

**GLOBALISATION AND SOCIAL EXCLUSION  
IN THE EU:  
POLICY IMPLICATIONS**

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# **Globalisation and Social Exclusion in the EU: Policy Implications**

**CEPS Working Document No. 159, November 2000**

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## **Abstract**

This paper discusses arguments in favour of trade restrictions in the EU as a response to globalisation. Its economic analysis unequivocally shows that trade and capital restrictions are not an appropriate response in Europe, even if globalisation is a major factor underlying social exclusion. Better policies exist to achieve redistribution, which do not sacrifice the gains brought by trade and capital flows. Indeed, in Europe, workers who are displaced for whatever reason are caught by extensive social protection systems. It is suggested here that fears that globalisation may undermine the ability of governments to levy taxes and raise revenues and so compromise the welfare state in Europe have little foundation. The paper also looks at “fair trade” arguments for trade restrictions in the EU against countries where there is child labour, discrimination and lack of freedom of association. Again trade policies are not a suitable response and their use could be detrimental to the welfare of those suffering from lack of respect for their basic labour rights. Serious attempts to tackle these problems should be undertaken via the ILO, not the WTO, and should be directed at their underlying cause, poverty.

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# Globalisation and Social Exclusion in the EU: Policy Implications

Paul Brenton

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## Introduction

A little less than one-fifth of the EU population still lives on less than 60 per cent of national median incomes, the threshold used in the EU to identify relative poverty. National poverty rates, which have changed little over the past decade, vary between 11 and 24 per cent.<sup>1</sup> The response of governments to the problems surrounding social exclusion is one of the major policy challenges posed by the early years of this new century. Unemployment, particularly long-term unemployment, is generally seen as the major factor leading to social exclusion. However, “the very fact of holding a job at a particular time does not necessarily protect people from the risk of social exclusion...between 20 and 40% of the population live on the margins of the poverty line and experience spells of low income over a period of 3-6 years, particularly as a result of repeated periods of unemployment”.<sup>2</sup> Therefore, from the perspective of social exclusion, the quality of work, in terms of its duration, stability and income, are important.

A key factor underlying social exclusion in Europe and in North America has been the increasing inequality between unskilled and skilled workers in terms of incomes and/or employment opportunities. These developments prevent significant groups of society from being able to fully participate in the basic social structures and activities enjoyed by the rest of the population. Wage and income inequality is often linked to exclusion from suitable housing, transport, health, education and training. At the root of these changes appears to be a substantial fall in the relative demand for unskilled workers during the 1980s and 1990s. What is contentious, however, are the reasons for this slackening of the demand for unskilled workers.

Everyday experience suggests that globalisation, as reflected in the increasing availability of cheap imports from low-wage countries, could lie at the heart of the recent adverse developments in European and North American labour markets. This has led to the popular impression that trade liberalisation and increasing flows of foreign direct investment to developing countries, together with improvements in transport and communications, have resulted in products formerly produced by unskilled workers in industrial countries being increasingly purchased from low-wage countries. Economic theory supports these notions. Economists strongly believe that trade and capital flow liberalisation bring overall gains to an economy. However, the theory demonstrates that there are distributional consequences of globalisation, such that in industrial countries unskilled workers may suffer permanent income losses. Those workers who successfully

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<sup>1</sup> CEC (2000), p. 5.

<sup>2</sup> CEC (2000), p. 6.

retrain or move to find alternative employment will tend to experience temporary loss of income.

But globalisation is not the only potential source of the changes in industrial country labour markets. Technological progress may have led to the automation of many of the tasks previously undertaken by unskilled workers in the industrial countries. The main issue that has concentrated the minds of analysts has been the relative extent to which globalisation and technological change are to blame for increasing social exclusion of groups of unskilled workers in industrial countries.

Much of the initial research on globalisation has been undertaken in, and has focussed upon, the United States. In many ways there appears to be greater sensitivity to the issue of globalisation in the US than in the EU. At a general level, concerns over globalisation in the US are difficult to comprehend since the US economy has been experiencing a period of unprecedented economic growth and rising living standards for the past two decades. However, the issue with regard to globalisation is how particular groups within society have been affected relative to other groups and, in particular, whether through the depression of wages and employment opportunities, less-skilled workers are becoming socially excluded. This higher profile of globalisation in the US reflects in part the fact that trade penetration, and in particular imports from low-wage countries, increased at a much faster rate in the 1970s and 1980s in the US, although from a much lower base than in Europe. The more extensive social protection systems in Europe have also shielded the most vulnerable and have therefore limited sensitivities to the perceived impact of globalisation on the employment and wage prospects of less-skilled workers.

If trade and capital flows have contributed significantly to the increase in wage and employment inequality for unskilled workers in industrial countries, is it then appropriate for governments in these countries to impose restrictions on the inflow of goods from, and the outflow of capital to, the developing countries? In this paper we argue that from an economic point of view the answer to this question is clearly negative. The output of recent empirical research on the impact of globalisation on European labour markets (see Brenton (2000)) shows that, as in the US, there is considerable uncertainty about the precise impact that trade and capital flows may have had. Some studies suggest that trade may have played a substantial and dominant role in influencing inequality, whilst other studies find the role of trade to be small relative to technological change. At present we can conclude that trade could have been an important factor behind rising inequality, but that there is no consensus on the magnitude of the impact of trade and capital flows. Nevertheless, even if globalisation were the principal factor, trade barriers and restrictions on long-term capital flows are inappropriate responses to the problems of inequality and social exclusion. The reason is that trade and capital movements bring benefits to the economy and there are policies that can address the issue of inequality whilst preserving the gains from trade.

To date neither the US nor the EU has resorted to widespread trade protection in the face of globalisation, although this abstinence from trade measures is far from guaranteed. Social policies and the safety net provided by the welfare state are clearly a fundamental foundation in all European countries and play an integral role in cushioning the impact of economic changes resulting from globalisation as well as rapid technological change. Another fear relating to globalisation, which we discuss in this paper, is that the freedom of

movement of capital and economic activity in general will undermine the ability of countries to maintain the degree of social provision that they managed to establish during the second half of the twentieth century. It is felt that in the face of footloose capital, countries will enter a race to the bottom in terms of taxes and social charges on business, which will necessitate a drastic reduction in the resources available for social protection. In short whilst globalisation may be contributing to the problems of social exclusion, it is at the same time handicapping the abilities of governments to implement policies that ameliorate the impact of enhanced trade and capital flows on inequality. In this way general support for the continuation of global economic integration will be compromised.

However, the evidence provides little support for the notion that globalisation is undermining the welfare state. In fact, expenditures on social policies have increased in most of the OECD countries during the 1980s and 1990s whilst the share of taxation in GDP has continued to increase. The welfare state in many European countries, for sure, faces a number of fundamental problems that require concerted action from policy makers, of which globalisation is at present only one, probably minor, factor. This does leave open the issue of whether unbearable pressures will be exerted on social protection systems if global integration continues. At what point will globalisation become too much? There is no complete answer to this question, but as we will discuss there will never be complete and perfect integration of world markets for goods and capital, and a number of important constraints will remain to limit the scope and extent of globalisation.

We then conclude the paper by looking at other related arguments for trade barriers and a retrenchment from globalisation. An often-heard case is that trade with many of the developing countries is unfair, because these countries do not respect the core labour standards that are taken for granted in OECD countries. As a result, labour costs in these countries are lower than they would be if these basic rights were respected. If inequality in OECD countries is rising due to unfair trade, then a legitimate response is to restrict such trade. However, evidence on the extent to which comparative advantages and actual trade flows are distorted by a lack of respect for basic labour rights is far from conclusive.

Even so, if the aim is to remove practices such as child labour and to ensure that the welfare of those subject to such practices, the children, rises, then trade barriers in industrial countries to imports from developing countries are not appropriate. There can be no guarantee that general application of bans on the use of child labour, trade sanctions or product-labelling schemes will benefit children in developing countries; the use of such policies could actually reduce their welfare! More appropriate and effective responses to the problem of child labour are likely to lie in poverty-alleviation schemes together with policies of targeted education subsidies, which provide a much more positive approach to overcoming the problem of child labour compared to bans and trade sanctions. Similar arguments also apply to discrimination in employment and to a lack of freedom of association.

### **Policy Responses to the Impact of Globalisation**

If increased imports from, and capital flows to, developing countries are important factors contributing to social exclusion in EU countries, what is the appropriate policy response? An impulsive reaction might entail stopping those factors that are perceived as contributing

to social exclusion with restrictions on imports and outflows of capital. However, given the array of domestic policies available in modern industrial countries, ***intervention that constrains trade will be one of the least effective mechanisms***. In essence, trade brings benefits as well as difficulties and those benefits are strongly expected to significantly exceed any costs that arise. Thus, the more effective policies will be those that tackle the problems of permanent income loss and temporary adjustment problems without removing the gains from trade. In other words, policy should seek to address as directly as possible the problems of social exclusion without making matters worse elsewhere, as trade barriers would (Deardorff (1998)). To date there has not been an extensive public discussion of how governments should respond to widening wage and employment inequality in Europe and what are the most relevant means of redistribution?

It is useful to distinguish between the permanent effects on the distribution of income and the short-term costs that arise from constraints on the adjustment process. With regard to the former, the EU could introduce trade barriers on imports from developing countries to try and reverse the increase in wage inequality. The extent to which such a policy would be successful in raising the relative returns to unskilled labour is unclear given the lack of certainty concerning the precise role of trade, relative to technology, in generating inequality.<sup>3</sup> Nevertheless, there will always be other policies that could achieve the same reversal of inequality but at a lower cost elsewhere in the economy. For example, the government could tax the wages of skilled labour and redistribute the funds collected to low-income households and/or it could levy a tax on the production of products that use skilled labour intensively. So, even if trade was the root cause of rising inequality and social exclusion, then trade restrictions are not the appropriate response because better policies for redistribution are available.

Along similar lines, if it were convincingly demonstrated that technological advancement was the main factor behind rising wage and employment inequality in Europe, would it really be sensible to restrict the development and application of new technologies? Most people would accept that even if new technology does cause inequality it brings other substantial benefits that are not worth losing. Again, better policies for redistribution exist than curtailing technical progress. ***Those who advocate restricting trade but are unwilling to contemplate constraining technology are unlikely to be taking account of the full benefits of trade.***

Given the uncertainty concerning the precise roles of trade and technology in generating inequality, trade restrictions would be even more foolhardy since the direct effect on alleviating inequality could be small. More importantly, if technology were the primary cause but trade restrictions were implemented, then the scope for additional redistribution would be constrained since some of the increase in overall income from more open trade would be foregone.

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3 Such a policy would have important implications for the developing countries and could undermine other policy objectives of the EU such as those related to development. In addition, there would be the likelihood of retaliation by developing countries which would further reduce welfare in the EU and elsewhere. This prospect explains why some authors feel that the current level of economic integration and welfare is far from secure and that a repetition of the policies that ended the last wave of globalisation in the early decades of the twentieth century, with disastrous economic and human consequences, cannot be ruled out.

Deardorff (1998) has argued, on the basis of the point discussed above, that from the point of view of policy response it does not matter whether the main source of rising wage and unemployment inequality is trade or technology. The appropriate intervention, in the form of policies for redistribution via taxes on skilled labour or on skilled labour-intensive products, will be the same whichever is the primary cause. Of course, there are already extensive policies of redistribution in all EU countries. This does not mean, however, that studies of the impact of globalisation or technological change are irrelevant, since a good understanding of the underlying causes of the recent changes in inequality is an essential part of the public policy debate and is necessary for explaining broadly why policies of redistribution are required.

Thus, there is clearly a need in Europe for a fuller and wider discussion of the recent changes in income distribution and in unemployment propensities for different groups in society and the causes of those changes. In addition, there is probably a case for a broad debate on the complete effects of trade, and globalisation in general, and in particular a better picture of the benefits that are provided. With such a background there would then be scope for a well-founded appraisal of appropriate policies for re-distribution and the case for and rationale behind such interventions in Europe.

It is worth noting that trade policy (for goods) is in the unique competence of the EU whilst the principal means of redistribution between different social groups remain in the hands of national authorities. Hence there is a need for a debate that involves both national governments and the EU institutions. The EU, through the structural funds, does implement policies that seek to reduce inequalities between different regions and, to a very limited extent, social groups. However, the rationale behind these interventions is not linked to trade or to technological change per se, which is sensible in the light of the discussion above. In addition the vast majority of funds (86 per cent of the budget allocated to structural operations during the planning period 2000-2006) are directed towards regional development.

There is little scope for the EU to intervene to compensate those who suffer permanent income loss due to globalisation and technological progress. As we shall discuss below, EU social policy is almost entirely dedicated to employment and adjustment issues, based on the perception that unemployment is the principal factor underlying social exclusion. EU policy does not seek to directly address problems arising from increased wage inequality for those in employment. This remains entirely in the domain of national authorities.

With regard to alleviating the short-term costs of adjustment to globalisation, there are no policies in the EU that are *specifically* targeted at trade-affected sectors or trade-displaced workers. This differs from the situation in the US where there is a dedicated programme for trade-affected workers. The Trade Adjustment Assistance (TAA) programme, established in the early 1960s, initially offered unemployment compensation and re-employment adjustment services to workers who had lost their jobs due to increased import competition. In the 1980s the programme rules were changed to shift the emphasis from compensation to training. As we will discuss further below, this reflects a general desire in OECD countries to move from passive to active labour market policies. In the 1990s an additional programme has been added (NAFTA-TAA) to provide assistance to those negatively affected by imports from Canada or Mexico, or total or partial plant

relocation to these countries, following the implementation of the North American Free Trade Agreement.

These trade adjustment assistance programmes in the US are relatively small scale. Sapir (2000) reports that on average less than 4,000 workers per month have been receiving assistance under the two schemes compared with a total number of long-term unemployed of 175,000 per month. So less than 2.5 per cent of unemployed workers have received trade adjustment assistance. Samuel et al. (2000) report that in 1997 the cost of the two schemes was \$300 million, of which \$120 million was dedicated to training and the rest to income support. The latter is typically available for one year after unemployment benefits, which is usually provided for 26 weeks, cease. Thus, trade adjustment assistance in the US amounts to a tiny fraction of GDP, less than 0.01 per cent.

Despite these trade adjustment schemes it is clear that there is considerable resistance amongst organised labour in the US to further trade liberalisation, apparently much more so than in EU countries. Sapir (2000) suggests that this is because the increase in trade with low-wage countries in the 1980s and 1990s has led to permanent income losses as well as temporary adjustment costs for groups of US workers. The small-scale TAA programmes, which are geared primarily to adjustment, have remained the only response.<sup>4</sup> Burtless et al. (1998) have argued that explicit compensation for trade-displaced workers should accompany training programmes. They advocate a wage insurance scheme whereby displaced workers would be compensated for half of the loss of earnings between previous and new jobs for a period of two to three years.

In Europe, displaced workers are generally caught by a much more extensive welfare system than exists in the US, which has cushioned the impact of trade (and technology) on income inequality and poverty. These welfare systems are almost entirely administered and funded at the national level and there are some important variations in the nature and extent of provisions between different EU member states. But, in the main, EU social protection systems are designed much more from an equity rather than an efficiency perspective, relative to the US approach (Sapir (2000)). Hence, whilst the increase in income inequality has been much less in Europe than in the US, the level of unemployment in Europe has remained persistently higher. Even so there are no mechanisms in EU countries to directly identify and compensate trade-displaced workers who find re-employment on less advantageous terms and therefore suffer permanent income losses.

National policies concerning taxes and transfers, including unemployment benefits, play a major role in reducing the extent of poverty in OECD countries. In the mid-1990s the pre-tax and transfer poverty rate<sup>5</sup> for the working-age population was about 23 per cent in Belgium, 25 per cent in France, 14 per cent in Germany and 23 and 24 per cent respectively in Sweden and the UK. However, the post-tax and transfer poverty rates for the working population were around 6 per cent in Belgium, 7 per cent in France, 9 per cent in Germany and 7 per cent and 12 per cent in Sweden and the UK respectively (Forster (2000)). In general the effectiveness of tax and transfer systems in OECD countries has increased in

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<sup>4</sup> Ruggie (1997) reports the desire of the Clinton administration to abolish the TAA schemes entirely and replace them with alternative retraining schemes.

<sup>5</sup> Proportion of persons in households with less than 50 per cent of median disposable income.



the period of globalisation. In a number of countries (Australia, Canada, Denmark, Ireland and the US) pre-tax and transfer poverty rates increased between the mid-1980s and the mid-1990s whilst post-tax and transfer rates fell. For most other countries post-tax and transfer poverty rates increased by less than pre-tax and transfer poverty rates, the exceptions being Germany and the Netherlands. So in most countries the redistributive impact of the tax-transfer system increased in the late 1980s and 1990s.

EU policy was redefined by the extraordinary Luxembourg Summit on employment which took place at the end of 1997. Agreement was reached on a coordinated employment strategy (the Luxembourg Process) whereby each year the Commission submits a proposal for Employment Guidelines. Member States are obliged to take account of these guidelines in setting their employment policies and make annual reports on their implementation. The guidelines are developed around four pillars: employability, entrepreneurship, adaptability and equal opportunities. In the main the guidelines relate to active policies to increase the rate of employment and remove discrimination. Targets have been set for raising the employment rate to 70 per cent by 2010, from 62.2 per cent in 1999. Member states are also required to develop strategies with regard to the acquisition of skills to allow adjustment to economic changes. The guidelines also mention reform of tax and benefit systems although to date little progress has been made on this front. The Joint Employment Report for 2000 concludes that “the development of comprehensive reforms addressing the combined incentive impact of tax and benefit schemes remains, therefore, a priority for most Member States”.<sup>6</sup>

### **Globalisation and the End of the Welfare State**

A further fear arising from globalisation is that the effectiveness of policies to deal with social exclusion will be eroded as, in the face of increasing mobility of some factors (primarily capital but also highly skilled labour to some extent), the ability to raise taxes to fund social programmes will be compromised. To maintain social spending, taxes on internationally immobile factors, i.e. most types of labour, will have to be continually increased. In this way Rodrik (1997) has argued that governments in industrial economies face a dilemma: globalisation generates rising demand for social protection but at the same time limits the ability of the state to fulfil that role. The argument is taken further to suggest that this process will erode the social consensus underpinning open markets such that there is a real possibility of a re-emergence of the extensive protectionism that undermined economic welfare in the 1930s.

Rodrik (1997) provides some statistical evidence to suggest that openness to trade together with free movement of capital is associated with reductions in government activity in industrial countries. However, there are a number of problems with this analysis. First, government expenditures on welfare and other programmes have been under review in many countries for reasons totally divorced from globalisation. Starting before the onset of the current wave of globalisation there has been a comprehensive and legitimate debate concerning how to reduce the burden of taxation in EU countries, often in the context of how to raise the rate of employment creation in Europe.

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<sup>6</sup> Joint Employment Report 2000, COM (2000), 551 final, 6.9.2000.

Secondly, Rodrik relates openness, as measured by the share of imports plus exports in GDP, to two measures of government activity, social spending and government consumption, both divided by GDP. Thus, there is no attempt to distinguish trade with industrial countries from trade with developing countries. Further, Rodrik's sample starts from the mid-1960s and captures, particularly for EU countries, a considerable expansion, until the 1980s, of trade between the industrial countries. This trade was primarily of an intra-industry nature, the two-way exchange of goods within the same industrial sector, and adjustment costs were fairly limited. Hence, in the initial period with trade and GDP rising and little pressure on social policies it is not surprising that rising openness was associated with a fall in the share of expenditure on social protection in total income. Next came the 1980s which saw a period of rapidly rising unemployment and a slowdown in the expansion of trade as a share of GDP. The average rate of unemployment in the EU-15 in the 1980s was 8.9 per cent compared with only 4 per cent in the 1970s. In the 1970s the share of total imports of goods and services in EU-15 GDP increased by 6 percentage points. In the 1980s import penetration rose by less than 3 percentage points, although this decade was marked by the rising importance of imports from developing countries. Hence, social expenditures increased rapidly whilst the growth of overall trade ratios slowed.

So, it was only really in the 1980s and 1990s that trade between industrial with developing countries, which is more likely than intra-industrial country trade to generate permanent costs and temporary adjustment problems, has increased. Martin (1998) reports OECD data which show that government spending on labour market measures increased on average in industrial countries from 2 per cent of GDP in 1985 to 3 per cent of GDP in 1995. This spending covers both what are termed passive measures, e.g. unemployment and related social benefits and early retirement benefits, as well as active labour market policies such as training, employment services and so on. With regard to the claim that globalisation has reduced the level of individual social protection for those suffering adverse employment developments, Martin concludes that "few OECD countries have taken steps to roll back the generosity of their benefit systems in recent years in terms of cutting benefit levels and/or reducing the average duration of benefit payments".

In addition, recent trends suggest that industrial countries are not facing overwhelming difficulties in raising revenues to finance the welfare state and social protection systems. The level of taxes in GDP has continued to rise in most OECD countries (*Financial Times*, 3/11/00), with tax reform and attention to tax loopholes generating a greater amount of taxation. Other studies have produced results that contradict those of Rodrik. For example, Swank (1998) finds that international capital mobility is not related to the general retrenchment of the welfare state or to a movement towards a minimal system of social protection.

Although globalisation may not, to date, have led to any substantial deterioration in the welfare state, it could be argued that the inexorable integration of the global economy will sooner or later compromise current levels of social protection in OECD countries.<sup>7</sup> But

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<sup>7</sup> In a very interesting paper Ludema and Wooton (2000) show that in the presence of forces for agglomeration of economic activity there will be a U-shaped relationship between trade liberalisation and taxes. This suggests that if there is a problem with funding the welfare state the answer may be further economic integration! This is consistent with Kerchgassner and

how much further has the process of globalisation to go? Will we eventually reach a state of perfectly integrated global markets? There are a number of reasons to believe that this integration will be constrained. Empirical applications of models that assume away constraints upon trade (such as the Heckscher-Ohlin model) vastly over-predict the amount of trade that actually takes place. This could be because there is a range of natural barriers to trade which imply that international commerce will be limited even if all man-made barriers to trade could be eliminated, which is quite unlikely. These natural barriers include distance and something that economists have identified as “home bias”.

Home bias implies that, other things being equal (mainly prices), consumers will still have a preference towards the purchase of domestically produced goods. To some extent this reflects history and culture but it appears to go much deeper than this. In a very interesting study of trade amongst Canadian provinces and between those provinces and US states, McCallum (1995) found that, after controlling for distance and economic factors such as size, trade between two provinces is typically 20 times more intensive than trade between a province and similar state on the other side of the border. This is perhaps strange given the apparent high level of economic integration and cultural similarity of Canada and the US. In this way as McCallum concludes, national borders still matter. Further, Wolf (1997) finds evidence of home bias in trade amongst US states. So even when all trade policy variables are removed there remains a preference for products that are locally produced. This suggests that a borderless world comprising a set of perfectly integrated national markets will not materialise. There are effective constraints upon the level of integration and upon the international division of labour.

Why then do borders continue to matter? One of the main reasons is that movement across a national frontier, even those in the EU where, with the Single Market, there are no border formalities and only empty border posts, entails movements into a different legal, regulatory and cultural jurisdiction. These borders ‘proscribe, adjudicate and enforce a wide range of norms, rules, habits, networks and the like’ (Thompson (2000)), which differentiate one geographical area from another, in terms of both consumers preferences and the legal and institutional environment for doing business. It is most unlikely that globalisation will lead to the harmonisation of tastes across the world. For many modern quality-differentiated products, proximity to the market remains a crucial aspect of effective supply.

On the supply side Rauch (1999) has argued that differentiated manufactured products are often produced in an environment in which complex networks of contacts interact to establish markets and set prices, which usually involves extensive search costs. This can be compared to more standardised products, such as primary products which are traded on organised exchanges or intermediate products, such as chemicals, where trade is based upon ‘reference prices’ quoted in specialist publications. Rauch suggests that trade rises much more slowly with production for the differentiated manufactured products relative to the standardised products. In addition, trade in standardised products has been declining in importance, so that differentiated manufactured products, where network costs are

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Pommerehe (1996) who find no evidence of tax competition amongst the cantons of Switzerland, where there is fiscal autonomy and mobility of high-skilled workers.

particularly important, are becoming increasingly dominant, but where growth is slower and trade may be ultimately constrained.

Similar arguments also pertain to international capital flows. Investors tend to hold a much smaller number of securities from other countries than one might expect in a well diversified portfolio. Again, investors appear to exhibit home bias and imperfect information and transaction costs remain a barrier to cross-country investment flows. In addition, the amount of long-term capital outflow from a typical OECD country is small relative to the amount of domestic investment, around 3 to 4 per cent (Brenton and Di Mauro (1998)), although the ratio of outward FDI to domestic investment is much higher in countries such as Sweden and the UK. It is worth remembering that the vast majority of long-term capital flows still take place from one OECD country to another. Most of the outward investment by EU countries goes to other EU countries and the US. A very small share of the stock of foreign direct investment by firms in industrial countries is held in developing countries, with most of that having been invested in China, primarily for means of access to an enormous domestic market.

Thus, whilst globalisation will continue, the rate and ultimate level of integration will be constrained. ***A borderless world in which national governments are completely hamstrung in their ability to implement independent policies, and in particular are unable to provide current levels of social protection is not a realistic possibility. The choice of the scope and level of social protection will to all intents and purposes remain a national prerogative.*** However, the key problems facing national welfare systems are, in fact, internal rather than external in origin. The factor that is proving to be the greatest threat is the ageing structure of western populations and the way in which the pension system in most OECD countries is funded.

Nevertheless, more intense trade and capital flows, together with technological progress, will place some further demands on social protection systems. There is clearly a need to monitor and improve the effectiveness of tax and transfer systems in alleviating poverty and of active labour market policies in facilitating the return to work. A difficult question that has not received a great deal of public debate is ***what is the most appropriate balance between active and passive labour market policies?***

On the one hand if too much attention is given to active labour market policies and fewer resources are devoted to compensation in the form of transfers, then the consensus behind open international markets could be undermined. This in turn would lead to a reduction in the overall level of income if a spell of protectionism were applied in response. In addition, if the emphasis is placed upon education and retraining, then it is clear that those who are helped by such schemes will benefit from the higher wages that are paid to skilled workers. However, those who are unable to benefit from such schemes will be relatively worse off. Thus, in this way retraining and educational schemes can be regressive in the sense that funds are targeted towards those who will become better off. On the other hand, if the emphasis is placed too heavily on compensation then the incentive to retrain, for those who are able to, is diminished. This in turn will reduce the amounts available for redistribution by constraining the number of skilled workers contributing to tax revenues.

The effectiveness of many active labour market policies is unclear, partly because few rigorous evaluations have been carried out in European countries, at least until recently. For example, training programmes have a very mixed record of success. The current state of knowledge demonstrates that such programmes tend to be successful for certain groups, such as adult women, but are generally unsuccessful for other groups, such as youths. However, it is not at all clear why this is the case (Martin (1998)). More generally, as the arguments above would suggest, there is a need to consider carefully how passive and active labour market interventions interact, both in terms of the impact on the individual and from the overall policy perspective.

*Is trade with developing countries fair trade? Should adoption of core labour standards be enforced through trade sanctions?*<sup>8</sup>

Concomitant with the process of globalisation and increasing imports in OECD countries from low-wage countries has been growing attention to, and discussion of labour practices in developing countries. It is argued that low wages in developing countries are partly the result of a lack of basic labour rights, so that the decline in the wages, employment and employment stability of low-skilled workers in OECD countries is due to trade which is unfair. In other words, it is argued that lack of enforcement of core labour standards leads to an unfair competitive advantage in international markets. This then leads to demands for the effective global enforcement of core labour standards. Core labour standards are typically taken to be those specified by the 1998 ILO Declaration on fundamental principles and rights at work: freedom of association and recognition of the right to collective bargaining; elimination of forced and compulsory labour; abolition of child labour; and elimination of discrimination in respect of employment and occupation.

With the lack of consensus amongst researchers on the precise role that trade with low-wage countries has played in influencing labour market outcomes in OECD countries, we must currently conclude that the impact of such trade can not yet be dismissed. Given this there are a number of issues which emanate from the debate over core labour standards. First, is whether lack of core labour rights significantly distorts comparative advantage and competitiveness?

*Does lack of core labour standards give an important competitive advantage?*

Here the theoretical analysis shows how under certain circumstances weak labour standards *can* lower wages in poor countries, increase exports from those countries and lower export prices and so reduce the wage of unskilled labour in rich countries relative to the returns paid to skilled workers.<sup>9</sup> However, low labour standards *do not necessarily* lead to lower wages in the country with lax standards. For example, discrimination in employment is likely to lead to higher, not lower, wages by reducing the supply of workers. In fact, the links between low labour standards and competitiveness and trade are complex depending upon the nature of labour markets and production technologies. General statements on this issue are therefore impossible to make. It thus follows that it would be nearly impossible to identify any margin of competitiveness arising from lack of implementation of core labour

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<sup>8</sup> This section draws on the comprehensive review of the issue provided by Brown (2000).

<sup>9</sup> The link between international product prices and relative wage rates is demonstrated by the Stolper-Samuelson which forms a fundamental part of the traditional theory of international trade. See Brenton (2000) for more details.

standards. Thus, any attempt to countervail what some have called 'social dumping margins' would inevitably lead to arbitrary, and probably protectionist, levels of tariffs in industrial countries.

Further, there is a range of factors that suggest that the impact on workers in industrial countries of low wages in developing countries due to low labour standards will be limited (Maskus (1997)). For example, if the industrial countries are producing goods that differ from those produced in the developing countries in terms of factor intensities, then the impact of low labour standards in the developing countries on wages in the industrial countries will be dampened. The impact will also be determined by the ease with which different factors of production can be substituted for one another and the sensitivity of demand for the product in the industrial countries to changes in price. The available empirical studies have yet to find any conclusive evidence that differences across countries in implementation of core labour standards has any significant impact upon the pattern of trade between developing and industrial countries.

Another concern with regard to core labour standards is that multinational corporations based in industrial countries are locating production in those countries where core rights are not respected. In other words, it is argued that the liberalisation of capital flows that has occurred with globalisation has led capital, in search of the highest return, to seek out those locations with the lowest labour standards. However, there is nothing to suggest that, in aggregate, foreign direct investment decisions are distorted by lack of implementation of core labour standards in particular locations. In addition, many multinationals are now actively implementing codes for responsible business conduct throughout the world. This has been enhanced by the recent adoption by the OECD of revised guidelines for multinational enterprises (OECD (2000)). These guidelines contain explicit recommendations from the signatory governments<sup>10</sup> to multinational enterprises for responsible business behaviour throughout the world, together with procedures for implementation and monitoring. The guidelines recommend that firms should respect trade unions and the development of collective agreements, contribute to the effective abolition of child and forced labour, and refrain from discriminating amongst employees according to race, sex, religion, political opinion or social origin.

More generally, it is erroneous to assume that differences in wages must be due to variation in labour standards. Clearly many other factors contribute. In fact in the face of a large labour pool that is relatively responsive to changes in wages, the impact of low labour standards on wages in developing countries will probably be quite small. The OECD (1996) amongst others concludes that low labour standards are not an important competitive factor. This has two implications. Firstly, that ***the impact of low labour standards in developing countries on workers in industrial countries is slight*** and secondly, that ***effective implementation of core labour standards will not undermine the ability of developing countries to compete on the world market.***

*Will globalisation undermine current labour standards in OECD countries?*

The second key issue is whether failure to internationally enforce labour standards will lead to a global competitive race to the bottom as far as employment protection is concerned.

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<sup>10</sup> All OECD countries together with Argentina, Brazil, Chile and the Slovak Republic.

The fear here is that international competition and the free movement of capital will make the maintenance of high labour standards untenable. Here again there are a number of reasons that suggest that this fear is, at least, exaggerated. First and foremost, the fear of a race to the bottom is based on the incorrect assumption that international competition will push standards down to their lowest level. Government regulations that improve employer-employee relations are unlikely to be watered down in a well-functioning democracy (Brown (2000)). Deregulation that leads to deterioration in labour relations will not improve firm performance.

In addition, some standards in industrial countries have emerged as part of the competitive process through negotiations between employers and employees. Thus, the overall package that the firm offers to the workers will comprise money wages, other benefits and working conditions. The precise outcome will reflect the particular preferences of the worker. Overall compensation will be related to the productivity of the individual and the market price of the product he or she produces. Firms that seek to reduce the compensation package on offer below that justified by the value of the workers' productivity by reducing benefits or working conditions will find that they will lose workers to other employers. International competition will be important to the extent that it affects the value of an individual's productivity (either through a fall in the price of the final product or via an outflow of capital).

Even if international competition leads to some downward pressure on standards, it is most unlikely that these will spiral downward to the lowest level observed in the international economy. The diversity of standards that we observe across the world reflects variations in incomes, preferences and technologies. Further, there are clearly cases, a notable example being the Netherlands, where very high labour standards have been maintained in the face of competition from low-wage countries whilst employment performance has dramatically improved. Thus, ***it is unlikely that increased global competition will inevitably lead to the downward convergence of labour standards.***

*Should trade sanctions be used to enforce core labour standards?*

The next important issue is, given that implementation of core labour standards is desirable, what policies could be pursued to encourage the adoption of basic labour rights throughout the world? Trade sanctions by developed countries have often been touted as a response by labour unions in those countries and was even raised by the US President at the Seattle summit of the WTO in November 1999, which given the understandable sensitivity of developing countries on this issue, effectively doomed that meeting to failure. In general, ***trade sanctions are not an effective way of achieving adoption of core labour standards and indeed they may worsen the situation*** for those in the developing countries whom the proponents of sanctions *may* be seeking to help. Whalley and Wigle (1999) demonstrate that trade sanctions in industrial countries will tend to reduce wages in developing countries and reduce exports from all countries in the world.

The fact is that trade sanctions will in general benefit the scarce factor in the developed countries (unskilled labour) and will be to the detriment of the abundant factor (unskilled labour) in the developing countries. It is for this reason that the humanitarian motive for trade sanctions cannot easily be distinguished from the protectionist motive, so that a careful analysis of the impact of such policies is required before they can be considered for

implementation. The analysis of appropriate policy towards labour standards varies somewhat according to the specific aspect of labour rights that is being addressed. We start by looking at the most emotive issue, that of child labour.

Economic analysis shows the importance of not just considering whether possible policy choices reduce the amount of child labour but whether in addition the welfare of the children increase. Similarly, policies such as labelling to highlight that products are not produced with child labour whilst raising the well being of the concerned western consumers may not necessarily improve the lot of the child labourers. A complete ban on the employment of children is often proposed as a suitable response to this problem. This is the easiest response.

In models in which parents act in their own interest and take no account of the interests of their children, it can be shown that a ban on child labour will benefit the children. However, the simple and popular description of selfish parents enjoying their leisure as their children work, whilst applicable to certain individual cases, is not relevant to an explanation of the mass phenomenon of child labour that we observe in many of the least-developed countries. In this case it is not the attitude of the parents that forces children to work but poverty and the realisation by parents that sending their children to work is necessary for survival. Krueger (1996) demonstrates that there is a very strong correlation between child labour and poverty, as reflected in average GDP per capita. In countries where income per head exceeds \$5,000 per year, child labour is almost non-existent. It is in this sense that the problem of child labour can be identified as a problem of development rather than a trade problem. In cases where parents are altruistic but survival requires that children work, a ban on child labour could harm the family if there are no accompanying measures to maintain and raise incomes.

If the response to the problem of child labour were trade sanctions by industrial countries, then in the case where families cannot survive without child labour the sanctions would constrain trade and reduce growth in the developing country but would have no impact on the use of child labour. A trade prohibition would probably divert child workers into even more undesirable jobs in the import-competing or non-tradables sectors. Trade sanctions are likely to be effective only in cases where it can be clearly demonstrated that the interests of the children are not being fully reflected in the decisions of the household. This is very difficult to establish and, as noted above, will not be widespread. However, with bonded child labour, whereby an employer makes a lump-sum payment to the parents of a child and then provides food, clothing and shelter for the child, it can be demonstrated that there is a transfer from the child to the parents which suggests that the interests of the child are not valued within the family. However, specific import bans related to bonded labour will be difficult to monitor and to implement and better policies to tackle the problem will be available.

More appropriate and effective responses to the problem of child labour are likely to lie in poverty-alleviation schemes. There are also other more directly targeted policies which may reduce the use of child labour whilst per capita income remains below the level at which child labour disappears. The two main policies that have been identified are those that overcome capital market imperfections in developing countries and, most pertinently, targeted education subsidies. Both of these types of interventions provide a much more



positive approach to overcoming the problem of child labour compared to bans and trade sanctions. There can be no guarantee that a ban on the use of child labour or trade sanctions will remove child exploitation; such policies could just force children into other 'undesirable' activities in the informal economy, such as living on the streets.

In industrial countries, families facing short-term financial difficulties can, in general, overcome these through access to the financial markets. In developing countries where financial markets are much less developed, families facing short-term difficulties and lacking collateral may be forced to sell their children as bonded labourers. Removing the causes of the failure of the capital markets in developing countries is not straightforward. In this case government grants to poor families or a policy of providing loans to families without collateral may be effective, but are likely to be difficult to implement.

The two main causes of child labour are, in general, poverty and lack of access to cheap education of suitable quality. Educational subsidies<sup>11</sup> tied to the child's attendance at school are a way of replacing the child's income in the home thus helping to ensure fuller educational participation and less child labour. "***The targeted educational subsidy dominates the use of sanctions, a ban on child labour, and product labelling as a strategy for improving child welfare and lowering child employment***" (Brown (2000)). However, funding such a subsidy scheme may be difficult in the least-developed countries where families cannot survive without child labour. Here international aid is likely to be necessary. In addition, it is likely that the subsidy would only need to be paid for one generation of children. When child labour is necessary for survival, this reflects the low productivity and low wages of the adults in the family. The provision of educational opportunities will enhance human capital and thereby raise productivity and wages of the next generation, thus confining child labour to history.

Moving on to discrimination at work, Maskus (1997) demonstrates that the impact of discrimination on exports and competitiveness is ambiguous, but that in general discrimination against women, for example, by depressing the supply of workers, tends to raise wages. Hence, discrimination is costly and inefficient for the country which tolerates such practices and its elimination will be welfare-improving. However, the power of special interest groups may be such that it is difficult for domestic governments acting alone to remove discrimination. Some groups in society may gain from being able to practice discrimination and they may be able to block proposals for reform.

In this case foreign action, in the form say of an import tariff on the good/country where discrimination takes place could assist reform but only if the threat of trade restrictions leads to the removal of the practice. If the country chooses to continue with discrimination and accept the trade sanction, then the welfare of female workers may fall. This will arise if the imposition of the tariff reduces the cost of discrimination by reducing the ratio of the female to the male wage, that is by reducing the cost of preserving the existing male wage premium. Such a situation will occur if the export sector uses female workers intensively relative to male workers. Trade sanctions proportionately reduce the demand for female workers more than the fall in the demand for male workers, and the female-to-male wage

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<sup>11</sup> The available evidence suggests that such subsidies may be more effective if paid to the mother, since increases in the mother's financial contribution to the family tend to raise the status of children in the household.

ratio will decline. Only if the export sector uses relatively more male labour will the trade sanction raise the costs of discrimination. Thus, the case for a trade sanction to help combat employment discrimination depends upon the precise circumstances of each case. More generally, open trade, by increasing competitive pressures, is likely to lead to the abatement of what are costly, to the country tolerating them, discriminatory practices. Hence reducing import barriers in the country practising discrimination rather than higher trade barriers in the industrial countries is the easiest policy to implement and the one that is likely to be most successful. In this regard the WTO may, by providing for consistent and binding reductions in trade barriers, contribute to the long-term removal of discrimination.

The impact of trade sanctions when basic rights with regard to free association and collective bargaining are denied is also ambiguous. If the export sector of a developing country is dominated by a monopsonist and labour unions are suppressed, then wages will be paid at a rate below that dictated by productivity. In this case the presence of a union would be welfare-improving. However, if trade sanctions in overseas markets reduce the demand for the export good, then there will be a decline in the demand for workers in the sector and the distortion caused by the single buyer of labour will be intensified. Again, only if the threat of trade sanctions leads to recognition of unions will the use of trade policies be successful. If the ban on association is maintained in the face of overseas trade restrictions, then workers in the export sector will be worse off.

Thus, one can conclude from this discussion that the use of punitive trade measures in industrial countries to offset lack of compliance with core labour standards in developing countries does not, under most plausible scenarios, represent the best way of intervening to encourage adoption of such standards. In many cases the use of trade sanctions may well have an adverse impact on the very people who are being denied their core labour rights.

Thus, on economic grounds there is little to support the linking of adoption of core labour rights to trade sanctions. There are additional reasons why the WTO is not the suitable forum for the enforcement of core labour standards. The bedrock of the international trading system that is overseen by the WTO is the principle of non-discrimination. As a general rule, certain exceptions, such as free trade agreements, are permitted; countries should not discriminate between goods according to their place of production. Given the wide variation across countries in the implementation of core labour standards, the use of trade measures through new WTO mechanisms would be discriminatory and would undermine the basic characteristics of the world trading system. It would be the least developed and poorest countries that would face the stiffest trade penalties in industrial countries. Most economic observers argue, therefore, that the most appropriate forum for dealing with issues related to core labour standards is the International Labour Organisation (ILO).

The ILO has a range of conventions covering child labour, discrimination and freedom of association together with mechanisms for monitoring their implementation. Member states are obliged to provide regular reports on the application of the conventions that they have ratified which are then scrutinised by a committee of experts. There is also a complaints procedure whereby any of the tripartite members of the organisation (representatives of government, business and labour) can initiate a complaint against a member country for

failure to apply a convention that has been ratified. In response the ILO can use positive measures, including dialogue and technical assistance, to facilitate change. Governments, employers associations and trade unions can also exert important pressure. But in the main the approach of the ILO is based upon persuasion. Coercion in the form of sanctions is not available to the ILO. It is for this reason that the WTO has been suggested as a forum for the effective enforcement, through trade sanctions, of core labour standards.

Although the linking of trade to labour standards has been resisted so far in the WTO, both the EU and the US have introduced mechanisms in preferential agreements. The EU has specific clauses in its scheme of the generalised system of preferences (GSP) for developing countries that provide for additional reductions in duties on top of those already available under the scheme for countries that demonstrate satisfactory legislation and implementation of ILO conventions on freedom of association and collective bargaining and on minimum age for employment. Here it is not trade sanctions but trade incentives that are being used as the incentive to encourage adoption of core labour standards. In effect, implementation of ILO conventions is linked to a transfer from the EU to the developing country concerned, although the size of the transfer will be relatively small. Similar clauses provide for duty reductions for countries meeting certain requirements regarding environmental protection.

However, recent developments may effectively render these clauses obsolete. Following substantial pressure after the completion of the Uruguay Round and in the aftermath of the collapse of the WTO Ministerial in Seattle and the discord between developed and developing countries in the WTO, the Commission has proposed to introduce a comprehensive scheme (“everything but arms”) of duty-free access for products from the least-developed countries. These are the countries where, given their levels of poverty, implementation of core labour standards is likely to be weakest. Hence, unless the EU is proposing to link this new offer of duty-free access to the least-developed countries to adoption and implementation of core labour standards, then this particular approach of using trade preferences to encourage compliance will be lost.

It should be remembered that the broad process of globalisation, which includes the freer movement of information, has enabled consumers in rich countries to become aware of these practices. In many cases, they existed prior to the liberalisation of trade policies in both the developed and developing world. In fact, the importance of export-oriented industries to the problems of child labour and discrimination at work is relatively small. It is estimated that 95 per cent of child labour is employed in the non-traded sectors in developing countries.<sup>12</sup> Trade sanctions will do little, nothing, or most likely have an adverse impact upon the majority of child labourers.

The problem of child labour and lack of implementation of other core labour standards is one of development. There is a large body of work that suggests that trade and capital flows can play a major role in economic growth and the economic advancement of developing countries. Thus, the use of trade sanctions will most likely harm development prospects and undermine attempts to ensure effective implementation of core labour

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<sup>12</sup> See, e.g., Memorandum submitted by the Department for International Development to the UK Commons Select Committee on International Development: <http://www.parliament.the-stationary-office.co.uk/pa/cm199900/cmselect/cmintdev/uc227/uc22702.htm>

standards. The attempt to involve the WTO in the issue of core labour standards relates to the fact that the WTO has an effective enforcement mechanism, whilst the ILO does not. However, in many ways this has been rather futile. The developing countries, understandably fearful of the protectionist use of trade sanctions related to labour rights, will never agree to the linking of adoption of core labour standards to market access to industrial countries. Hence, attention has been diverted away from the important debate, which is how the ILO can be amended to help facilitate the effective implementation of core labour standards and how industrial countries can contribute to this process? The issue is not one of trade and labour standards, where there is an easy fix in the form of trade sanctions, but one of development and labour standards, where the solution is not as simple, but where open trade can play a significant positive role.

## Conclusions

Whilst it is impossible to reject the assertion that globalisation has had a major impact on wage and employment inequality in Europe and therefore upon social exclusion it is possible to dismiss trade protection and controls on long-term capital flows as an appropriate response. This does not imply that governments should do nothing about the interests of low-skilled workers but that more effective policies for redistribution are available. To date social protection systems in Europe have sought to catch displaced workers regardless of whether they have been affected by globalisation or by technological advance. This is consistent with the view that the magnitude of the impact of trade relative to technology is irrelevant to the policy response, given that both trade and technology bring benefits to an economy which suitable policies for redistribution should seek to preserve.

The fear that globalisation will undermine current social protection systems appears excessive. There is no strong evidence to suggest that to date governments have been dismantling welfare systems in the face of globalisation. In addition, there are a number of reasons to believe that borders will always matter and that the seamless world foreseen by some in which all scope for independent action by national governments is removed is most unlikely to materialise.

In principle, because trade sanctions are inappropriate, and in practice, because developing countries will never be amenable, the WTO is not the appropriate forum to handle issues related to core labour standards. This does not mean that progress on ending child labour and discrimination in employment as well as freedom to associate and bargain collectively should not be sought, but that the ILO provides a more suitable framework. Continued efforts to push the WTO to allow adoption of trade sanctions in response to lack of implementation of core labour rights will not aid those who suffer from lack of basic labour rights in developing countries. If trade sanctions are permitted, their use will probably worsen the welfare of the poorest citizens of the poorest countries. Even if the WTO resists such pressures, attention and efforts will be drawn away from progress on the issue in the ILO.

***In sum, industrial countries should categorically rule out the use of trade sanctions as a means of punishing developing countries for lack of implementation of core labour standards.*** A more positive approach should be pursued, firstly, at the ILO, where some consideration should be given to enhancing the effectiveness of the ILO in those

cases where countries are probably able but find it difficult to implement core labour rights. Secondly, and more importantly, in conjunction with the World Bank, policy initiatives should be elaborated to improve the provision of education in developing countries and, with regard to the problem of child labour, to develop schemes of targeted educational subsidies.

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