Conclusion

In this paper, we used an adaptation of basic trade theory that incorporated the effects of national institutional arrangements and policies in order to examine the links between trade globalization, politics, and institutional/policy choice. This allowed us to make several important points. The first point is that globalization is a bundle of mechanisms and these mechanisms do not have an identical impact on the politics of institutional/policy choice. Each mechanism must be carefully examined to trace how it shapes the politics of institutional/policy choice. In this article, we have examined the impact of trade globalization on institutional/policy choice (except for choice of trade policy). The second point is that it is necessary to examine why countries choose to maintain divergent institutions in order to examine whether globalization will lead to institutional/policy change and/or convergence. As part of the analysis, we outlined three reasons why countries choose to maintain divergent institutions/policies.

We reached several conclusions about how trade globalization affects institutional and policy choice. To the extent that institutions and policies are optimal responses to differing factor ratios used in production then trade globalization, to the extent that it leads to convergent factor ratios used in production, provides incentives for domestic political actors to changes national institutional arrangements so that they converge. However, to the extent that national institutional arrangements are statically inferior in some countries because of either economic path dependency or distributional politics, our analysis suggests

that trade globalization will not generate a common pattern of institutional convergence. There are several reasons for this. First, to the extent that the inferior institutions are proportionally balanced in the way they disadvantage sectors, there is no interaction with trade. For example, taxes that are proportionally balanced across sectors have no trade effects and do not interact with trade. Second, to the extent that inferior institutions/policies have differential effects across sectors, opening to trade reduces the deadweight costs of inferior institutions/policies. Thus, trade globalization reduces aggregate pressure for changing institutions/policies. Third, to the extent that trade redistributes the benefits and costs generated by inferior institutions/policies, the most likely outcome is for trade globalization to reinforce the political equilibrium behind existing inferior institutions. Under certain circumstances, trade globalization could break apart the coalition behind a particular set of inferior institutions. However, the new winning coalition might merely support a different set of inferior institutions that provides distributive benefits to the new winning coalition. Since the new winning coalition is not certain to choose the most-efficient set of institutions/policies, even when trade globalization leads to institutional change, we do not expect that change to lead to convergence. Because of these factors trade globalization will not lead to a common pattern of institutional convergence.

These results challenge two groups of scholars. The first group sees globalization generating competitive pressures on states and societies to dismantle economically inefficient institutions and policies leading to institutional and policy homogenization, albeit incomplete homogenization. The second group accepts the existence of some international pressures pushing for homogenization but argues that either a variety of factors will block or alter this pressure or this pressure is less severe than originally thought. Both accept that globalization produces pressures towards a common pattern of change. We show that the

trade globalization aspect of globalization does not produce any homogenizing pressures in the first place. Even in the smaller number of cases where trade globalization contributes to institutional/policy change, it will not be institutional change leading to homogenization but institutional/policy change leading to a new pattern of divergence.

These results provide some insight into the issue of whether globalization will undermine the large redistributive welfare states existing in advanced industrialized countries. Much of the recent work examining this issue has concluded that there has not been convergence on small welfare states. The question then is why. Most current explanations of this propose some mechanism that either blocks the pressures from globalizations for reducing the welfare state, such as entrenched political interests, or some mechanism where globalization interacts with domestic factors, such as differing varieties of capitalism, to lead to differential outcomes. We argue that trade globalization need not be blocked, resisted, or refracted by domestic institutions, because it does not produce common pressures to reduce the welfare state in the first place. In fact, under many circumstances, trade globalization can make it easier to maintain large welfare states. The fact that countries with large welfare states such as Sweden and the Netherlands are both open to trade and have large levels of trade openness should be no surprise.[23]   Our results do not mean that there will not be conflict over welfare states and demands to reduce the size of the welfare state, but our analysis suggests such conflict will primarily be driven by domestic political considerations. For example, those who lose from a large welfare state will always have reason to demand that the size of the welfare state be reduced and have every reason to claim that globalization requires this.

Although our analysis has been abstract, it has important implications for how the concrete question of how the politics of institutional/policy choice should be understood

when considering the impact of trade globalization. Our conclusion is not that trade globalization as an economic force, reigns supreme and drives institutional/policy choice overriding the impact of politics. Our analysis leads to the conclusion that domestic politics is supreme relative to trade globalization. Politics is supreme even when faced with a common pattern of increasing trade globalization as is occurring in the present. Trade globalization is not a dominant second-image-reversed effect that overwhelms domestic politics (Gourevitch, 1978).

Table 1

Reasons for Institutional Diversity			
	Why Diversity	Impact of Trade Globalization	Comments
Economically Optimal Institutional Adaptation to Differing Relative Factor Inputs to Production	Differing relative factor inputs used in production due to differing relative factor endowments.	Institutional Convergence	One situation where trade globalization can explain institutional convergence. But institutional convergence concerns the less interesting convergence of economically optimal institutional divergence.
Economic Path Dependency	Increasing returns to scale/agglomeration effects. Examine those situations where diversity due to economic path dependency is no longer statically economically optimal. Transition costs block adoption of statically economically optimal institutions.	Reduces pressure for institutional convergence/reinforcement of institutional diversity because benefits of replacing statically inefficient institutions decline relative to transition costs	We suggest this is not the most important reason explaining institutional diversity, although it has received a lot of attention in the literature.
Political Divergence	Institutions provide distributional payoffs to a winning coalition that outweigh deadweight costs. Side-payments are blocked so that economically optimal institutions cannot be constructed while maintaining equivalent payoffs t winning coalition.	1. Reduces pressure for institutional convergence/reinforcement of institutional diversity because deadweight costs decline leaving more benefits to satisfy members of winning coalition and outsiders. 2. May undermine winning coalition under some conditions by redistributing costs and benefits of institutions among individuals and groups. Or may reinforce winning coalition. Change dependent on how institutions distribute benefits and costs, who is in winning coalition, impact of globalization and rules governing political choice	We believe the most important reason explaining non-economically optimal institutional diversity.

| | | (electoral rules, etc.). | |

Table 2: The effects of trade globalization on the politics of institutional/policy choice.

Effects of Trade Globalization	Impact on Institutional/Policy Choice
First Effect of Trade Globalization	
Reduces Deadweight Costs	Reinforces existing institutional/policy choice at the aggregate societal level.
Various Configurations of Second Effect of Trade Globalization	
Increase gains by members of winning coalition and reduce losses of losers from institutions	Reinforces existing institutional/policy choice. The likely impact of trade globalization.
Increase gains by members of the winning coalition and increase losses of losers from institutions	Reinforces existing institutional/policy choice unless there is a tipping point that allows losers to overturn the winning coalition. Such a tipping point may exist because losers have collective action problems that obstruct organizing but increased losses allow such an obstacle to be overcome.
Decreases gains of winning coalition and reduces losses of the losers from institutions	Can lead to change in institution/policy change if the decline in gains of the winners drops the distributive gains less deadweight costs below zero.
Changes the benefits and costs of the members of the winning coalition so that now some members of the old winning coalition are no longer winners from the institution. Or changes the benefits and costs of the members of the winning coalition so that some other institutional arrangement is more advantageous for some members of the old winning coalition. As a result the winning coalition is split up.	A new winning coalition will form that can construct an institution/policy so that the distributive gains of the winners exceed the deadweight costs. The new winning coalition may or may not support an institution/policy that generates fewer deadweight costs so that the institution/policy is closer to maximum economic efficiency. The new institution/policy may or may not be closer to a first best institution/policy in terms of economic efficiency so institutional/policy convergence may or may not be increased.

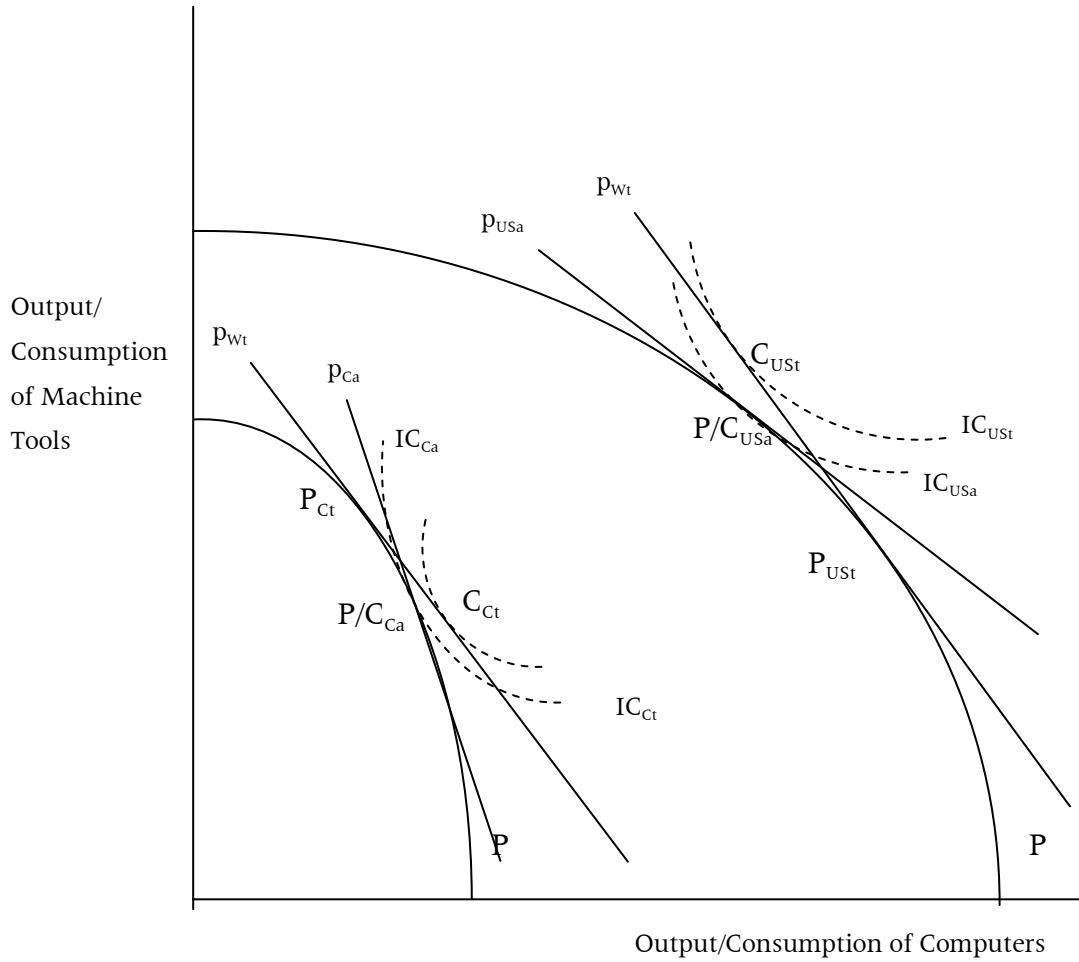**Figure 2: Production and Trade with Strictly Inferior Institutions**

Output/
Consumption
of Machine
Tools

Output/Consumption of Computers

Figure 3
Institutional/Policy Choice Without Trade (Autarky)

Institutions/Policies

(Share of Benefits – Share of Costs – Share of Deadweight Costs) > Economically Optimal Institutional

(Share of Benefits – Share of Costs – Share of Deadweight Costs) < Economically Optimal Institutional

Political Support & Opposition

Winning Coalition

Losing Coalition
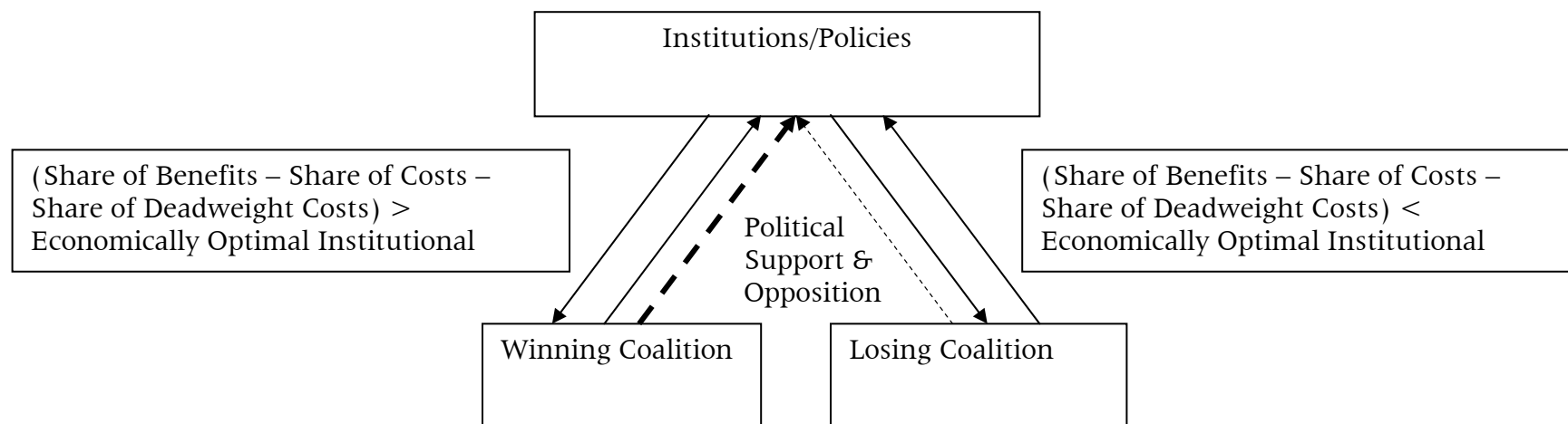
Figure 5
Institutional/Policy Choice With Trade Globalization

Trade

1. Trade Reduces Total Deadweight Costs.
2. Trade Redistributes Remaining Costs and Benefits of Institutions.

Institutions/Policies

(Share of Benefits – Share of Costs – Share of Deadweight Costs) > Other Institutional Arrangements Including

Economically Optimal Ones **????**

(Share of Benefits – Share of Costs – Share of Deadweight Costs) < Other Institutional Arrangements Including

Economically Optimal Ones **????**

? Political Support & Opposition **?**

Winning Coalition

Losing Coalition

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Notes

[1] Helpful discussion with the convenors and fellows of the GAAC German and American Young Scholars' Summer Institute, "Institutions and Economic Performance in Advanced Economies since 1945" is gratefully acknowledged. We would also like to thank John Freeman, Torben Iversen, and Milada Vachudova for helpful comments.

[2] Because the level of trade openness is endogenous to the choice of trade policy it requires a separate analysis of the type conducted by Frieden and Rogowski, 1996 and many others. In our analysis, the level of trade openness is exogenous.

[3] For arguments concerning functional equivalents, see Berger and Dore, 1996. On arguments suggesting that trade globalization is weaker than commonly assumed, see Hirst and Thompson, 1996. On arguments suggesting that entrenched political coalitions have resisted the forces of globalization, see Geyer, 1998.

[4] These institutions may be economically inferior but social superior under some criteria.

[5] The last refers to how inter-firm relationships are structured and function, and emphasizes the degree to which market or network relationships dominate. See also Soskice, 1997.

[6] The national production possibility frontier (PPF) is the outward boundary of attainable production in a nation given a set of factor endowments, technology and institutions. In the case of a PPF with two goods, it shows all the highest attainable combinations of the two goods that can be produced by a nation.

[7] We actually examine the important form of economic path dependency where path dependency leads to institutions that are statically inefficient although dynamically efficient, i.e., on the most efficient dynamic path. An example might be one city that focuses on the declining mining sector because it had coal nearby that

is now being depleted and the other focusing on the rising computer sector with the mining city being unable to pay the transition costs to get on the computer sector path. Economic path dependency that leads to institutions different from others but that are statically the most efficient possibility are of less analytical interest because there is no reason even on economic efficiency grounds to want to replace them or to expect them to come under economic pressure to converge. The example would be two cities that focus on different sectors of production but both are statically the most efficient possibilities, take for example a city that focuses on software and another city that focuses on biotechnology because of increasing returns to scale (agglomeration effects) but each has identical and high returns to labor and capital. The cities might have divergent institutions and still face no pressure to make them converge.

[8] These reasons do not exhaust the reasons explaining institutional diversity, but they are the most interesting for exploring, on the one hand, why countries might maintain statically economically inferior institutions, and, on the other hand, one situation where we would expect institutional convergence due to globalization. Among the reasons for institutional diversity that we do not examine are bounded rationality explanations (economically rational mistakes, under some criteria such as discounting or high information costs), cognitive explanations (mistakes), sociological explanations, and reasons of economically optimal economic path dependency, see footnote 12.

[9] Among some other possible reasons are differing bounds on rational choice such as differing levels of uncertainty or processing capability, agglomeration effects that do not produce economically path dependent institutions that are sub-optimal, or differing sizes of country. An example of how differing size would affect institutional choice would be if returns to scale affected which institutions were economically optimal. In such a case, a small country and a large country might find differing institutions economically optimal or if two countries after trade globalization found themselves with sectors of differing size although using identical factor ratios in production because of differences in comparative advantage.

[10] Such differences in institutions would mirror differences in the implementation of technology in countries with identical access to the same technology due to producing at different places on the production function to factor endowment differences.

[11] To the extent that optimal institutional diversity is driven by differences in the relative size of sectors, then trade openness will not lead to institutional convergence because the two countries can be expected to have differing relative size of sectors.

[12] Trade theory expects factor ratios used in production to fully converge only under certain circumstances. To the extent that trade theory has outlined circumstances when factor ratios only partially converge, such as when two countries are not producing all goods traded, etc. etc., then under those same circumstances we would not expect the "optimal" institutional divergence to fully disappear and would expect some residual divergence to remain.

[13] In this case, the institutions are statically economically inferior, but from a dynamic perspective they are economically superior in that they are the best institutional choice available given the country's particular history.

[14] Institutional diversity might also appear due to economic path dependency that is not "statically" economically sub-optimal if increasing returns lead to agglomeration effects that create both diversity and functional equivalency in terms of economic performance. An example would be where one region focuses on car production and another region focuses on steel production where returns to factors of production are identical but institutions are different "statically" economically optimal adaptations to circumstances. Such institutional diversity due to economic path dependency is less interesting than the persistence of sub-optimal institutions, which we focus on. The analysis of such a situation would be a variation of that we carried out above concerning economically optimal institutional adaptation to differing relative factors of production used in production.

[15] If one path choice were more beneficial at the time in the 1950s, then if the choice were repeated 100 times the US would make the same choice each time and so there would be not be multiple branches of the future to consider.

[16] There are other reasons why economic path dependency might exist, see Liebowitz and Margolis, 1995.

[17] Another possibility is a tax that harms production but is transferred to the members of the winning coalition.

[18] We assume that capital cannot reliably compensate labor for accepting a switch from inferior Canadian to superior US institutions.

[19] An alternative story might be that the welfare state keeps a country limited to less profitable product markets and out of more profitable product markets. This competitive pressure will force the welfare state to be abandoned.

[20] This has also been described as a rent-seeking coalition. Of course, the use of the term "rent-seeking" implies the fundamental unjustness of the coalition's use of political power for redistributive purposes, which is not accepted by everyone and is a normative question.

[21] An alternative causal mechanism that would save the globalization convergence thesis would be if trade globalization somehow produced identical winning coalitions in every country, which would then choose identical sub-optimal institutions.

[22] The old winning coalition could respond to the potential defection of steelworkers by changing the distribution of benefits from the capital returns tax to compensate steelworkers for the losses they face with globalization. This would save the old winning coalition. Such a rescue would depend on whether an institutional arrangement could be created that steelworkers could rely upon to ensure such compensation.

[23] This is a quite different argument than that the large welfare state is used to compensate for trade openness (Mosher, 2000).