Globalization (POL 1004) Examination Key

The final grade structure will be as follows:

<table>
<thead>
<tr>
<th>Grade Points</th>
<th>Grade scale</th>
</tr>
</thead>
<tbody>
<tr>
<td>80 &gt;</td>
<td>A</td>
</tr>
<tr>
<td>71 – 80</td>
<td>B</td>
</tr>
<tr>
<td>61 – 70</td>
<td>C</td>
</tr>
<tr>
<td>51 – 60</td>
<td>D</td>
</tr>
<tr>
<td>41 – 50</td>
<td>E</td>
</tr>
<tr>
<td>0 – 40</td>
<td>F</td>
</tr>
</tbody>
</table>

Section – I

[04 × 15 = 60 points]

1. **MANDATORY TO ANSWER:** Discuss the labor market structures in developing and developed countries (5-points). Explain the process through which globalization can impede the bargaining power of the labor (10-points)

Answer:

For 5-points (first part of the answer)

- Least Developed Countries (LDCs) have large reserves of surplus labor
- Formal vs. Informal sectors (low-skilled labor concentrated in informal sector in LDCs)
- Because of surplus labor concentrated in informal sector, Labor market conditions are NOT always tight in LDCs
- Hence, difficult to mobilize Labor in LDCs (also because of erratic working conditions, low education levels, women in work force, no labor union representation)
- These conditions pose collective actions problems in LDCs
Skilled labor group can surmount all these problems in LDCs because they are small in number and demand for such skilled labor is often very high. In addition, they are well educated, represented by labor unions.

So, in Low income LDC the labor is largely unskilled and concentrated in informal economy while in High/middle income countries, labor is skilled and employed in formal economy.

For 10-points (second part of the answer)

- Trade and FDI often scout for destinations which can reduce their labor costs & maximize profits.
- They tend to go to LDCs where labor cheap because cheap labor is concentrated in informal economy and unskilled with no bargaining rights.
- Attracting FDI (& trade) in LDCs creates more demand and jobs for this surplus labor.
- Even governments are keener to attract more FDI and open the economy for trade because they create job opportunities for the vast surplus labor LDCs have.
- Thus, indirectly, globalization (represented by trade and FDI) leads to expansion of surplus labor in LDCs.
- Though FDI and trade may create jobs and increase wages marginally, because surplus labor is concentrated in informal economy, it impedes their “bargaining power” (due to the factors listed above).
- So, globalization creates jobs BUT at the same time lowers the labor’s bargaining power especially in LDCs because in those economies the majority of the labor force is concentrated in informal economy with no rights and proper working conditions.
- But in high income countries most of FDI is in high-end advanced manufacturing, services sectors which need skilled labor. And because skilled labor is concentrated in
formal economy in high income countries, globalization forces improve the bargaining power of the labor in high income countries.

2. **MANDATORY TO ANSWER: Why democracies are more inclined to attract FDI?**

**Answer:**

Traditionally, research on democracy and trade openness indicates that democracies prefer free trade because the abundant factor – labor – benefits from open markets. This is a staple view on economic integration based on Heckscher-Ohlin-Samuelson, Ricardo-Viner type models of international trade. Since the size of the ‘selectorate’ (i.e., those who have a say in policy formation) increases with democracy, a majority will prefer open markets. In authoritarian countries, the policy process is heavily dominated by capital (a powerful but narrowly-based selectorate). Since capital is the scarce factor in poor countries, control of policy can mean supernormal profits for local capitalists. Under open-economy conditions, the scarce factor within poor countries will lose as local capitalists (industrialists) are forced to compete with (both vertical and horizontal) FDI for domestic markets and for labor. New entrants, particularly MNCs, which generally offer higher wages than domestic firms, are likely to alter labor market conditions in a way that works against monopoly-seeking domestic firms. As these countries democratize, the monopoly positions of state firms and domestic industrialists are likely to erode, to the benefit of labor and larger segments of domestic society, or those who make up the ‘selectorate’ (i.e. the voters). Therefore, it is in the interest of democratic rulers to allow FDI
which not only have positive effect on the economy in the medium to long run, but also benefits the labor, which form the electorate base for democratic leaders.

3. What is *California effect* (5-points)? Explain how *California effect* can influence laws and practices protecting labor rights (10-points).

Answer:

For 5 points:

- Refers to capacity of importing jurisdictions to affect the laws & practices of exporting jurisdictions.
- It all started in California (in automobile industry) adapting…..
- Later Germany standards spilled over to EU (to counter uneven competition)

**Scope & Conditions of California Effect:**

Three factors account for diffusion of *California effect*:

- First: Purchasing power of importing country matters! (it dictates demand)
- Second: Domestic politics matter! (lobby groups, consumerism, political interests)
- Third: Limits to *product* & not *process* standards! (former easy to monitor & enforce)
For 10 points:

California effect process (making this diagram is NOT enough. Must explain the whole process)
How does California effect extend to laws & practices:

**Labor Rights Laws:**
- Laws deal with legal protection
- Many countries have strong laws
- Monitoring easy & hence *California effect*
- No information asymmetries (akin to product standard)
- Can always (& easily) demand for strengthening LR laws in EX-nations
- Pressure from international community can also work (often not necessary)

**Labor Rights Practices:**
- Their practical implementation
- But enforcements are not strong (why?)
- Monitoring NOT easy & hence weak *California effect*
- High information asymmetries (akin to process standard)
- Fooled by hiking laws! So, NGOs *shift burden of proof* to Importing-nations
- Pressure from international community also work (often a necessity)
4. What is trade protection? Discuss the arguments that support and oppose trade protectionism.

Answer:

The view that free trade is injurious and should be restricted and hence restrict trade using two measures namely,

- **Tariff**: A tax imposed on an imported good
- **Quotas**: A legal limit on the quantity of a good that may be imported

Arguments in favour of trade protection can be classified into the following categories:

1. **Qualified arguments**: justified under particular conditions
   (valid IF long term benefits of protectionism > short-term costs)

2. **Questionable arguments**: offer short-term solutions to problems.

3. **Incorrect arguments**: incorrect economic reasoning.

(I) Qualified arguments

1. **Infant industry argument**: An *infant industry* is a new domestic industry that has not had the time to become efficient and may therefore be unable to compete with more mature foreign firms. In order to be able to grow in size and achieve economies of scale (lower production costs) a new firm may need protection from imports until it has grown in size. Mainly used by LDCs.
Problems: 1. Identify the industries; 2. Protected industries may lose the incentive to become more efficient; 3. Governments may continue to protect an industry longer than needed.

2. **Strategic trade policy.** Industries considered to be important to the future growth of an economy should receive protection until they achieve the necessary economies of scale. Ex: computers, telecommunications, semiconductors. This is very similar to the previous one

Problems: 1. Identification of the industries; 2. Selection of appropriate protectionist policies; 3. It is likely that all or most countries will use protection for the same industries at the same time, which contradicts the idea of creating comparative advantage; 4. Gov might continue to protect these industries longer than needed.

3. **Efforts of a LDC to diversify.** Diversification means to increase the variety of goods and services produced. It can be thought as the opposite of specialization (basis of comparative advantage). Some countries might be better off diversifying their production and exports, as in the case of LDCs that are highly specialized in the production and export of one or few commodities.

Arguments against excessive specialization:

- Fluctuations in global D or S → fluctuations in prices of primary goods → unstable export revenues.
- ↓export or export prices → ↓export rev and ↓incomes

4. **National security.** Certain industries that are essential for national defence (aircraft, weapons, chemicals, certain minerals) should be protected so that a country can produce them itself.

Problem: it can be used by industries that have an indirect use in defence, such as steel, to try to acquire protection against foreign competition. Also, it is difficult to determine what is essential for national defence.

5. **Health, safety and environmental standards.** There is concern that these standards may sometimes be used as a form of ‘hidden’ protection.

(II) **Questionable arguments**

1. **Tariffs as a source of government revenue.** More common in LDCs: ease with which imports can be taxed. In contrast, income taxes are more difficult to levy and collect in LDCs for three reasons:

   a. Large shares of the population live on very low incomes.
b. Large proportion of people self-employed and working in the informal sector.

c. Poor enforcement of tax collection and high tax evasion rates.

2. **Means to overcome balance of payments deficit.** A balance of payments deficit occurs when the outflow of money from a country is greater than the inflow. It usually happens when imports are greater than exports. Imposing barriers to the entry of imports limits the need to make payments abroad.

   However: ↓imports→ ↓exports in the exporting countries. There is a risk that these countries may retaliate by imposing protectionist measures of their own. In this case all countries would be worse off: ↓ in international trade and worsening balance of payments problems (↓imports + ↓exports).

3. **Anti-dumping.** *Dumping* is the practice of selling a good in international markets at a price below the cost of production (usually by providing export subsidies). It is considered to be an unfair practice and is illegal according to int’l agreements.

   **Problem:** it is difficult to prove that dumping is being practised, so it is often used by many governments as an excuse to protect their domestic producers when this is not necessary or justified.

4. **Protection of domestic jobs.** Import restrictions cause consumers to shift consumption away from imports and towards domestic produced goods. As domestic production increases, unemployment falls.

   **Problem:** if unemployment in the domestic country falls, this means that unemployment has increased in those countries that now export less. These may retaliate by imposing import restrictions, with the result that all countries will be worse off.

**(III) Incorrect arguments**

1. **Wage protection argument.** Some foreign countries can produce at lower costs because of low wages, so that imports from those countries will sell at lower prices and domestic firms will not be able to compete. Protection becomes necessary to restrict imports from low-wage countries.

   Although very popular, this argument is based on **incorrect economic reasoning.** A low wage country likely has a comparative advantage in producing goods that make use of its cheap labour resources. This is the basis of specialization & trade according to the theory of comparative advantage.
5. Explain the process through which globalization distorts the unity of elites in autocracies. Under what conditions hardliner-elite faction would convince softliner-elite faction to oppose democratization and vice-versa?

Answer:

*Step 1:* Globalization shakes elite cohesiveness….

*Step 2:* Choice between elites (a) Greater democratization; or (b) Repression

*Step 3:* Greater democratization: ONLY IF & IF elites interests are secured

*Step 4:* If the option is NOT viable, hard-line elites win and thus prefer repression over democratization.

Key therefore is the existing levels of welfare! = is it too high or too low?

If too low = strain on elites’ assets!

If too high = fiscal discipline! (& also strains elites assets)

- So, if existing welfare levels are either very high or very low then hard-line faction will convince soft line faction of elites that democracy will strain their assets.

- And, if existing welfare levels are moderate then soft line faction will convince hard-line faction of elites that democracy is better and not repression.
6. Explain how globalization has affected the developing countries ability to raise tax revenues (5-points). Discuss the reasons why democracies lack institutional incentives to expand tax revenues (5-points) and why democratic citizens resist tax reforms (5-points)?

Answer: (5-points)

- Dependence of trade taxes was key for democratic and non-democratic governments
- Import Substitution and Industrialization (ISI) strategy = high trade protection (through trade taxes) = apart from protection, trade taxes are ‘easy to collect’ & ‘invisible’.
- This led to way too much dependence on trade taxes for governments!
- Trade Liberalization in the 1990s focused on eliminating trade barriers (and lowering trade taxes).
- Trade Liberalization’s consequences to LDCs was to offset trade tax with something else (some other form of taxes)
- The focus then shifted to ‘tax reforms’ on ‘hard to collect’ taxes (such as income tax, payroll taxes, consumption taxes, VAT etc).

5-points: Why political elites in democracies lack both institutional resources & incentives to expand tax revenues?
Non Democracies:

• Access to key institutional tool: Apply force
• Compliance levels high (eg: fines, confiscation of property, punishment, deaths)
• Can tax businesses (albeit discriminately) & low taxes could be costly!

Democracies:

• Absence of ‘forcing’ tool!
• Compliance low (minimal penalties)
• Less incentives to impose taxes/complaince on businesses

Thus, democratic policy makers have both weaker incentives & resources to propose and enforce reform

5-points: why democratic citizens resist tax reforms?

• Ross (2004) ‘cost-benefit model of taxes’; Confidence in govt. = f {taxes vs. public goods & services}
• It is therefore more likely that citizens in poor countries (though compromise with govts with weak public services) object to rise in taxes!
• On the other hand, autocratic regimes have greater incentives to provide public goods (or repress) in order to stave off revolution!
• So citizens there are more willing to accept tax hikes in return for a guaranteed public goods & services (which remain largely free in most autocratic states).
Section II

[05 × 05 = 25 points]

1. What is crony capitalism? List four features and consequences of crony capitalism.

A: It is a term to describe an economy in which success in business depends on close relationships between business people and government officials (as against rule of law).

- Features of crony capitalism
  - Legal plunder
  - Family ties between business & politicians to influence economy
  - Favoritism in distribution of legal permits, govt grants, contracts, licenses, special permissions, auctions etc.,
  - Unified front to set high entry barriers for new comers (to limit competition)
  - Fudged privatization policies
  - State intervention in the economy
  - Weak regulations (+ ambiguous laws & regulations)

- Consequences of Cronyism ?
- Undermines markets
- Prevents effective resource allocation by diverting resources
- Reduces faith & trust in institutions
- Reduces economic growth & investments
- Leads to wealth & income inequality
- Creates backlash against reforms & globalization

2. Discuss (a) Efficiency or disciplining hypothesis; (b) Compensation hypothesis

A:
- **Efficiency or Disciplining hypothesis**
  - Global tax race to the bottom
  - Globalization restrains governments’ leeway
    - Globalization reduces efficiency of benevolent governments
    - Globalization disciplines self-serving governments
- **Compensation hypothesis (Rodrik, 1998)**
  - Citizens want to be compensated for the risks of globalization

3. How to interpret Rudra’s (2005) Potential Labor Power (PLP) index? In other words, when will labor be in a more favourable bargaining position?

\[
PLP = \left( \frac{\text{Number of skilled workers}}{\text{Number of low-skilled workers}} \right) \times \left( \frac{1}{\text{Surplus labor as % of working age population}} \right) \times 100
\]
A: All else equal, labor will be in a more favorable bargaining position under the following assumption:

- % ↑ in high-skill workers is > % ↑ in surplus labor
- % ↑ in low-skilled workers is accompanied by greater % ↓ in surplus labor
- Surplus labor ↓ & skill ratio remains constant

4. List five observations from the graph below on surplus labor (expressed as % of total working population):

A:

i. The decline is faster in high income countries suggesting that there is up-gradation of skills.

ii. The decline in middle income countries is not as fast as it is in high income countries but better compared to low income countries.

iii. The decline in low income countries is very slow suggesting that unskilled labor skill upgradation is not as swift as it should have been.

iv. The decline in surplus labor in all three income groups could be due to improvement in education levels (specially secondary schooling).

v. The decline in surplus labor in all three categories could be due to decline in birth rates (i.e. slowdown in population growth).

5. List three benefits and costs associated with FDI.

A: (i) Benefits of FDI (comprehensive list of benefits)

- FDI creates long-term growth and development
- FDI brings capital, technology, know-how
- FDI increases trade
• FDI generates spillover effects
• FDI increases competition and effectivity
• FDI boosts employment, workers’ wages/welfare
• FDI strengthens host-country institutions
• FDI supplants domestic special interests
• FDI finance balance of payments

(ii) Costs of FDI (comprehensive list of costs)
• FDI upholds and augments dependence
• FDI ‘expropriates’ added value \(\Rightarrow\) lower growth
• FDI creates encklave economies
• FDI supplants local capital
• FDI institutionalizes inequality
• FDI leads to a ‘race to the bottom’
• FDI harms environment
• FDI undermines state sovereignty

Section III

1. D
2. E
3. D
4. E
5. A
6. E
7. D
8. D
9. D
10. B
11. D
12. D
13. D
14. E
15. C