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21st Century Trade Agreements and the Owl of
Minerva

Bernard Hoekman and Douglas Nelson

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Abstract

The post Second World War liberal trade order has been a driver of global economic growth and rising average per capita incomes. This order confronts increasing opposition, reflecting concerns about adjustment costs and distributional effects of globalization, and the ability to pursue national policy goals. At the same time the development of complex production relations distributed across many countries calls for cooperation on a variety of regulatory policies. Contrary to what is argued by opponents of globalization, this does not imply one size fits all rules that constitute a threat to national sovereignty and democratic legitimation. There remains an important 'traditional' integration agenda that centers on rule-making by major trading powers on policies that generate negative international spillovers. But the core challenge for the political economy of 21st Century trade agreements is to support regulatory cooperation to better govern international production and address the non-pecuniary externalities associated with greater economic integration.

Keywords

Trade agreements; globalization; WTO; adjustment costs; economic integration; political economy.

JEL Classification: F02, F13, F15, F60

Introduction

The world's economies, at least those that we used to call "industrial" or "modern" and the global economy of which they are a fundamental part, are somewhere in a fundamental transformation, apparently every bit as significant as the transition from agriculture to manufacturing as the primary driver of economic development.¹ As Hegel's widely cited aphorism reminds us, our understanding of the causes, effects and meanings of the transition to a post-modern political economy must necessarily be profoundly incomplete until the transition itself is complete. This fact implies profound uncertainty facing citizens, elites and analysts, all of whom seek to adjust to that uncertainty. The stakes are high. Capitalism, democracy and the nation state were all forged in the fires of industrial modernism, as were the fundamental supports of this modern triad—unions, party systems, welfare states, and market supporting regulation and macroeconomic policy. In addition, the post-War liberal international economic order (LIEO), including the GATT/WTO and the European Union (EU), is organically related to those same economic and political-economic institutions (Ruggie, 1982). In a world where the President of the United States appears to reject a trading order of which the US was a founding member, major supporter, and beneficiary; the United Kingdom is rejecting EU membership; and anti-globalist populists in a number of OECD countries threaten to withdraw from fundamental commitments of that system, liberal trading relations face an existential crisis for the first time since the end of the Second World War. All of this means that any discussion of the political economy of 21st Century trade agreements needs to address not only the changes in such agreements needed to be consistent with the transition to post-Modern economic conditions in Europe and the US and the incorporation of rising powers, but also the prospects for survival in the face of concerted political attack.

In this paper, we begin with a brief discussion of the success of the post-War LIEO and its economic and political foundations. From there, we consider the economic and political changes that challenge this order. Next, we turn to what, prior to the emergence of aggressive anti-globalist politics in major OECD countries, appeared to be the key issues facing 21st Century trade agreements. Finally, we discuss the political foundations on which any further extensions of such agreements must rest. In all of this, we are well-aware that we are attempting to provide an analysis long before the owl of Minerva spreads its wings. Our focus will be broader than is usual in an economic review article and encompass contributions and insights from political science as well as economics. We also devote less attention to discussion the recent economic literature on commercial policy as comprehensive, up-to-date surveys have been compiled in Bagwell and Staiger (2016b).

1. Political & Economic Foundations of 20th Century Trade Liberalization

The era in which industrial capitalism became the driving force of the most spectacular increase in human productivity ever recorded was also the first era of globalization. The innovations in management and technology that permitted massive gains from economies of scale were supported by

¹ In this paper, we use the term "modern" to denote the distinctive political, economic, and cultural structures associated with industrial capitalism. In particular, the modern political economy will be taken to refer to a political economy with democratic politics organized as a nation state. While this usage is quite common, it leads us to use the term "post-modern" in a very specific way, as referring to the distinctive political, economic and cultural structures associated with post-industrial capitalism. When we refer only to the economy, we will use the terms "industrial" and "post-industrial". As the reference to Hegel's owl of Minerva in the title suggests, our knowledge of such a post-modern political economy is conjectural at best. When terms like "liberal" and "modern" refer to geographically and temporally specific entities, they are proper nouns and might expect to be capitalized (to distinguish them from adjectival usage). However, as there is no standard here, we follow the relatively common usage of leaving them in lower case.

falling transportation costs which increased the “extent of the market”.² It is now well-understood that protection (and the Hawley-Smoot tariff in particular) did not cause the depression, but it is equally well-understood its effect on both trade and growth was certainly negative (Irwin, 2011). More international trade was a key handmaiden of the catch-up growth that characterized the early post-War period in Europe and, since tariffs were the main barrier to that trade, trade agreements emphasizing liberalization of tariff protection (the EEC and the GATT, and their successors) were handmaidens of that trade (Eichengreen, 2007).

Given the wartime destruction and post-War reconstruction via catch-up to the (primarily North American) technological frontier, the pre-War tariff schedules of the core economies were no longer quite as tightly related to their underlying economies and political-economies as they had been when they were written. This meant that tariff reduction could be relatively easy. However, the continuing dominance of pre-War elites, and their protectionist policy attitudes, meant that this low-hanging fruit was not so easily harvested. This problem was offset in two ways. Perhaps most importantly, trade policy was associated with Cold War foreign policy (Cooper, 1987). This allowed trade policy to be carried out as a technocratic task associated with the basic foreign policy role of the state, and not as a part of the public politics of an electoral democracy. The combination of a “Golden Age” of growth and the Cold War provided a supportive backdrop for the creation and management of a Liberal trading system. Liberal trading relations were easily seen as an essential component of an anti-Soviet international economy. The strong economic performance of the “Golden Age”, in a context of rapid growth of trade, led to elite acceptance of a broadly liberal perspective on trade.

In addition, the technocratic task was conceptualized in terms of “exchange of substantially equivalent concessions”. That is, the logic underlying liberalization was mercantilist, which was politically easier to sell to legislatures still used to viewing trade in those terms. Furthermore, since tariffs are price measures and trade volumes are easily observed, the “value” of concessions was relatively non-controversially calculable. As a result, the core countries reduced tariffs considerably through the first four rounds of GATT negotiations. However, early success in tariff cutting in these countries, and the strong association of the GATT process with the Cold war led to increasing pressure to, in language used to identify problematic dynamics in the European integration programme, broaden (extend standard disciplines to new commodities and to non-core countries) and deepen (extend GATT disciplines to non-tariff barriers). From the Kennedy Round forward, the latter involved increasingly “constitutional” issues. While this process eventually resulted in the creation of the WTO, especially in the context of an increasingly diverse membership, the traditional approach to multilateral management of the system via Rounds, increasingly focused on constitutional issues, and quasi-judicial management away from the Rounds, “worked” only once—in the Uruguay Round. The first round of multilateral negotiations under the WTO, the Doha Round launched in 2001, failed to be concluded successfully. With low tariffs in the core, and a commitment to permit deviations from WTO disciplines away from the core, the potential gains from traditional negotiations are modest. Moreover, with respect to constitutional and non-tariff, regulatory, issues that increasingly are the main focus of interest, the method of exchange of concessions that proved very effective in inducing countries to reduce the level of their tariff bindings is less applicable. The type of take it or leave it package deal that was devised at the end of the Uruguay Round (1993) with the creation of the WTO was a one-time event that could not be replicated thereafter.

The GATT/WTO system was constructed by a group of governments that, while differing widely among themselves, were characterized by a set of fundamental similarities, they were mostly: capitalist democracies, constructing welfare states, built on industrial economies. All the original core members of the GATT/WTO system were what, at the time and for many years after, were called

² On falling transportation costs and trade, see Jacks *et al.* (2008).

“advanced industrial economies.”³ During the early GATT years, negotiations focused on reducing tariffs on manufactured goods: agricultural goods were excluded by the core countries for domestic political reasons; and developing countries were excused from most GATT disciplines under the belief that they required “special and differential” treatment (Hudec, 1987). Because the core countries viewed manufactures as fundamental to their own macroeconomic dynamic, and as broadly the sector in which they possessed strong comparative advantage, exchange of concessions on manufactures trade was relatively easy. The GATT process was rendered even easier by the fact that much of the trade within the core was not only intra-core (minimizing “leakage” to non-core economies), but intra-industry. The latter not only made comparison of concession magnitudes easier, but was believed to give rise to lower adjustment costs than inter-industry tariff cuts. Moreover, special and differential treatment meant that “sensitive” sectors in which developing countries had a comparative advantage (clothing; footwear; some agricultural products) could be excluded from liberalization, as these countries did not engage in the reciprocity game.

We have already noted that, at least until sometime in the 1970s, trade policy was treated as foreign policy (Cooper, 1987), and an obscure and technical element of foreign policy at that. As a result, trade policy was not a public political issue in most countries of the core. The incendiary link to unemployment effects of adjustment was broken in part by high post-War growth and in part by the extension of welfare states to cover the remaining unemployment risk. Because unemployment was generally low, welfare state costs tended to be low. Thus, both sides of Ruggie’s (1982) compromise of “embedded Liberalism” were secure: the left accepted globalization; the right accepted broadly market-consistent welfare states; and political elite acceptance of the legitimacy of both cemented the stability of the system. The political and economic foundations of this arrangement began to come apart in the 1980s, appearing to accelerate into full crisis by the second decade of the 21st Century.

2. The Changing Context facing 21st Century Trade Agreements

The Uruguay Round (1986-1994), among a wide range of accomplishments, created the World Trade Organization (WTO), putting the institutional structure of the multilateral trade regime on a firm legal footing, extended multilateral disciplines to textiles/apparel and agriculture, and transformed dispute settlement into an effective instrument of mediation for trade conflicts by shifting to a negative consensus rule for the initiation and adoption of dispute resolution procedures. This completed a process of constitutionalization (“legalization” in the jargon of political scientists, see e.g. Goldstein *et al.*, 2001) that began in the Kennedy Round and proceeded in parallel with the process of liberalization that was the *raison d’être* of the GATT. Unfortunately, the very success of the Uruguay Round and the WTO has revealed a number of political and economic problems for the institution, and the general programme of extending the Liberal trading order. Some of these problems have been accumulating for some time, while others have become apparent only recently.

A number of challenges flow from the success of the GATT/WTO process. Tariffs in the core are low, with remaining high tariffs applied in sectors where further reductions will prove politically difficult. The Single Undertaking was a massive constitutional undertaking setting the structure of the WTO. Even without the failure of hegemonic leadership, the likelihood of another such undertaking in the foreseeable future seems unlikely. This is problematic because, as we argue below, the fit between the current institution and the needs associated with the emergence of post-industrial economies, globally integrated firms, and China appear quite poor. Even without such major challenges, the widespread demand for “re-balancing” in the context of the “Doha Development Agenda” (started in

³ China was an original contracting party to the GATT in 1947 but withdrew shortly thereafter. The original set of 23 GATT signatories included India and other developing economies. These countries had different interests from the core industrialized members. As a result, as discussed in depth by Hudec (1987), development concerns came to be recurring matter for debate and led to inclusion of ‘special and differential treatment’ provisions in GATT in the 1960s.

2001) have, as yet, proven elusive (after 16 years!). The Doha Round has become symptomatic of the large differences that exist between WTO members, with both the original core countries and many developing seeking to rebalance the rules of the game. With a current membership of 164 countries, widely varying in economic development and political commitment to the multilateral system, another major constitutional moment will be much more difficult to orchestrate.

With the collapse of the Soviet Union and the end of the Cold War, the Liberal trade regime relied increasingly heavily on the elite consensus that grew out of the policy successes of the post-War “golden age”. This was especially true as economic performance in the core deteriorated dramatically through the 1970s and key sectors, such as steel, automobiles and consumer electronics, faced competition first from Japan and then the East Asian newly industrialized countries. Agreement on trade policy was a part of the broader consensus on deregulation and a general presumption in favor of expansion of market allocation where possible. In the United States this was part of a general reaction to the post-War Keynesian welfare state and tended to manifest itself as anti-government, not anti-market, politics. Similar dynamics affected post-War political equilibria in essentially all the core countries of the Liberal trading system. Not recognized at the time was the ease with which this anti-government populism could morph into anti-globalist, and even anti-market, populism.

The working out of the original GATT logic combined with broadening of membership to include such a wide range of nations that consensus was nearly impossible, with the end of the cold war, and with the welfare state and faith in the government’s ability to manage the economy in retreat, further extension of the Liberal trading order would have been difficult (to say the least). We have already noted that the exhaustion of the relatively easy liberalizations associated with the early Rounds made negotiations more difficult, we now note that transformation of the core economies constitutes an even more fundamental challenge. We focus here on major changes in the economic context of trade negotiation: post-industrialization of the core; the emergence of generalized global production (what Baldwin (2016) calls the “second-unbundling”); and the rapid emergence of China as a world power. All of these require a fundamental re-thinking of the nature and role of trade agreements in the 21st Century. And that rethinking must take place, and actions on that rethinking must take place, well before Hegel’s owl of Minerva has flown.

The shift to services. Like the transition from an agrarian to an industrial political-economy, the transition to a post-industrial political economy is complex and complexly disturbing to the social, political and economic arrangements of the industrial political-economy. These challenges would be difficult to manage in a closed economy, but the intimate relationship between post-industrialization and globalization has made the politics of globalization both confusing and incendiary. The economic core of post-industrialization is the transition to an economy whose fundamental dynamic is driven by the service sector, reflected in part by an increased share of employment in that sector. This is driven by technologies that permit more efficient (labor-saving) production of manufactures, but is supported and accelerated by technologies that permit extensive global sourcing. That is, industrial employment is reduced on both the local efficiency and the global outsourcing margins. While this certainly promotes a shift in the economies of the LIEO core to service production in which those economies have a comparative advantage, with all the benefits in terms of aggregate income emphasized by trade economists, the shift from manufacturing to services involves adjustment costs that are both larger and less well understood than the shifts within manufacturing that characterize adjustment to earlier liberalizations.

Just as services are essential to the post-industrial economy in general, they are essential to the post-industrial *global* economy and the relationship of the core trading economies to the global economy. The fundamental problem is that services do not lend themselves as well to the exchange of concessions that worked so well for trade in manufactures (Francois and Hoekman, 2010). Reasons for this are that barriers to trade in services often reflect national regulation of services activities as well as discriminatory measures that pertain to “modes of supply” that involve cross-border movement of capital and people. The General Agreement on Trade in Services (GATS) identifies four modes

through which trade may occur, two of which involve cross-border factor movement and one the movement of consumers. Given this broad definition of trade, it is not surprising that the GATS involved only very weak liberalization commitments (Hoekman, 1996).

Global production. The archetypal Modern firm was large and concentrated production to take advantage of economies of “scale and scope” (Chandler, 1977). This concentration economized on transportation costs but, more importantly, allowed management to control complex processes in an efficient way by utilizing advances in the use of information. The exports of these large concentrated firms were the focus of the early rounds of GATT negotiations. Advances in both transportation and information/communication technology, which also form the foundation of the post-industrial economy more generally, have worked to transform global trading relations. These technologies have permitted both the emergence of small, flexible firms, primarily in service sectors (Rajan and Zingales, 2000) and the emergence and rapid expansion of very large firms engaged in fully global production and distribution. As Baldwin (2014) argues, this changes the context of the trade regime in a fundamental way. Where trade was primarily in finished (or finished intermediate) goods, sold at arm’s length, tariff reduction (and reduction in other barriers to trade in those goods) was the key goal of those seeking a LIEO. However, when the goal of firms is to construct a global production structure, an essential part of such a strategy is to apply proprietary technology (product, process and managerial) to a corporate strategy involving a complex mix of exporting, direct investment and arm’s length contracting (here as part of the overall production process, not the final exchange of a product).⁴ Thus, the need is less for free exchange of commodities, but the creation of an environment in which finance, services, information, and intermediate inputs to production can be exchanged efficiently and securely. While the firms engaged in global organization of production still have an interest in traditional trade policy disciplines, they are much more interested in an environment with good protection of property rights, reliable communication, and consistent, market-conforming regulatory environments. A key driver of the Uruguay Round was to begin to establish such disciplines, as reflected in the TRIPS agreement and in the GATS. But the WTO is not, and probably cannot be, focused on these issues to the degree that is needed (demanded) by international business. This explains the shift to preferential trade agreements that govern the trade and investment relationships of the three “regional factories” of the world economy – Europe, Asia and North America (Baldwin, 2016). However, the trends in this direction are global.

The ‘China shock’ and re-distributional effects of globalization. The third major shock to the global economy is the emergence of China as a great, political and economic, power. Following decades of aggressively egalitarian and anti-market policy, China began to reform its economy in the very late-1970s, with more thoroughgoing encouragement of market-oriented policies in the late-1980s and 1990s, ultimately involving accession to the WTO in December 2001 (Naughton, 2017). China’s reforms resulted in literally unprecedented growth—averaging 9.7% per year from 1978 through 2016 (World Bank data online). This was accompanied by a major transformation of the economy as China became the largest manufacturing economy and the largest exporter in the world, with much of this increase coming in the 2000s. As with Europe’s growth following the Second World War, international trade played a major role in supporting that transition. However, as was also the case with other high growth economies in transition (primarily in Asia and Eastern Europe), and unlike the case of post-War Europe, much of this export growth was associated with participation in global value chains anchored on the US, Europe or Japan. Thus, post-industrialization, global value chains, and Chinese export growth are all part of a single complex that is transforming both national and global political-economies. Not only do each of these involve pressure to adjust in fundamental ways in both the national and international economies, but the complicated relationships between them raises difficult questions about what form such adjustment should take. Not surprisingly, these

⁴ For an excellent presentation of the state of the art on these issues see Antràs (2016).

economic pressures interact with changed political circumstances to make the future even more uncertain.

It is an axiom of political economic analysis that material (i.e. economic) well-being, and changes therein, are the fundamental drivers of politics—at politics over economic issues such as globalization and post-industrialization. This axiom certainly draws credibility from the rhetoric around the public politics of those issues. More specifically, as far as the public politics of globalization and post-industrialization are concerned, the primary measure of the costs and benefits of economic change, and policies responding to such change, is labor market performance—their effects on employment and wages. In evaluating these effects, it is important to distinguish between the long-term, structural, effects of such changes and the short-term, adjustment, effects. The former should inform structural policies (e.g. trade policies) while the latter should inform strategies to cope with adjustment costs.

In labor markets of the post-War Golden Age, moderately educated, primarily white, male, workers found manufacturing employment at wages that could support a middle-class lifestyle. Extensive unionization and strong growth in the leading manufactured goods sectors underwrote high wages and job stability in core countries. Additionally, the development of the welfare state promised income insurance in the face of economic downturn. This is the compromise of “embedded Liberalism” that many in the post-War era believed had found a way to balance the demands of capitalism and democracy (Blyth, 2002). At the international level, this involved a balance between sovereignty and interdependence (Finlayson and Zacher, 1981). The maintenance of these balances meant that there was little political interest in opposition to a broadly market conforming domestic economic policy or a relatively tight link between the domestic economy and the global economy. A breakdown in either of those balances could call the entire system into question. Thus, just as the complex of factors discussed above (post-industrialization, global production, and China) have made the functioning of the multilateral system more difficult, they have also changed the political environment within which that system operates.

Instead of labor being concentrated in industrial (and traded) production, in the post-industrial labor market tends to be divided into skilled and unskilled service labor (Emmenegger, 2012). In both cases, labor needs to be flexible in the face of changing demands, with skilled service labor requiring general skills that can be applied across a wide range of sectors, and unskilled service labor filling relatively short-tenure jobs that require little in the way of specialized skill (Wren, 2013). The former jobs pay a premium, while the latter do not and the rising demand for general skills is having a significant effect on the income distribution (Goos *et al.*, 2014). Post-industrialization thus hits the low-skill middle class in two ways: rising productivity allows firms to substitute capital for labor in manufacturing, resulting in a relatively constant output of manufactures while the share of labor in manufacturing has dropped dramatically and became more skill-intensive; while the jobs available for unskilled workers are mostly relatively low-paid service jobs. Furthermore, given that service jobs, both low and high skilled, generally have a minimal requirement of brute strength, women have been increasingly able to compete on equal terms with men for such jobs. On the one hand, this has resisted the rise in household inequality as the two-income household increasingly became the norm, but on the other hand, men have found themselves in much more competitive labor markets. Whether high or low skilled, the post-industrial labor market is characterized by considerable uncertainty as well.

It is possible that unions and welfare states could have resisted trends like these, but both of these institutions have been buffeted by post-industrialization and politics. Unions are at their strongest when workers with similar labor market traits are concentrated in large workplaces and governments are broadly supportive. We have already noted that fewer and fewer workers are employed in such workplaces, as service jobs involve smaller firms with more flexible workforces (in particular, the significance of part-time work has grown substantially throughout the core economies of the LIEO), while the large firms that remain are increasingly characterized by global workforces. Neither of these make union organization easier. In principle, union decline could be resisted if governments were committed to supporting them, but the reverse has been more common throughout the (post-)

industrial world. There is a broad, though perhaps not terribly deep, consensus among economists that the fundamental driver of post-industrialization is technological change, though it is clear that, as with the post-War Golden Age, globalization has played an important supporting role (Desjonquieres *et al.*, 1999, Van Reenen, 2011).

Where the literature on the economic effects of post-industrialization is overwhelmingly focused on structural consequences (e.g. changes in national income and its distribution), the literature on response to globalization (trade and migration in particular) includes extensive research on both structural change and adjustment, though it is not always clear in the presentation of research to which of these a given piece of research speaks. In thinking about the labor market effects of trade, we need to distinguish between two sorts of shock: a large increase in trade with low wage countries; and a change in the structure of trading relations (i.e. the dramatic increase in global organization of production). The standard textbook account of a national economy's response to a change in trading conditions contains the main tools needed to understand the structural (i.e. long-run) effects associated with the first of these shocks.⁵ Since 1990, the core (post-)industrial economies have seen sizable falls in the relative price of manufactured goods exported by developing and transition economies and these have been associated with large increases in the volume of imports from those countries (Krugman, 2008). Since these goods would have been importables before the 1990s, and thus these price changes do not involve a negative terms-of-trade shock, the effect on national income should be strongly positive. That is, the rich countries get a price cut for the goods they are importing and can specialize even more in production of their exportables. Of course, the same models that underwrite this conclusion also tend to suggest that there could be sizable distributional effects from factors used intensively in the production of importables to factors used intensively in the production of exportables.⁶ In fact, this relationship underlies much of the research on the political economy of trade policy.

While most attempts to measure the size of this effect produce rather small numbers, something in the neighborhood of 10-20% of the rise in the skill premium as of 2006, such estimates are based on datasets that are both too short to convincingly allow the adjustment to the long-run implied by the theory and too early to incorporate the large increases in imports from developing countries and countries in transition. Krugman (2008) makes the valuable point that the global organization of production has made the analysis more difficult. The construction of price series and implicit factor flows proceeds from industry definitions that involve a relatively high degree of aggregation. Thus, we may observe considerable north-south intra-industry/intra-firm trade in goods whose production, in fact, use quite different input combinations (i.e. are actually different commodities). This interferes with empirical inference based on the standard model. On the one hand, in terms of a multi-cone version of the standard model, it implies equilibrium relative factor price differences (that is, trade with economies with quite different relative factor prices need not imply any pressure for factor-price equalization); on the other hand, if one is thinking in terms of implicit trade in factors, the implied flow of unskilled labor may be considerably larger than we are usually estimating. Thus, while the direction of the effect of trade on the skill premium seems unproblematic, the magnitude is far from clear. Furthermore, given that high-income OECD economies have adjusted to the price changes/trade

⁵ Current research has dramatically expanded the textbook model to include monopolistic competition, firm heterogeneity and unemployment. The first two tend to increase gains from trade without much changing the analysis of distributional effects, while the latter makes the analysis more complex without fundamentally changing the main long-run message of the textbook model.

⁶ This is the implication of the Stolper-Samuelson theorem. That theorem strictly applies to a world with 2 good and 2 factors (the Heckscher-Ohlin-Samuelson model). With more goods and factors, dimensionality matters to the identity of the gainers and losers, and to whether the gains and losses are real –i.e. unambiguous relative to all prices of consumption goods (Jones and Scheinkman, 1977). The key in any case is the relative price change, not the volume of trade, although these should go together.

volumes in question, any reversal of those changes would produce a new round of redistributions (and a fall in aggregate income).

Dealing with adjustment costs of structural transformation. Baldwin (2016) argues that the new millennium has witnessed the emergence of a qualitatively new globalization—the “second-unbundling”—associated with global organization of production involving construction of value chains that involve exchange of northern technology for less expensive southern inputs. While this is consistent with the Krugman story we have just noted, it also implies a more unstable allocation of tasks across the global economy, affecting both skilled and unskilled workers. Along with, and to a considerable extent indistinguishable from, post-industrialization, 21st Century labor markets are likely to be characterized by declining returns to unskilled work and greater employment/income uncertainty throughout the value chain/task structure. Major changes in demand for relatively unskilled work can also be expected within services sectors – e.g., an expansion in demand for health care and personal services workers as societies age, offset by declines in sectors such as transport as a result of technological changes. As we shall see below, these trends create potentially fertile ground for the emergence of populist political movements.

One of the difficulties of learning from research on trade and labor markets is the difference between trade and labor economists in the focus of their research. Not only does this difference, and the fact that it is unrecognized by trade and labor economists, lead to miscommunication between professional economists, but it is also confusing to consumers of that research. In simple terms, trade economists tend to focus on long-run structural questions, while labor economists focus on adjustment problems. While it is widely understood among economists of all flavors that structural policy (e.g. trade policy) is an inappropriate response to adjustment problems, it is unquestionably the case that adjustment problems are far more politically significant than long-run, Stolper-Samuelson type, distributional issues. A sizable literature on adjustment developed in response to the trade shocks in the 1980s showing, among other things, that adjustment costs are heterogeneous across sectors and workers, falling particularly hard on older workers in declining sectors (e.g. Kletzer, 2002). As concerns with Japan, and the “Newly Industrialized Countries” in East Asia faded, so did research on this topic, but it came back with renewed strength in the face of China’s entry into the world trading system as a major participant.

With better data and more modern econometric techniques, and a “China shock” of literally unprecedented magnitude, labor economists have been able to compellingly identify large adjustment costs (Autor *et al.*, 2016a). Much of the rhetoric around this work suggests that the consensus in the research on the 1980s, that trade was not a major source of the long-run rise in the skill-premium (i.e. the long-run fall in return to unskilled labor), was wrong. Unfortunately, that conclusion rests, first and foremost, on a simple confusion: the earlier conclusion was about a long-run fall in the skill-premium, the current work speaks to potentially large adjustment costs between long-run equilibria. The point is not that these adjustment costs are insignificant. Far from it. As with job and income loss of any kind, these costs are highly significant to the people experiencing them. Furthermore, given that these adjustments are essential to reaping any gains from trade, the recognition that the people bearing the costs are precisely the people generating the gains, creates a sound normative case for adjustment assistance.

Unfortunately, normative arguments of this sort are rarely politically effective. However, the implications of increased inequality and increased job risk for political stability are a matter of general concern. In recent years, anti-globalist populist movements have achieved striking success. While the roots of these movements appear to be more associated with the dislocations associated with post-industrialization, the electoral success of these movements does appear to be associated with large trade shocks, the China shock in particular (Autor *et al.*, 2016b, Colantone and Stanig, 2017, Jensen *et al.*, 2017, Rodrik, 2017). As with our discussion of structural and adjustment issues in the economic response to trade shocks, it is important to be clear that this work shows a link between political activity (primarily right-wing populist activity) and adjustment to the China shock, not changes in the

long-run structure of the economy. The problem from a political perspective is that it has proven essentially impossible to compellingly distinguish between these two sources of change. It is certainly the case that the rise of right-wing populism precedes the rise of global value chains by more than a decade and seems to be more associated with post-industrialization than globalization (Iversen and Cusack, 2000), and in some countries is more associated with opposition to migration than trade in goods. Furthermore, the link between change in economic status and participation in populist politics is not terribly strong (Inglehart and Norris, 2016). Unfortunately, a foreign threat is always a better political foil than technological change. In the past, and independent of the source of social, political and economic stress, relatively unskilled workers were more protected by unions and welfare states, but both of these institutions have been weakened by post-industrialization and globalization. Furthermore, both of these institutions were organically related to Modernism and, with the passing of the Modern age, it is not at all clear that these could be simply reconstructed even if there was the political will to do so. We return to these issues following our discussion of the content of 21st century trade agreements.

3. 21st Century Trade Agreements

21st Century trade agreements are only in part trade agreements. Although significant business still remains from the 20th Century trade agenda (binding tariffs in the WTO at applied levels; reducing tariff peaks and trade-distorting policies in the agricultural sector), 21st Century trade agreements go beyond this to focus on creating an institutional environment supportive of global economic activity in a post-industrial world. This is in large part a regulatory agenda that involves what Tinbergen (1954) has called positive integration: efforts to agree on common rules and joint pursuit of specific types of policies as opposed to agreement to refrain from using policies that create negative cross-border pecuniary spillovers (negative integration). Whereas Tinbergen had in mind a shift to greater supranational governance and institutions of the type that have been put in place over time in building the European Union, positive integration need not involve the classic sequence from free trade agreement to customs union, common market and economic union with the associated creation of supranational institutions. Instead positive integration in the 21st Century is likely to remain inter-governmental. The key is that it involves transnational cooperation in pursuit of common regulatory objectives among subsets of like-minded countries – and insofar as agreement can be obtained in the WTO, among all 160+ members of that organization.

As with the ongoing program of stabilizing the national relationship between the market and civil society, the global program requires institutions that contribute to the political legitimacy of the global market. In a world of primarily democratic political systems, this legitimation is rooted in civil society, which for the foreseeable future is irreducibly national (Nelson, 2015). Ruggie (1982) called this balancing act in the case of 20th Century trade agreements the compromise of embedded liberalism. Facing an environment in which the fundamental drivers of capitalist development, at least in the core of the LIEO, are changing, the most fundamental challenge confronting 21st Century trade agreements is to reconstitute embedded liberalism in such a way as to be consistent with post-industrial economics generally and global economic structures in particular. In this section, we discuss economic dimensions of such agreements, leaving the political foundations for the following section. We will argue that deeper cooperation between countries is needed to sustain the LIEO and address some of the challenges we have described above.

The changes in the world economy discussed above affect the motivations for trade cooperation, its content and modalities. The rise of global value chains (GVC) and associated international fragmentation of production, offshoring and cross-hauling of FDI increases the interest by businesses to reduce nontariff barriers to trade in goods and services, and gives rise to a rationale for focusing on rules for domestic policies (Antràs and Staiger, 2012). The effects of national regulation of economic activities – or lack thereof (e.g., corruption) and the importance of intangible assets and contract enforcement for GVC-based production makes regulatory heterogeneity a matter of greater concern

(source of costs) for firms than remaining border barriers. This includes policies that affect the “digital economy” (e.g., data protection requirements; access to telecom services and the internet backbone) and domestic regulation that impacts on the cost/feasibility to provide services. Cooperation on service sector regulation is a central part of the agenda for firms not just because services are becoming more tradable but because a wide range of services are critical inputs in the production of goods and a key driver of productivity performance, including through the ‘servicification’ of manufacturing (Beverelli et al. 2017). Barriers to trade in services do not take the form of tariffs but encompass restrictions on foreign direct investment (FDI) and cross-border movement of services suppliers (natural persons). Such restrictions are often (much) higher than barriers to trade in goods (Borchert et al. 2014; Jafari and Tarr, 2017).

Reducing the costs of regulatory heterogeneity is not only important to firms. The rising share of global production that involves tasks and activities in developing countries increases the salience of regulatory matters for consumers (voters). They may be concerned with both pecuniary and non-pecuniary spillovers associated with (a lack of) foreign regulation of production processes (Vogel, 2012). This augments concerns of workers (labor) discussed above regarding adjustment costs and distributional effects of globalization. GVC-based production technologies challenges national policymakers because: (i) they need to consider a wide range of interdependent, complementary policies, both domestic and foreign, that affect the operation of GVCs (Hoekman, 2014); and (ii) they are not able to affect directly production processes in foreign countries. Regulators have responded through greater international cooperation and incentivizing the provision by firms of information on process failures and good practices within/across chains (Hoekman and Sabel, 2017). NGOs have responded through private action to govern GVCs – most notably the development of voluntary sustainability standards that include a focus on labor standards and protection of the environment (Abbott and Snidal, 2010; Ruggie, 2014). Groups seeking to support what they regard as good social norms – including internationally agreed and widely accepted standards – increasingly pressure their governments (as well as lead firms – producers; large retailers) to regulate what happens inside their supply chains and to include provisions in trade agreements to improve enforcement of national legislation pertaining to economic governance, human rights, labor standards and protection of the environment.

In a number of these areas a focal point for cooperation is international standardization – e.g., ILO conventions; in others it is international agreement on attaining specific performance targets – e.g., the Sustainable Development Goals. Indeed, international cooperation on standards-setting is not done in trade agreements. However, international firms and consumers both may regard trade agreements as useful mechanisms to influence domestic regulation (‘behind-the-border’ policies). The underlying goals are different, but the focal point – domestic (foreign) regulation of economic activities – is the same. A major challenge for 21st Century trade agreements that is distinct from the 20th Century trade agenda is to balance the desire by firms to lower the costs of regulatory heterogeneity with the concerns of consumers/voters regarding the realization of national regulatory objectives and safeguarding of national social preferences. A key question confronting policymakers in this regard is determining if and how trade agreements can help to address the pecuniary and non-pecuniary spillover costs of regulatory heterogeneity.

From shallow to deep integration

The trade literature makes a useful distinction between shallow and deep trade agreements that helps to distinguish the challenges confronting 21st Century trade cooperation from 20th Century trade agreements. For purposes of this paper, we will define shallow integration as cooperation that centers on discriminatory treatment of products and producers when accessing markets, whereas deep integration focuses (additionally) on the substance of prevailing (desired) regulation of production

processes.⁷ Shallow integration of goods markets entails reducing discrimination at the border on foreign-produced goods through (reciprocal) reduction of border barriers ('market access' in the terminology of Bagwell and Staiger, 2016a) and application of the national treatment and most-favored-nation principles. In the case of services, shallow integration includes policies constraining factor movement: reducing (removing) discrimination against foreign investors (FDI) and allowing (facilitating) the cross-border movement of services suppliers (natural persons) on a time-limited basis to provide services. Complete liberalization requires full national treatment – i.e., policies are applied equally to domestic and foreign services and services providers. To date this is the exception in trade agreements, the EU being the only example where a group of countries treat national firms and services the same as those from other member states.

Most of the trade literature focuses on shallow integration of trade in goods, and mostly on the market access (reciprocal tariff reduction) dimensions and related nontariff barriers that apply at the border.⁸ It is important to emphasize that shallow integration remains highly relevant and will continue to be a staple of 21st Century trade agreements, although this agenda pertains more to FDI, subsidy policies and trade in services than to border barriers against trade in goods given that these are policy areas where the level of discrimination against foreign producers are most significant (e.g., Borchert et al. 2014 and the Global Trade Alert database of trade-distorting policies).⁹ Such shallow integration is straightforward conceptually, even if difficult in practice given that it is intrusive (e.g., national treatment in public procurement or the provision of subsidies is politically fraught). As China has become the world's largest trader its use of subsidy and related industrial policies that are held to discriminate against foreign firms and distort global competition the salience of negotiating rules of the road for the use of such policies is a major and urgent 21st Century challenge. The modalities of cooperation to address this challenge are firmly 20th Century in nature and well understood.

Deep integration goes beyond market access commitments and national treatment. The focus is not on removing discrimination (as the underlying policies are (mostly) not designed to discriminate) but to attenuate adverse trade effects of domestic regulation. The term deep integration is used loosely in the literature, generally implying agreement to accept disciplines on the use of domestic policies that go beyond national treatment, without specifying what exactly this entails.¹⁰ Limão (2016) provides an insightful definition: deeper integration involves cooperation to integrate production structures across countries. In what follows we will use the term to describe cooperation on regulatory policies, processes and standards that supports this outcome by lowering trade and operating costs for firms located in participating jurisdictions. Such a fall in trade/operating costs can be achieved if cooperation results in firms no longer confronting the fixed costs associated with having to demonstrate to regulators in each market that their products or production processes satisfy regulatory requirements. Even if differences in social preferences or national circumstances are such to prevent adoption of approaches that lead to common norms, mutual recognition or equivalence (see below),

⁷ The theoretical and empirical trade literature has generally defined deeper trade agreements as spanning discrimination implied by nontariff barriers (Ederington and Ruta, 2016 provide an in-depth survey of research on nontariff trade policies). Empirical efforts to categorize the 'depth' of trade agreements have tended to build on the Horn, Mavroidis and Sapir (2010) distinction between WTO+ and WTO-X commitments as a way of determining "depth" of trade cooperation – i.e., the extent to which an agreement entails more commitments than the WTO on matters covered by the WTO agreements (WTO+) and the extent to which it addresses matters on which the WTO has no disciplines. Empirical compilations using this typology include Hofmann et al. (2017) and Dür et al. (2014). The WTO+ and WTO-X distinction and mappings of the content of trade agreements is a critical input into empirical analysis but not very useful to differentiate between 20th and 21st Century trade cooperation as it is purely descriptive and takes the WTO as a baseline.

⁸ See, e.g., the surveys by Freund and Ornelas (2010) and contributions to Bagwell and Staiger (2016b).

⁹ See <http://www.globaltradealert.org/>.

¹⁰ Much of what we would define as representing shallow integration is considered to be deep in the trade literature, reflecting the (implicit) view that shallow is limited to market access improvements through reciprocal tariff reduction commitments.

deeper integration can still reduce trade costs through agreement to adopt common processes ('good practices') relating to how regulations/domestic policies that may affect trade and investment are developed (transparency; consultation; use of impact assessments, etc.) and implemented (OECD, 2017). Such cooperation can have a beneficial effect on foreign firms by reducing policy uncertainty without constraining the substance of the underlying regulation.

Shallow integration of goods (liberalizing market access) is a rent re-distribution story – taking the hands of import-competing industries out of the pockets of consumers (Finger, 2002). Static aggregate welfare effects will generally be small, however, as they are limited to the removal of deadweight losses ('Harberger triangles'). In the case of services, the welfare effects of reducing barriers to movement of foreign producers (FDI; temporary movement of suppliers) may be more complex. Welfare may fall if the result is to shift rents to foreign entrants and such rents are large. Deep(er) integration can have large positive welfare effects by reducing wasteful use of resources to document compliance with regulatory norms that are equivalent, enhancing the realization of regulatory objectives by allowing regulators to cooperate in the design of standards, and learning from different approaches across jurisdictions to achieve similar regulatory goals.

Shallow integration is associated with horse-trades (reciprocity) – each country agreeing to lower tariffs as a quid pro quo for partner countries doing so as well. Reciprocity ensures there are joint gains and that agreements are credible (self-enforcing) as commitments can be withdrawn if a country reneges. Deep integration cannot be pursued through reciprocal exchanges of marginal changes to regulation. Instead the focus is on the content of regulatory policies and regimes. Cooperation may take the form of harmonization (adoption of common norms) through a process of international standardization through bodies such as the ISO, or by a small country adopting the standards of a large partner such as the EU or US. It may also take the form of identifying 'good regulatory practices' (OECD, 2017) – agreements on the process of development of regulatory norms and their implementation/enforcement. In specific areas it may involve mutual recognition of regulatory standards or agreement that regulatory regimes have very similar goals and are equivalent in terms of their effectiveness. All such instances of international regulatory cooperation are not based on the 'first difference reciprocity' (Bhagwati 1988) approach that is used to negotiate market access commitments (shallow integration). This is generally neither feasible nor appropriate for deep integration, as it involves looking for joint welfare improvements in regulatory processes that reduce trade costs and uncertainty without adversely affecting the realization of national regulatory/social goals. A necessary condition for such cooperation is 'full reciprocity': each party (polity) must have very similar policy objectives and institutions/regulatory regimes that are equivalent in terms of their effectiveness in pursuing these goals.¹¹

Regulatory cooperation must be driven (led) by regulators. In practice international regulatory cooperation occurs frequently, but outside the confines of trade agreements (Hoekman and Sabel, 2017), raising the question what the value added is of pursuing deeper integration through trade agreements. It is not enough to point to the fixed costs of differences in regulatory regimes and policy uncertainty across countries and argue that deep trade agreements are needed to lower such costs,¹² as this can proceed through different channels. The value added of embedding commitments in trade agreements is that they offer a means to enforce cooperation – agreed rules of the game are self-enforcing as countries can withdraw market access concessions if a partner reneges on a commitment. An implication is that it must be incentive compatible for countries to use market access threats to

¹¹ See e.g., Lawrence (1996) and the contributions in Bhagwati and Hudec (1996) for early discussion of deep integration; Hoekman and Sabel (2017) for elaboration of the arguments that are developed here.

¹² There is extensive empirical evidence that regulatory heterogeneity and policy uncertainty has negative effects on trade and investment (see, e.g., Limão, 2016). Research has also established that the domestic institutional environment and quality of economic governance matters for the size of potential net gains of trade reforms. The question is whether trade agreements are an efficient mechanism to address the matter.

enforce regulatory cooperation. It is not clear that this is the case for much of what falls under our definition of deep integration as regulatory norms do not lend themselves to ready reversal (assuming the standards and associated regimes address market failures or noneconomic objectives). This suggests trade agreements are more appropriate (effective) for shallow integration. As mentioned, a large shallow integration agenda remains in areas that will be central to the 21st Century trade agenda, including agreeing on rules for subsidies, investment and industrial policies associated with state-capitalism (first and foremost China, but also in other countries – both developing and developed).¹³

This is not to say that some of the motivations that have been offered in the literature for trade agreements do not apply to cooperation that aims at deep integration as defined here, i.e., efforts to lower trade costs and address non-pecuniary externalities or deal with market failures more efficiently. Pursuit of deep integration in trade agreements may reflect commitment motives by governments attempting to address time-consistency or political economy constraints that impede the ability to adopt good regulatory practices and/or engage in international regulatory cooperation (see Maggi 2014). This may include addressing international non-pecuniary (noneconomic) externalities, e.g., associated with labor standards, human rights or the environment) (Limão, 2016). A potential argument for pursuing deep integration in trade agreements is that this permits issue linkage – different policies that generate cross-border externalities can be put on the table and tradeoffs made. In principle, a bigger negotiating set is better in getting to yes. However, this depends importantly on how issues are related (the extent to which they are symmetric, complementary or separable), whether transfers are available and whether the benefits from cooperation are excludable – see Maggi (2016).

In practice, issue linkages may not be useful to support deep integration. Indeed, linkage strategies may be counter-productive because constituencies (regulators; consumers) have no desire (incentive) to change regulatory regimes once these have been established. This is an analogue of the point that first difference reciprocity is unlikely to be effective as a modality of cooperation. The implication is that issue-specific agreement (cooperation) may be feasible, i.e., there is no need or benefit of seeking to agree on issue areas as part of broader packages. If so, this may open the door to club-based cooperation as a mechanism to achieve coordination benefits (reduce regulatory duplication and redundant procedures). While this notion is speculative, it suggests there may be less need for 21st Century trade cooperation to take the form of traditional preferential trade agreements in which discrimination in favor of signatories is the instrument that sustains cooperation. It also suggests it may facilitate cooperation at the multilateral level under WTO auspices as there is less of a case for linking regulatory cooperation to shallow integration-type issue areas that are contested and that have generated the deadlock that led to the failure of the Doha round.

While pursuit of positive/deeper integration is in our view a necessary and important dimension of ‘21st Century’ trade cooperation as one means of addressing concerns of both international firms and domestic consumers, voters and workers, making progress will not be easy. There is a view among many observers that in practice deep integration initiatives will need to be pursued incrementally, with subsets of countries cooperating on specific policy issues in clubs (e.g., Lawrence, 2006; Hoekman and Mavroidis, 2015a;b). Even then there is no assurance of success. The difficulty of obtaining political support for regulatory cooperation (deeper integration of markets) was clearly revealed in the 2014-16 experience of the EU in its negotiations with Canada (on a Comprehensive Economic and Trade Agreement – CETA) and with the US on a Transatlantic Trade and Investment Partnership—TTIP) (Young, 2016). Despite these talks being between like-minded high-income OECD member countries, there was major opposition and concern regarding the inclusion of regulatory matters in the discussions. As discussed in the next section, the political foundations for deeper cooperation between nations need to be in place, even if cooperation involves only a small number of countries. Going

¹³ See, e.g., Brou and Ruta (2013) on the rationale for agreements on subsidies; Blanchard (2015) on investment policies. There are of course thousands of bilateral investment treaties but these focus on investment protection as opposed to market access

beyond club-based cooperation to pursue deeper integration at the global (multilateral) level spanning all WTO members is an order of magnitude more difficult.¹⁴

The decision by some 40 countries, counting the EU as one, at the 2017 WTO Ministerial conference in Buenos Aires to launch plurilateral discussions to explore common rules for e-commerce illustrates that deeper integration is likely to involve either clubs that agree on good regulatory practices for a given area or will be pursued in the context of preferential trade agreements. A downside of the latter is that they tend to be closed, although there is no reason why non-members of a trade agreement could not participate in regulatory cooperation initiatives.¹⁵ Whether open or closed, deep integration regulatory cooperation is excludable and often will be: a necessary condition for benefitting from what is agreed is that regulatory institutions will need to be “similar enough” if not equivalent. Given large differences in institutional capacity and quality across countries, this suggests a need for making available technical and financial assistance to countries that are interested in participating in regulatory cooperation/deep integration initiatives but do not satisfy the preconditions for being able to do so (Hoekman and Mattoo, 2013).

4. Political Foundations for 21st Century Trade Cooperation

The deeper integration that is needed from both a global resource allocation perspective – to support further specialization, trade in services and the development of the digital economy – and to enhance the effectiveness and efficiency of domestic regulation to address market failures and provide global public goods will not materialize unless it is supported by politics. There is a complex, but organic, relationship between capitalism, democracy and the nation-state.¹⁶ Contrary to the notion that capitalism thrives, or even survives, under conditions approaching anarchy, in addition to the services that must be provided by the state to ensure any well-ordered society, capitalism requires a distinctive set of policies including (but not limited to) such things as the identification and protection of property rights, enforcement of contracts, and so forth. Creating such a liberal state was the political programme of the early proponents of what would eventually be called capitalism. An essential part of this programme was the constitution of the market as a distinctive domain of civil society, separate from that part of civil society regulating the relationship between citizenry and state, and characterized by, among other things, a radically individualist notion of the relationship between people.¹⁷ By rendering the individual an essential part of the liberal political vision, the liberal programme laid the foundation for a political order rooted in, and legitimated by, individual citizens. Thus was forged the organic relationship between capitalism and democracy. Democracy, in turn, requires a distinctive relationship between civil society and the state. Legitimation of the political order that embeds capitalism requires active approval of that order by civil society. As an ongoing, self-conscious entity, civil society, and thus democracy, has historically only really been possible in the context of a nation state. The business of modern civil society is the self-constitution of a people and the governance of their public life; the modern political economy is an organic amalgam of capitalism, democracy and the nation state.

¹⁴ However, the 2013 WTO Trade Facilitation Agreement (TFA) illustrates that it is possible for all WTO members to agree on what in fact is a deep integration initiative. The TFA involves a set of good practices that all WTO members have agreed to – i.e., a substantive regulatory norms in the area of customs clearance and transit regimes. A key feature of the TFA is that the timing of implementation of these practices by developing country WTO members can be determined unilaterally and may be made conditional on the provision of development assistance. See Hoekman (2016).

¹⁵ Thus, third countries may and do participate in certain of the EU’s regulatory mechanisms. See e.g., Lavenex (2015) and Young (2015) for discussions of experience in this regard.

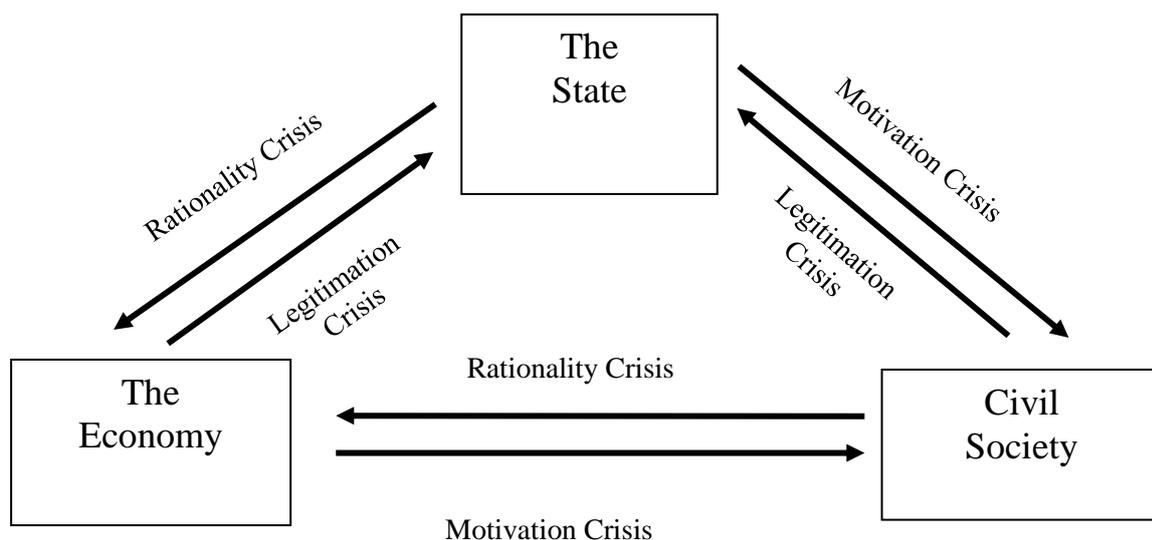
¹⁶ See Mann (1993) for an outstanding presentation of the historical development of this Modern triad. This and the next paragraph draw extensively on Mann’s development.

¹⁷ This programme was so successful that this domain, the capitalist economy, ceased to be seen as part of civil society and came to be called simply “the economy”.

The modern political economy was also the site of Baldwin’s (2016) first unbundling—that is, the concentration of production in what, as a result, became the industrial economies. As we have already noted, these economies developed large, integrated firms that, as a result of the cost savings associated with economies of scale and internalization, were able to serve the world market. The growth associated with modern capitalism was spectacular, raising the standard of living dramatically in the industrial economies, but also producing historically unprecedented inequality and economic instability. As a number of scholars noted, these latter consequences of modern capitalism were not obviously consistent with expanding democracy. Furthermore, the development of capitalism was associated with the increasing extension of democracy, which came to be seen as having a problematic relationship with capitalism.

Consider the simple model of modern capitalism in figure 1.¹⁸ The essential thing is that this diagram represents the three-sided relationship that defines the modern capitalist political economy and the characteristic crises that emerge in the relationships between its component parts. A rationality crisis occurs when the state or civil society undermines the functioning of the economy by undermining the individualistic, rational logic that dominates the capitalist market. Similarly, a motivation crisis occurs when the logic of the market, or the logic of the state, undermines the social functioning through with communities constitute themselves. This can result in generalized anomie (thus “motivation crisis”) but, as we shall see, this can also produce polarization and generalized social conflict. Finally, a failure of the state to stabilize the relationship between the market and civil society results in a withdrawal of legitimacy and a failure of political order. Classical theory develops a number of these in considerable detail. For example, Weber (Weber, 1924/1978) saw democracy as undermining rational policy making. An alternative channel is emphasized by Schumpeter (1942/1975), for whom the dynamism associated with entrepreneurship (the engine of capitalism for Schumpeter) produced popularly unacceptable levels of instability, leading to demands for “socialism” (Schumpeter’s term for what we now call the welfare state). It is essential to note that these are all possibilities, but there is no assertion that there must be crises.

Figure 1: The Modern Political Economy [after Habermas (1975)]



¹⁸ This figure, and the analysis in this paragraph, is based on Habermas’ (1975) classic *Legitimation Crisis*.

The upshot of all of these is simply that there is an inherent tension between democracy and capitalism that must be managed somehow. Polanyi (1944), in particular, saw this tension producing what he calls a “double movement” between liberalization and protection, as first the market and then civil society dominates the states response to underlying conditions. Too much of one or the other produces a crisis, but this would be conjunctural, not structural.

As the democratic constraint drew tighter—through both the increasingly broad extension of democratic rights and the increasing acceptance, by elites and civil society, that the government possessed tools to reduce, or eliminate, the tendency toward political-economic crisis—and because protection had manifestly failed as a response to the depression (Irwin, 2011), the state increasingly relied on some mix of Keynesian macroeconomic policy, corporatism, welfare state insurance of income, and market conforming regulation (Hall and Soskice, 2001). All of these are national economic policies, which retain the organic link between capitalism, democracy and the nation state. The post-War system for managing Liberal trading relations made all three of these central to that order. On the one hand, liberalization, generalized most favored nation treatment, and multilateralism all emphasized the gains from interdependence; but, at the same time, this order was based on sovereign nations as the essential members, while a commitment to safeguards (temporary re-imposition of protection against imports that cause serious injury to a domestic sector) recognized the essential role of national industry. The essential role of the Keynesian welfare state was baked into the system from the start—though this is most apparent in the international financial order (this is the core of Ruggie’s (1982) compromise of embedded liberalism). Because civil society was inherently national, democratic constraint was national. However, given that production in the first era of globalization was fundamentally national, making sovereignty an essential building block of the post-War, multilateral trading system was central to stabilizing democratic capitalism. It is important to note, in this context, that the key is not so much sovereignty as that the locus of civil society is the linchpin of any democratic political system and that must be broadly congruent with the regulatory link between state and economy.

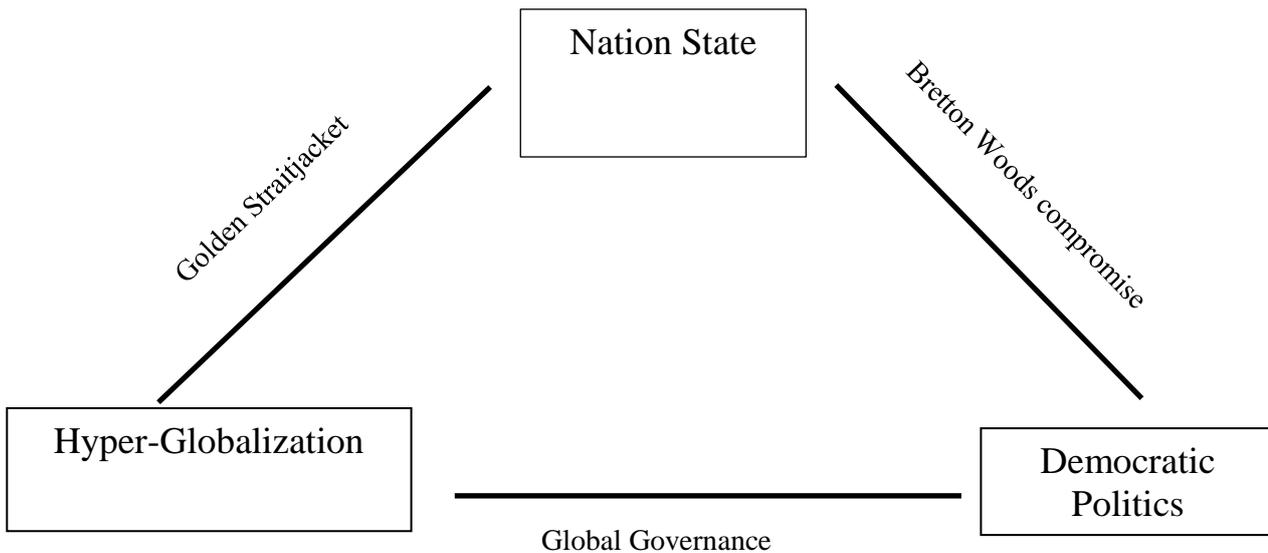
In the late-1960s and early-1970s, a literature developed arguing that foreign direct investment was undermining national sovereignty. In fact, the title of Raymond Vernon’s (1971) treatment of this issue was *Sovereignty at Bay*.¹⁹ The main concern of that literature was whether national governments could continue to manage the national economy in a way consistent with their interpretation of national interests in an environment characterized by extensive foreign direct investment. Those worries, whether or not well-founded, ultimately reflected a concern with what was essentially modest globalization of what could still be seen as fundamentally national firms. That is, the modern triad remained an accurate characterization of the underlying political economy. If our analysis of the consequences of Baldwin’s second unbundling for 21st Century trade agreements is correct, a gap is opened between the geographic locus of the economy and that of the civil society that legitimates the political regime that stabilizes the relationship between the economy and civil society.²⁰ It is civil society that provides the objective function of the state in managing the economy. With the organic relationship between the economy and civil society attenuated, the content of that objective function becomes unclear, the legitimation of capitalism becomes problematic, as does the nation-state’s relationship to the market.

Rodrik (2011) presents a “political trilemma of the world economy” that bears a family resemblance to the analysis presented here. The Habermasian (1975) analysis in figure 1 is structural—that is, it is an attempt to characterize any Modern political economy. The Rodrik analysis in figure 2 is an attempt to characterize a historically and institutionally specific “trilemma”.

¹⁹ For other examples of this literature, see, for example: Servan-Schreiber (1967) and Stephenson (1972).

²⁰ As the reference to the “owl of Minerva” suggests, we could well be wrong. The literature cited in the previous footnote, arguing that multinationals were a threat to sovereignty, is a cautionary tale in this regard.

Figure 2: Rodrik's (2011) Trilemma



Other than in some science fictional future world, the “State” in figure 1 is more-or-less a nation state, although deep integration agreements like the EU and ANZCERTA, as well as extensive international standardization, sector-specific regulatory cooperation and private standards-setting suggest that there is considerable middle ground between nation state and world government.²¹ Given that Rodrik isolates the state as separate from democratic politics, what we call “civil society” and what Rodrik calls “democratic politics” denote more-or-less the same thing. Thus, the difference between the two diagrams relates to the relationship between “hyperglobalization” and “the economy”. In other work, Rodrik (2007) has simply called this “deep economic integration”. Thus, Rodrik is identifying precisely the same gap that we do. The difference is that we do not see this as a trilemma, but as another chapter in the ongoing attempt to stabilize the relationship between capitalism and democracy. There is not much to distinguish Rodrik’s analysis from that of Polanyi (1944) other than time period. The issue remains the link between civil society, state, and market in a time of transition. It is notable, that (contrary to the fears of both Schumpeter and Polanyi) this relationship was, in fact, stabilized.

Our conceptualization simply sees three elements that have played an essential part in Modern capitalism, not as inconsistent end states (as in Rodrik) or inconsistent goals of a social order (as in Weber, Schumpeter and Polanyi). As we conceptualize this relationship, all three elements are essential to modern, democratic capitalism, no more, and no less, in a globalized environment than in the relatively closed national economies of the first unbundling. Essentially, Rodrik’s analysis offers three different worlds, each of which embodies a different version of Habermas’ modern triad but contains only two of the broad desiderata on which Rodrik chooses to focus. However, relative to the Habermas framework, this requires Rodrik to ignore (or treat *ad hoc*) one of the elements of the modern triad.²² The second unbundling creates a new kind of integrated global economy that makes the global economy more like a national economy. Stabilizing such a global economy requires the

²¹ See for example Abbott and Snidal (2010) for discussion of the extent and role played by such transnational governance mechanisms and the role of international organizations.

²² Rodrik’s trilemma is often seen as a political-economic version of the open economy trilemma (Mundell, 1963) but that trilemma emerges as a necessary consequence of a specific model of the international economy. Rodrik’s trilemma is more an empirical generalization, with each corner representing a large (loosely specified), positively valued social structure. There is no necessary set of relations defining Rodrik’s trilemma.

identification of a civil society to define the goals of that stabilization and, in turn, to legitimate that stabilization, but it is far from clear how to even think about such a civil society.

Note that the issue here is civil society, not sovereignty. As a practical matter, civil society only exists in interaction with a state and, as the world is currently arranged, this means that the nation state will play a fundamental role in the regulation of the relationship between the economy and civil society. That said, if our above analysis is correct, and capitalism is truly increasingly global, stabilization of democratic capitalism must proceed on a global basis. The simultaneous legitimation of capitalism and democracy becomes much more difficult. Nelson (2015) argues that, while the WTO contains some governmental attributes, it does not constitute a state in the sense necessary to generate a meaningful civil society. Part of the problem is that the national civil societies organized relative to the states that make up the membership of the WTO are far too heterogeneous to view themselves as engaged in an ongoing democratic discourse. This does not mean that the WTO cannot play an essential role in the governance of trading relations, but it does mean that it cannot carry the weight needed to legitimate a programme of ongoing globalization. For this purpose, two, non-exclusive, indeed complementary, ways forward seem most promising: deeper integration initiatives and transnational technocratic integration involving nongovernmental entities as well as states.²³

It has been widely noted that, at least to this point, and abstracting from the unique case of China, the most distinctive forms of post-industrial globalization (value chains, etc.) tend to be more regional than global: a European system; a North American system; and an Asia-Pacific system (Johnson and Noguera, 2012). To the extent that the densest globalizations are organized in this way, there are both practical and programmatic reasons why we might expect more rapid advance here than in the global/multilateral system. From a practical perspective, these regional economies have much to gain from stabilizing their economic relations, and much to lose from failing to do so. With economies that are already highly integrated, deep integration agreements that permit effective regulation might well be able to fill the regulatory hole opened by the globalization of the second unbundling.

Much of the analytical literature on regional integration by economists derives from Viner's classic analysis of *The Customs Union Issue* (Viner, 1950) in terms of trade creation and trade diversion.²⁴ This framework, and its extensions, has been used to as the basis of a sizable amount of empirical work as well (e.g. Frankel, 1997, Egger *et al.*, 2011; Limao, 2016). While this research answers an important question about the consequences of forming a preferential trade agreement, as a framework for thinking about why such agreements form, and in particular why deep agreements form, it has proven to be more of a stumbling block, than a stepping stone, to understanding. Deep agreements, beginning with the European Economic Community (and its various successors), have never been primarily about trade effects. With respect to such key industrial sectors as coal and steel, and atomic energy, the goal was to create transnational industries explicitly linking the early members (and especially France and Germany, the source of more than a century of Europe's most deadly conflicts). As the European project advanced, this joint management of transnational capitalism became a central part of what legitimated that project (Caporaso and Tarrow, 2009). This, of course, is precisely what we mean by filling in gaps in economic management. Similarly, more current North-South (West-East) deep integration has been about locking in reform and managing complex economic relations (Mansfield and Milner, 2012, Baccini and Urpelainen, 2014).

Neofunctionalist integration theory expected the transnational authority to expand its regulatory reach by responding to problems/crises to which the national authorities were unable to respond

²³ As the analysis that follows demonstrates, both of these play an essential role in an earlier political science literature usually referred to as neo-functionalism (Jensen, 2007, Sandholtz and Stone Sweet, 2012).

²⁴ The volume edited by Bhagwati *et al.* (1999) collects a number of the classic papers using this framework and also contains excellent surveys of this line of research. For a more recent survey, see Maggi (2014).

(Jensen, 2007, Sandholtz and Stone Sweet, 2012).²⁵ By focusing primarily on gains and losses via terms of trade effects (i.e. trade creation and trade diversion), as in much of the economic trade literature, we lose track of both why the agreements form and, more importantly, we end up evaluating deep integration with an inappropriate framework.²⁶ To the extent that new, deep regional agreements solve common management and regulatory problems that emerge from the increasingly dense production relations in a region, the neofunctionalist logic might well be transplanted from Europe to North America, or even to the even more heterogeneous Asia-Pacific region.

An essential part of this neofunctionalist logic is the development, and expansion, of a transnational elite who both develop and share a common understanding of the regional political economy as a set of technocratic/legal issues that must be managed. Starting with the fundamental work of (Haas, 1956, 1964) and the neofunctionalists, the political science literature has developed the analysis of this elite in terms of complex interdependence (Keohane and Nye, 1977), regime theory (Krasner, 1983), the theory of epistemic communities (Adler and Haas, 1992), and legalization (Goldstein, Kahler, Keohane and Slaughter, 2001). These governance structures need not necessarily involve state actors but, depending on the nature of the issue involved, they often will (Abbott and Snidal, 2010; Jupille *et al.*, 2013). Through all the rhetorical permutations, a common concern (especially relative to Realist theory) is with the development of institutional and ideational frameworks within which a transnational elite can pursue the programme of transnational governance. That is, there is a body of specialist knowledge the possession of which constitutes its possessors as a group, and the application of which legitimates the actions taken consistent with it. In the context of international trade regulation, and taking full recognition of asymmetries of power, the community of elites involves private citizens, national government officials and employees of international organizations that share a common knowledge of legal, economic and political frameworks and values (e.g., Hass, 1997; Ruggie 1998). In the case of deep integration initiatives as defined above that aim to manage economic relations beyond border measures, it is critical that the set of people involved in deliberations go beyond those who have worked on shallow integration agreements. Regulators and constituencies with a direct interest in regulation – i.e., representatives of international business and consumers/voters (e.g., parliaments) – need to be involved.

The neofunctionalist logic, in both its general form and with particular reference to the creation of a transnational elite and elite discourse, seeks to substitute for the lack of a civil society coextensive with the reach of the economy. The expectation/hope of the neofunctionalists, for the case of the EU was that repetitive interactions, very much including economic interactions, would lead by small steps to deeper integration. These small steps help build a sense of community, the foundation of civil society. Perhaps more importantly, as the transnational authority was seen to successfully manage the tasks allocated to it, national citizens were expected to see themselves as part of a transnational polity and to engage with those new institutions as part of their understanding of the EU institutions as legitimate. Thus, as the EU institutions successfully took on more regulatory responsibility (Majone, 1996) and the European Parliament took on more political responsibility (Hix and Høyland, 2013), European residents were expected to increasingly see themselves as part of a European political system, a transnational political community. There is considerable evidence that this has, in fact, happened in Europe (Risse, 2010).²⁷ As the EU came to take an increasing role in the policy-making relevant to citizens of member states, those citizens became involved in a transnational discourse about the nature of that role. Thus, the experience of the EU holds out some hope that the neofunctionalist logic linking programmatic success to an increasingly democratically constrained

²⁵ Economists have studied a closely related issue under the label “endogenous optimal currency area” (Eichengreen, 1996). The essential notion here is that economic integration leads to correlation of business cycles that, in turn, leads to greater demand for integrated policy.

²⁶ See e.g., Ethier (1998) who explicitly focuses on the drivers and consequences of deep trade agreements.

²⁷ It is important to understand that, as Risse (2010) argues, this supranational identity does not supplant national (or any of the manifold other forms of) identity. Rather it is a complement.

elite to the emergence of a genuine transnational civil society might apply to other deep integration initiatives. A major difference that will characterize such initiatives – assuming they materialize – is that the type of supra-national institutions that were put in place in the EU are unlikely to be feasible in other parts of the world. Given a presumption that cooperation will primarily remain inter-governmental, a path forward is the pursuit of club-based cooperation. This can be expected to be anchored primarily in regional trade agreements (PTAs), but as discussed in the previous section may also be feasible as stand-alone, single issue club-based initiatives.

Both the EU and the WTO weathered the worst economic crisis since the Great Depression without major violations of the norms of their respective systems (Bown and Crowley, 2013, Guiso *et al.*, 2016). This would seem to provide strong support for the predictions of neofunctionalist theory. And yet, quite contrary to the expectations of neofunctionalists, this period also saw the emergence of anti-globalization movements as successful protest movements against precisely the technocratic elites that had just provided evidence of their capacity to manage a major crisis. Populism is always anti-elite (that is, after all, what "populism" means, see e.g. Müller, 2016), but a distinctive element of the current populist moment is that anti-globalization (in some form) seems to be the language of choice for mobilizing virtually everywhere currently experiencing significant populist politics. Taken at face value, these anti-globalist/populist movements might seem to suggest a reemergence of the tension between capitalism and democracy that worried Schumpeter and Polanyi in the 1930s. This would be consistent with the argument of this paper that democratic legitimation of market relations requires the development of transnational capacities for managing those relations. However, the issue appears to be more complex than a simple version of this argument would suggest. First, it is undeniable that the historically unprecedented China trade shock produced equally unprecedented, but highly localized, adjustment pressures in all of the core economies of the global trading system (Balsvik *et al.*, 2015, Autor *et al.* 2016a, Malgouyres, 2017) and that this shock is associated with the electoral successes of populist parties (Autor *et al.*, 2016b, Colantone and Stanig, 2017).

The implications of the economic and political effects of the “China shock” for the prospects for extensions of the liberal trading order are unclear. With respect to the economics, we would argue there are essentially no first-order implications from the extant economic research as this identifies a unique shock (this is key to the empirical identification strategy of research on the “China shock”). There is no suggestion of continued imports from China at the rate observed in the last two decades, and there is no other exporter from which we expect an equivalent shock. Thus, we learn little about the political sustainability of trade liberalization going forward from the China shock research (i.e., it has weak external validity). Moreover, trade policy should not be conditioned on adjustment problems but be determined by the long-run consequences for the economy, not the short-run adjustment costs. This is not an argument for *laissez faire*. Virtually any coherent practical or normative logic tells us that adjustment costs must be dealt with. Furthermore, there is compelling evidence that states which retained the capacity/willingness to respond to labor market adjustment problems have had less problems with anti-globalist populism (Swank and Betz, 2003). This suggests that current populism is not necessarily driven by globalization (or any other strictly material phenomenon), but is fundamentally about the choices governments make. Political cowardice masquerading as “constraints imposed by globalization” is a much bigger threat to extension of the liberal trading order than is increased international trade. A commitment to capitalism, global or national, requires a commitment to sensible domestic adjustment policy. Without such supporting policies, anti-globalism may well be a plausible second-best response to liberalization induced redistribution.²⁸

Unfortunately, the preceding does not help us understand the politics of anti-globalist populism, or allow us to evaluate the magnitude of its threat to liberal trading relations. For all that they are very widespread, these politics are not rooted in any systematic or well-founded analysis of the link between trade (or globalization more generally) and labor-market outcomes (or income distribution

²⁸ Swank and Betz (2003) refer to general redistributive policies, not redistribution conditional on trade displacement.

effects more generally). Part of the evidence for this is the well-established finding from opinion research that voters/citizens have very little systematic knowledge about anything (e.g., Achen and Bartels, 2016). This is likely to be especially true of international trade as it has rarely been a major public political issue. Even economists specializing in the topic differ widely on the degree to which international trade, as opposed to skill-biased technical change or changes in policy/institutions, drives long-run changes in the income distribution, though the modal position would seem to be that the effect is small.

That said, especially in the years following the 2007-09 financial crisis, a well-founded concern with increased income inequality and income insecurity has produced a turn to populist politics. In terms of the simple framework in figure 1, the economic changes associated with the transition to a post-industrial economy appears to have produced a motivation crisis that manifested as a polarization of civil society (Kriesi *et al.*, 2012). However, instead of being structured along the left-right (loosely, capital v. labor) axis that has been the foundation of politics in OECD countries at least since the end of the Second World War, a new dimension emerged that overlaid the left-right axis.²⁹ To the extent that traditional parties had a systematic position on international trade policy, and for reasons we have already discussed they mostly did not, the traditional right was pro-business and generally supportive of trade liberalization, while the traditional left was pro-labor and was generally less supportive of liberalization. In party systems dominated by two relatively centrist parties (e.g. the UK and the US), political entrepreneurs sought to use this new dimension to restructure the existing parties, where party systems were characterized by relatively easy entry of new parties, the result was new parties explicitly organized in terms of the new dimension (Kriesi *et al.*, 2013). In either case, there was a strong tendency for the radical right to focus on immigration, while the new left focused on loss of policy autonomy to transnational institutions (in the EU) and trade agreements. Significantly, the language deployed in either case was primarily cultural and political, eschewing the economic language emphasized by the traditional parties. In this context, the traditional parties of the center left and right, and traditional elites in the mainstream parties, have sought to avoid these issues altogether.

The prospects for significant extensions of liberal trading relations, via multilateral or regional cooperation, depends to a considerable extent on whether this new cleavage becomes increasingly prominent and increasingly institutionalized in the politics of the core countries of the LIEO. If the organic link between civil society and the market cannot be restabilized, there is a very real prospect that the 21st Century story of trade agreements will be a story of reversal. Given the previous experience of such reversal (in the 1930s) this is a prospect that no one should look on with equanimity.

5. Concluding Remarks

The LIEO is in a pivotal moment. The large scale economic and political changes under way in the current environment make prediction particularly difficult. Furthermore, we have only alluded to a major change in geopolitical and economic environment that is every bit as significant for the future of the LIEO as the changes we have discussed to this point: the emergence of China as a genuinely great, economic and political, power. China's population of about 1.4 billion people is 18% of world population, it produces about 17% of world GDP, and it is the world's largest exporter (over 13% of world exports) and the world's second largest importer (nearly 10% of world imports). Perhaps more strikingly, 1990 to 2016 China's share of world manufacturing output (value added) increased from 5% to nearly 25%, while its share of exports over that period rose from 2% to over 17% . At the same

²⁹ Research on European politics is agreed on the existence and (more-or-less) on the content of this second dimension, but there are as many labels as there are people studying the dimensions, e.g., Hooghe *et al.* (2002) refer to green/alternative/libertarian (GAL) v. traditional/authoritarian/nationalist (TAN). Although the language of "left" and "right" is often used, the cleavage is fundamentally cultural and political.

time, China has the largest active duty military in the world (with US at third largest, after India) and possesses significant nuclear weapons. At various points in time, there have been attempts to see the EU, and even Japan, as rising to political-economic parity with the US, but it is clear that since the collapse of the Soviet Union, the US was the uniquely dominant military power in the world and was the dominant economic power for the entire post-WWII period. This is changing rapidly in the new millennium and is surely significant for the future of the LIEO.

Starting with Kindleberger's (1986) classic statement, political scientists developed a theory of hegemonic stability to account for the periods of stable, open global economies (Mansfield, 2009). Mechanical applications of this logic led some in the 1980s, to argue that the rapid rise of Japan as an economic power constituted a major threat to the LIEO. An essential part of this story was that Japan had developed a state-led version of capitalism that allowed it to outperform the more laissez-faire capitalism in the west and, thus, was a threat to the stability of that system (Prestowitz, 1989). Current arguments about the problematic nature of Chinese participation in the LIEO make essentially the same arguments: China is really not capitalist; really not democratic; and really, really big. The big difference is that China is a rising military power as well and, for some, this makes the threat of a power transition all the more menacing (Mearsheimer, 2010). The essential fact is that China has been a huge beneficiary of the LIEO and it is hard to see what it would gain from destroying that system. This does not mean that China will not seek change in the rules of the system (formally or informally) to produce outcomes that are in its interests, but that the main goals it will seek have to do with being a central party to any rule-making. That is, in the WTO, as in the global political economy more generally, China seeks recognition as a great power, a peer of the US.

For the global LIEO, as for the liberal trading system and the broader international political system, the real issue is whether that system can deal with a power transition involving not only a rise in the influence of China, but a significant reduction in the relative political influence of the United States. Here, current events are not comforting. The good news is that, as Ikenberry (2011) argues, the post-War LIEO constructed by the US and its allies is a *liberal* order—i.e. it is rooted in fundamental values of democracy and capitalism. It is, as a result, a singularly open order. China will be more difficult to accommodate because it is not, at this time, a particularly democratic power and it is currently early in the process of transition to capitalism. However, as the literature on varieties of capitalism (Hall and Soskice, 2001) suggests, the system already accommodates a quite wide range of varieties of both democracy and capitalism. The issue is less whether the LIEO, and the WTO in particular, can accommodate a rising power like China, the question is whether the declining powers will be willing to make room, economically and politically, for a new world power. Here the news is not so good. As we have already noted, the US and the EU are in the midst of a sort of collective identity crisis in the form of widespread anti-globalist populism. Not only is trade (and migration) seen as problematic *per se*, but China (like Japan in the 1980s) is the poster-child for the problems of globalization. Dealing with this will require skillful leadership which seems in singularly short supply. There are good prospects that this populist moment will pass, but at this point the owl of Minerva seems quite happy sitting where she is.

The implications for 21st Century trade cooperation from our discussion are twofold. First, there remains an important shallow integration agenda that revolves around further rule-making to address perceptions that national policies – especially in large emerging economies – are imposing significant negative international spillovers. This is an agenda that requires the major trading powers to agree on additional rules of the game for domestic industrial policies that are not captured by existing WTO agreements. Second, there is need to engage more vigorously on deeper integration among subsets of countries that have common values and regulatory objectives. International regulatory cooperation is not a panacea but it offers prospects for both reducing trade costs for businesses – and thus boosting productivity growth through further specialization and investment – and for addressing concerns of consumers (voters) regarding the realization of national regulatory goals and dealing with the pecuniary and non-pecuniary spillover effects that are associated with greater economic integration. In

both cases the way forward centers on club-based cooperation. The shallow integration agenda that is central to the survival and expansion of the Post-War multilateral trading system is essentially a matter that requires agreement between China, the US and the EU – the three largest trading powers in the world. Deep integration can only occur between countries that share similar objectives and have sufficiently similar institutions and capacities. The challenge here is to ensure that such cooperation is not restricted to preferential trade agreements but is (also) pursued through open plurilateral agreements under the umbrella of the WTO.³⁰

³⁰ See Hoekman and Mavroidis (2015a;b; 2017) for in-depth discussion of the modalities of club-based initiatives in the WTO and the advantages for the LIEO of plurilateral cooperation under WTO auspices as compared to deeper integration in the context of preferential trade agreements – the revealed preference of most WTO members.

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