Chapter Four

ADDING Value by Opening Up

The last two chapters explained why the world isn’t as globalized as many people think and analyzed how sensitive actual levels of cross-border integration are to the cultural, administrative, geographic, and economic differences between countries. This chapter explores the case for further integration given such headroom. It looks at how much we might gain by reducing the barriers between countries and further opening up.

Of course, thinking about gains from more openness only makes sense within the context of World 3.0. Believers in World 1.0 tend to either ignore cross-border interactions or focus on restricting/reversing them. And those still true to World 2.0 presumably see integration as having proceeded so far that relatively little is to be gained through more openness.

Adopting a World 3.0 perspective, then, let’s begin by considering previous estimates of the gains from liberalizing trade. Standard estimates of the gains from the proposals on the table in the stalled Doha round of world trade talks tend to fall in the $50–100 billion range, and gains from complete liberalization of merchandise trade range from less than $100 billion up to $300 billion. While those are a lot of billions, even that last estimate appears modest when we recall that in the

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wake of the financial crisis, banks such as Citigroup and Royal Bank of Scotland individually transferred larger amounts of “toxic” assets into “bad banks,” and trillions were spent on stimulus programs.

More precisely, the estimated gains from the Doha proposals represent roughly 0.1 percent of a $60 trillion world economy, or about $10 for every person on the planet, and even the estimates for complete liberalization amount to only 0.5 percent of world GDP or about $50 per capita. Note that these are also much smaller than estimates based on similar models suggesting that the United States, for instance, could add 8 to 10 percent to its GDP by reforming its tax code. Finally, the estimated gains from liberalizing merchandise trade have shrunk since the early 1990s because of rapid tariff reductions in general and growth in relatively open East Asian economies in particular.

In light of these estimates, think of an elected politician, possessed of some desire to be of service to constituents, but certainly not indifferent to personal political survival. Offer such a politician a 0.5 percent boost in GDP in return for a complete scrapping of controls on merchandise trade, and see how many takers you get. There probably wouldn’t be many in normal times and perhaps none during periods of high unemployment.

That’s the bad news. The good news is that the standard estimates of potential gains from globalization focus on just the tip of the iceberg. In fact, these estimates fail to capture the full potential of opening up for half a dozen broad reasons. First, we possess a more extensive set of policy instruments and levers than the models underlying these estimates presuppose. Second, while it is traditional to focus on volume and cost effects, cross-border interactions actually yield a broader array of economic benefits, as elaborated in this chapter in the specific context of merchandise trade. Third, looking beyond the usual focus on merchandise trade and including trade in services, as well as cross-border flows other than trade—flows of capital, people, and information—amplifies the economic gains from opening up. Fourth, not just economic value but also the cultural and political value of opening up must be considered. Fifth, complementarities across different channels of
cross-border integration—such as between trade and migration, as described later—imply that channel-by-channel analysis will underestimate total gains. And finally, there is the commitment to cutting barriers to trade over time that has been built up over several decades of global trade negotiations. Conclusion of the Doha round would lock in some of the past gains as well as maintaining psychological momentum.

Reviewing all these omissions and assigning very rough magnitudes to some of them (drawing on studies cited later in this chapter, among others), I reckon the potential gains from opening up to be several times as large as the estimates of $100 to $300 billion cited earlier: several hundred if not as much as a thousand dollars for everyone on the planet. Beyond these or other numbers, though, the more basic point is that the models used to generate them conceive of the potential gains from opening up far too narrowly. In making this argument, it is useful to begin with a brief description of the mathematical models that underlie standard estimates of the gains from trade liberalization.

**CGE Models and CAGE Barriers**

The estimates of the gains from freeing up trade cited above are based on computational general equilibrium (CGE) models that use computers to calculate the behavior of supply, demand, and prices in the whole economy—or, in the context of trade liberalization, across multiple economies. This is a challenging task that has elicited very complex modeling efforts. Thus, the World Bank’s LINKAGE model incorporates eighty-seven countries/regions, fifty-seven sectors, multiple labor skills and capital vintages, and on the order of fifty thousand mathematical equations.³

That said, the real world is much, much more complex and so CGE models have to simplify reality a great deal.⁴ At the macroeconomic level, most such models assume full (or fixed) employment and zero governmental and trade deficits. The few real-world distortions that they do recognize mostly reflect state intervention. In the context of
trade liberalization, these distortions include tariffs on imports and exports (or “tariff equivalents” in the form of exchange controls, quotas, etc.) and production subsidies, all of which are typically tacked onto transportation costs. The question that CGE models address is, How much would welfare rise if such distortions were removed? The models answer it by reshuffling a fixed amount of resources across industries (but within countries) to maximize cost efficiency as distortions are reduced or removed. The total gains from trade are the increased output observed as countries proceed to specialize in line with the principle of comparative advantage.

Juxtaposing the kinds of administrative changes contemplated in CGE models against the administrative barriers discussed in the previous chapter, it becomes clear that the former tackle only a subset of the latter. For instance, standard CGE models generally don’t consider harmonization of regulations of the sort necessary to simplify the packaging problems confronting the Canadian jelly bean manufacturer who would like to export to the United States—although some work on this has begun. Trade facilitation measures also tend to be omitted despite estimates (in nonstandard modeling) that they might yield gains worth 1 percent of global GDP—more than the sorts of liberalization that are the usual focus of such analysis.

We can expand this list of administrative barriers that might be targeted to include many areas of gross administrative inefficiency within or across countries. Examples include countries in which it takes three months or more to obtain trade documents and regional trade agreements that are so complex that they have never actually been invoked. Such inefficiencies clearly dampen cross-border economic interactions by increasing internal distance but again, aren’t part of the standard set-up.

As we look beyond administrative barriers to the other broad categories of impediments highlighted in the previous chapter, cultural barriers stand out as another obvious target. Without suggesting that cultures can or should be homogenized, we can clearly engage in “cultural facilitation” to ease at least some cultural barriers—examples include insularity,
hubris, and distrust of foreigners—that impede cross-border economic activity. Possible policy initiatives include broadening and ensuring more balanced coverage of foreign news, limiting nationalistic chest thumping, insisting on education, promoting second and third languages (particularly English as a language of wider communication), encouraging more cross-border trips and longer stays including immigration, and so on. Chapters 11 and 15 will deal at greater length with cultural barriers and what to do about them; the point here is that they fall outside the compass of CGE models.

Unlike administrative and cultural barriers, the geographic barriers highlighted by the CAGE framework might seem immutable, but even here, there is room for remediation. Consider Africa, whose trade performance, interregional as well as intraregional, has lagged that of other regions. Part of the problem is that Africa is very far away from major world markets, so that when one divides foreign market sizes by geographic distance (i.e., assumes a distance sensitivity of −1) and adds them up, sub-Saharan African countries can access one-third the foreign demand that European countries can. We can’t do anything about this geographic reality. Yet distance to markets isn’t the only factor underlying very poor African trade performance.

African exports to the United States illustrate the interregional problems: these exports experience transport costs three times as high as those from developed countries. Some of that higher cost reflects the incidence of landlocked countries, but much also seems related to ports that are among the slowest and costliest in the world—about which something could presumably be done.⁸

Africa’s intraregional trade is also low, and reveals even more clearly the influence of very bad infrastructure. By one estimate, if all the interstate roads in West Africa were paved, that might as much as triple trade within the (sub)region⁹ And that estimate does not include the effects of, for instance, reducing the checkpoints on roads that are paved. More than a dozen of these checkpoints typically crop up between one capital city and the next, adding to corruption as well as transportation costs and times.¹⁰ Landlocked countries in sub-Saharan
Africa are hit particularly hard by such problems: they incur inland transport costs that are more than four times as high on average as those experienced by coastal countries in the region.\textsuperscript{11}

Note that this discussion of geographic barriers has circled back toward administrative barriers, reminding us that the categories of barriers discussed in the previous chapter have a tendency to intertwine.\textsuperscript{12} Instead of focusing further on different types of barriers, then, I will simply point to the existence of a broad array of policy instruments and institutions that represent levers for increasing openness.

These levers aren’t fully accounted for in CGE modeling, and their effects are often viewed too narrowly. The usefulness of the CAGE framework in this context, as Supachai Panitchpakdi, secretary-general of UNCTAD, put it to me, is that it helps expand what he calls the policy space. And according to him, the need for more policy space to implement appropriate development strategies has only gone up since the crisis.

\textbf{ADDING Value Through Merchandise Trade}

My own perspective on models of the gains from trade reflects my graduate training in economics—micro rather than macro—at Harvard, followed by twenty-five years on the faculty at the Harvard Business School, and now at IESE Business School in Barcelona, studying business and global strategy. I’ve come to think that business is fertile in insights about the derivation and distribution of value from globalization for society generally (although, obviously, such insights have to be adapted to focus on the public interest or total welfare rather than just private interests or profits). This is because of the business world’s general emphasis on value creation and capture (my own textbook on business strategy is organized around these themes\textsuperscript{13}) as well as its extensive experience with internationalization. As discussed in chapter 2, businesses, especially large ones, exhibit greater levels of cross-border activity than markets in
general and are key intermediaries in trade as well as in other types of cross-border flows.

Figure 4-1 presents a simple scorecard that I developed to help businesses assess the private economic value created or destroyed by cross-border operations. I use it here to understand the social value of increased openness. The scorecard parses value creation into six components—volume, cost, willingness to pay, intensity of competition, risk, and knowledge dynamics—that, with a bit of wordsmithing, lend themselves to the acronym of ADDING value. Pascal Lamy, director-general of the World Trade Organization, was a discussant when I presented the ADDING value scorecard at the World Export Development Forum 2010 in Chongqing, China, and provided a powerful summary of the action implications: Focus on value, not on volume. He also pointed out that while businesses had figured out this value proposition decades earlier, trade professionals had yet to fully take it on board.

I contend that standard estimates of the gains from opening up focus on the first two components of the scorecard, adding volume and decreasing costs (the shaded ones in the figure), but miss out on the other four. Let me elaborate.

FIGURE 4-1

The ADDING value scorecard

<table>
<thead>
<tr>
<th>ADDING economic value</th>
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<tbody>
<tr>
<td>Adding volume</td>
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<tr>
<td>Decreasing costs</td>
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<tr>
<td>Differentiating</td>
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<tr>
<td>Intensifying competition</td>
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<tr>
<td>Normalizing risk</td>
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<tr>
<td>Generating and diffusing knowledge</td>
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<tr>
<td>Economies of scale</td>
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The first component of the scorecard, *Adding volume or growth*, is the one that is most evident in discussions of trade liberalization. Thus, in their introductory economics text, Paul Samuelson and William Nordhaus observe that to arrive at the total gains from trade, you need to add up all the consumer surplus and producer profits generated by the increased trade, or more roughly, all the increased output you see from specialization and production.\(^\text{14}\) When you hear people say, “Trade liberalization will expand GDP by 0.5 percent,” that’s the logic they’re following.

This added volume does, in a sense, depend on the second component of the scorecard, *Decreasing costs*; more cost-efficient allocations of resources underlie the expansion of output in CGE models. But the typical treatment of cost effects in such models is narrow. They don’t consider investments in cost reduction, such as improving the infrastructure that seems the real bottleneck in sub-Saharan African trade. And since economies of scale—broadly speaking, negative relationships between volume and costs—can’t easily be squeezed into general equilibrium models (they are a distinct potential source of market failure that I will revisit in chapter 5), they tend to be ignored as well.

This is a big mistake. Economies of scale, while perhaps not as pervasive as businesspeople often assume, are more important than economists, particularly international economists, have allowed. But even the latter are starting to shift perspectives. Thus, a recent study covering several dozen countries over two decades found that a third of the manufacturing and natural resources industries studied showed increasing returns to scale, one-third showed constant returns, and one-third did not exhibit a clear pattern.\(^\text{15}\) The industries most highly affected by economies of scale experienced a 10 to 20 percent cost reduction with each doubling of output. These are large numbers compared with the numbers we’ve looked at so far. If increased openness does unlock greater scale economies in industries where they matter, then that’s an added benefit that is left out of standard modeling efforts.

The third way trade can add value is through its role in *Differentiating* the products or services available to buyers, thereby improving their
willingness to pay. CGE models do allow goods to be differentiated in a very particular way, by country of origin; otherwise, however, they focus, like most economic models, on costs as opposed to other product attributes. But as my thesis advisor, Nobel Prize winner Michael Spence, used to tell us in graduate school, differentiation is 90 percent of what business competition is about. In this context, trade can help expand variety, improve available quality, or promote upgrading over time. And particularly for small countries, the very availability of a scale-sensitive product may hinge on integration with world markets. The cost of trade restrictions that lead to products being unavailable can be an order of magnitude larger than those associated with tariffs, that is, products being available at a higher cost.

A fourth way more openness can add value is by Intensifying competition. CGE models generally assume that competition within an industry is perfect: that it features many small businesses individually incapable of influencing market outcomes. Or occasionally, they allow for monopolistic competition: a slightly less perfect form of competition that involves some fixed costs, and, as a result, a large but finite number of differentiated producers, each with a limited amount of market power. Models of monopolistic competition have been particularly helpful in understanding intraindustry trade in variety, with different varieties produced in a few (different) locations due to fixed set-up costs but then traded internationally to satisfy within-country preferences for diversity. But they do not allow for concentrated industry structures featuring just a few competitors. The study of scale economies cited earlier and a lot of other research, not to mention common sense (think Toyota or Google), suggest that this is a bad idea: while not all parts of the economy are concentrated, some surely are.

With concentrated structures, there are very few competitors, in effect, and competition may become sluggish and market performance suffer due to high prices and—this is probably even more important—greater technical inefficiency. The question here is how greater openness affects this small-numbers problem. Both economic logic and empirical evidence suggest that openness generally helps allay the
problem, as discussed at greater length in chapter 5. So does practical experience. Thus, at a WTO workshop in Geneva where I presented the ADDING value scorecard, my fellow panelist, Eduardo Pérez Motta, the head of the Competition Commission of Mexico and previously its envoy to the WTO, stressed the intensification of competition as perhaps the biggest benefit of trade liberalization, especially in a country rife with cozy domestic oligopolies.\textsuperscript{21}

These arguments all focus on industry-level competition. Openness can also provide a tonic to competitive vitality in a broader sense. In closed economies, businesses and industries tend to lobby—and spend money on—securing purely pecuniary (and private) advantages from trade restrictions. Such "rent-seeking" uses up real resources but doesn't actually produce anything, and as such, represents a huge hidden cost of protectionism—and a huge benefit of openness. The classic example is Anne Krueger's estimate in the early 1970s that such pursuits may have swallowed up as much as 40 percent of Turkish GDP\textsuperscript{22}

A fifth way openness can add value is by helping Normalize risks. Most models used to estimate the gains from opening up presuppose a risk-free world: economic agents are fully informed about future events, have access to a complete set of contingent markets, and can compute benefits and optimize across all courses of action. But to discuss issues of social welfare without taking risks into account seems, especially in the aftermath of a crisis, more than a bit limiting.

What my scorecard emphasizes is normalizing or balancing risks instead of simply trying to minimize them. This reflects a basic tradeoff. In a world where markets are semiglobalized, diversification across national markets still washes out "unsystematic" risk, but connecting them up does create the risk of contagion. Minimizing one type of risk and ignoring the other usually doesn't make sense—even though there is a natural tendency to (over)emphasize contagion risk in the wake of a global economic crisis. I elaborate on these points and on the management of global risks in chapter 7. In addition to capital risks, chapter 7 focuses, within merchandise, on the risk-sensitive category of food grains—where market integration affords significant risk diversification.
benefits whereas moves to close off markets through measures such as export bans raise riskiness.

The sixth way trade can add economic value is by helping *generate and diffuse knowledge* faster. Economists have been interested in technological progress, in particular since Nobel Prize-winner Robert Solow’s landmark finding more than half a century ago that productivity gains explain more than 80 percent of U.S. economic growth.²³ Standard estimates of the gains from trade liberalization have little to say about this engine of economic growth because they describe the differences between two “steady states” but don’t really address changes over time.²⁴ Conceptually, though, openness should increase incentives to innovate by expanding the market and permit quicker diffusion of innovations. In addition, given cross-country diversity, openness might add to the creativity of the innovation process, as discussed later in this chapter. And finally, there is the argument about extra competitive pressure cited earlier.

It has long been known that imports of capital goods—machinery, equipment, and so forth—boost productivity by facilitating adoption of new technologies. More recent evidence suggests that imports—and inbound FDI—may facilitate innovation as well as imitation.²⁵ Exports (and outbound FDI) are correlated with rapid productivity growth as well, and the more recent evidence, in particular, suggests that this is partly because foreign markets serve as learning labs.²⁶ In addition, openness also seems to increase the rate at which more efficient firms replace less efficient ones. Since such turnover, especially among small firms, accounts for more productivity growth in countries such as the United States than upgrading by establishments that continue operating, this is no small matter.²⁷

To fully appreciate the possibilities associated with a faster productivity growth rate over time, consider two initially identical countries, one of which liberalizes and one that does not. If liberalization yields a one-off gain of, say, 0.5 percent of GDP, then the country that liberalized will be 0.5 percent larger than the one that didn’t—forever. But if liberalization yields 0.5 percent faster productivity
growth, the country that liberalized will be 5 percent larger than the other in ten years, and more than 25 percent larger in fifty!

To conclude this section, recall that standard estimates of the economic gains from merchandise trade—for example, the 0.5 percent of global GDP cited earlier—focus on the first two components of the ADDING value scorecard, adding volume and decreasing costs, and omit the others. Including the other components (as well as exploiting the expanded set of policy levers identified in the previous section) should, to my mind, push the estimate well past 1 percent of global GDP, to 2–3 percent or more.

More speculatively, the expanded conception of value might afford a better handle on how openness could benefit developing countries in particular. As Pascal Lamy, the director-general of the WTO, explained to me, most of the action in standard models of the gains from trade involves price reductions, effectively locking in the biggest benefits for those who spend the most—that is, rich countries. Greater emphasis on scale economies, differentiation, the intensity of competition, risks, and knowledge development, he felt, might increase not only assessments of the potential gains from trade but also affect the fraction estimated to accrue to developing countries.28

**Not by Merchandise Trade Alone**

The ADDING value scorecard can be applied not only to merchandise trade, but also to other types of cross-border flows. Services are the most obvious extension: they account for roughly two-thirds of global GDP but only one-fifth of global trade, leaving trade in services only about an eighth as intense as trade in merchandise. While some services are intrinsically untradable—think of the market for haircuts—services' overall level of trade intensity appears to be much lower than it could be. Policy restrictions are particularly pronounced in transportation and professional services.29

Service liberalization commitments require a sophisticated system of rules and regulation whose effects are hard to quantify. The few
academic studies that have nonetheless attempted to calibrate their effects using CGE models tend to conclude that a given percentage cut in services barriers would produce greater gains than those from a comparable cut in merchandise trade barriers. In addition, these studies, like the ones cited in the previous section, focus on a subset of the economic gains identified by the ADDING value scorecard and therefore presumably understate total economic gains. And finally, because of improvements in cross-border service delivery enabled by information technology, it is possible to argue that the potential gains from liberalizing trade in services are increasing over time—unlike the decreasing estimates for gains from merchandise trade liberalization cited at the beginning of this chapter.

Beyond trade in products and services, there are also cross-border flows of capital, people, and knowledge. Let’s start with capital. It might seem strange to talk right now about the benefits of cross-border capital flows. But it is important to distinguish among different types of capital flows. Foreign direct investment (FDI)—foreign companies buying, setting up, or reinvesting in businesses in a country—represents a long-term commitment even if the rate at which such commitments are entered into varies greatly from year to year. FDI helps transfer knowledge and information as well as capital, and functions, like trade, as a channel for product market integration with the prospect of ADDING value just as broadly.

Other cross-border capital flows offer a narrower set of gains focused on exploiting international differences in the cost and marginal productivity of capital as well as diversifying risk. Such flows are also capable, however, of increasing volatility, because they don’t simply vary from year to year: they can and often do go into reverse. So such capital flows do have to be managed, although it is rarely optimal to manage them to zero. These points are discussed further in chapters 7 and 8. For now, I offer two conclusions. First, some degree of cross-border capital mobility makes fundamental sense despite contagion risk; managed properly, such capital flows add to rather than detract from the gains from globalization. And second, even if there was a move to staunch such flows or associated speculative activity, that would not eliminate the need
exposed by the crisis for better cross-border coordination of financial markets. Such coordination would represent further finance-related globalization, albeit of another sort.

Turning next to cross-border labor flows, prior work suggests that the potential for gains is simply enormous. CGE-style estimates of the benefits to eliminating all restrictions on cross-border labor mobility are on the order of 100 percent of global GDP or more, rather than 1 percent.32 This will seem less surprising if we remember that productivity in rich countries is several dozen times as high as in poor ones. Migrants from poor countries to rich ones close a substantial part of that gap when they move and can take advantage of rich countries' superior capital, technology, and institutions—and contribute to those countries' general labor supply, specific skill/occupational categories, the diversity of goods and services available there, and levels of entrepreneurial activity.

Of course, some readers may object that complete liberalization simply isn't in the cards. Yes, but the real point is that even moderate relaxation of current restrictions on labor mobility might yield economic gains substantially larger than the other dimensions of opening up discussed so far. Estimates that assume more reasonable (i.e., restricted) liberalization of cross-border labor flows still predict gains of several percentage points of GDP.

That said, the readiness with which we can agree that complete labor liberalization is unlikely attests to the continued importance of barriers. These must be managed, but in a way that emphasizes integration—using some of the mechanisms for reducing cultural barriers discussed earlier—rather than interdiction. In other words, management isn't always code for moderation. Some developed countries, in particular, seem to have no real choice but to liberalize. Thus, the European Union is haunted by 50:50:50: the prediction that by 2050, 50 percent of its population will be fifty years or older. Japan's demographics are even worse. The OECD has estimated that without large-scale immigration, U.S. living standards could drop by 10 percent, the EU's by 18 percent, and Japan's by 23 percent.33 Again, these are very large numbers! The challenge of balancing labor supply and demand is discussed at greater length in chapter 8.
Finally, there is the matter of cross-border flows of knowledge. The flows already discussed can carry knowledge from nation to nation (whether embedded in traded products, transferred as a result of FDI, or vested in people), but knowledge can also move across borders in other ways (e.g., licensing, consulting, piracy). Also note that knowledge flows embody strong increasing returns to scale: unlike many other commodities, using knowledge in one place doesn’t reduce the ability to use it elsewhere. (This is an example of a positive externality; negative externalities are tackled in chapter 6, with a focus on global warming.)

On the one hand, cross-border knowledge flows are clearly already significant: most countries are estimated to rely on foreign sources of technology for 90 percent or more of their productivity growth. For small, poor countries, this percentage approaches 100 percent. And based on R&D expenditures, only one country, the United States, can plausibly be argued to depend more on domestic than on foreign technology development.

On the other hand, knowledge is still quite localized. Thus, patents with inventors in different countries cite each other only 50 to 75 percent as much as patents with inventors in the same country. And a study of G7 countries estimates that a dollar of foreign R&D is worth 74 cents of domestic R&D at distances under 2,000 kilometers (within North America or Europe), 37 cents at distances between 2,000 and 7,500 kilometers (between North America and Europe), and 5 cents at even larger distances (between Japan and the other parts of the “Triad”).

Attempts have also been made to unpack this distance effect. The G7 study concludes that trade, FDI, and language skills all serve as channels for international technology spillovers. A study of OECD countries emphasizes that the ease of doing business in a particular country and the quality of its tertiary education system raise both the productivity of its own R&D and international R&D spillovers. And then there are issues of mind-set. Businesses, even within the same country, are notoriously prone to the “not invented here” syndrome—which is probably aggravated internationally by lack of familiarity and other cultural
barriers discussed earlier. But the key point is that all these determinants of cross-border knowledge spillovers are amenable to policy influence.

To understand the magnitude of the potential gains, consider a stylized calculation that ignores the distance-related effects just discussed and buckets R&D into “domestic” and “foreign.” An increase in cross-border spillovers by ten percentage points would overshadow domestic R&D efforts for all but the three top spenders on R&D—the United States, Japan, and China. Even for the United States, which accounts for over one-third of global R&D, the boost would come close to 20 percent of domestic spending. And of course, spillovers are even more vital for countries that are behind or are very small.

In summary, the potential economic gains from liberalizing cross-border labor flows are very large and those from boosting services trade and knowledge flows also seem significant. Added to the economic gains from liberalizing merchandise, they probably push the potential gains from opening up past 5 percent of global GDP. The additional cultural and political benefits discussed in the next section supply a further boost.

**Beyond Economic Value**

To assess the cultural gains from openness, one must take cultural differences—and preferences for cultural diversity—seriously. This clashes with economists’ aversion to “unnecessary” differences. Thus, even Jagdish Bhagwati, the distinguished trade economist, has suggested that “if everyone’s alike, of course you’re better off economically.” Whatever the intent, the effect is to get people freaked out about cultural homogenization.

Such fears are unnecessary: as the last chapter indicated, cultural differences are alive and well in World 3.0, even between the United States and Canada. Chapter 11 elaborates on this point and on the potential for culture-related gains rather than just losses from increased interactions across cultural boundaries. One benefit is suggested by work in cognitive science on the advantages of different
perspectives, frameworks, and the like—cognitive diversity—in problem solving.\textsuperscript{40} Given the international differences discussed in the previous chapter, national cultural diversity is likely to generate lots of cognitive diversity.

But that is still an economic benefit. Openness can also add to cultural variety through \textit{inspiration} (e.g., African inspiration of New World music and, recently, reverse flows), \textit{mixture} (e.g., creole languages), \textit{transplantation plus adaptation} (e.g., Balti curries from Birmingham), or \textit{transnationalization} (e.g., the culture joining the global scientific community). Even more important, it can expand the variety available to individuals. As cultural economist Tyler Cowen notes, "Trade, even when it supports choice and diverse achievement, homogenizes culture in the following sense: it gives individuals, regardless of their country, a similarly rich set of consumption opportunities. It makes countries or societies 'commonly diverse' as opposed to making them different from each other."\textsuperscript{41}

That sounds rather good from an individual perspective! In fact, a similar argument about the political benefits of openness—that it goes hand in hand with democracy and enriched political opportunities—has been made by people as diverse as Immanuel Kant, the philosopher; Joseph Schumpeter, the economist; and Seymour Martin Lipset, the political scientist. (Note that this has occurred without much fretting about the spread of democracy being unduly homogenizing.)

The possible connections between openness and democracy rely particularly heavily on informational flows and include the freer exchange of ideas and increased political competition that result from openness, and the discouragement of autocracy by the transparency required to keep capital markets happy. While the actual connections aren't as clear as one would like, the weight of the evidence does suggest a positive relationship between trade and democracy.\textsuperscript{42}

That last conclusion is subject to a particular caveat: democratizing a country afflicted by a high degree of inequality may lead to a backlash against globalization (e.g., Bolivia in recent times). For this reason and others, chapter 9 explores at length the connections between economic
inequality and openness. Particularly worth stressing here is the suggestion that domestic entrenchment of the sort that a closed economy is more likely to spawn than an open one significantly impairs overall economic performance. Thus, one study found that country growth varied positively with the wealth of self-made billionaires but negatively with heir-controlled wealth.43 In fact, high levels of the latter, typically found in countries with restrictions on inbound foreign direct investment, reduced growth by as much two percentage points a year! This is a huge effect, but its magnitude is less surprising if one recalls the earlier discussion of rent-seeking and its social costs.

In addition to its domestic political ramifications, cross-border integration also seems linked to international political harmony. Specifically, the parts of the world that are isolated economically have also experienced far more military interventions by outsiders. The simplest way to see this is to look at the map in figure 4-2. The shading captures the number of disputes that countries are involved in at the WTO, with the darkest indicating more than a hundred. And the dashed line is drawn around the locations of 95 percent of all U.S.

FIGURE 4-2

Trade frictions versus military frictions

[Map showing trade frictions versus military frictions with legend: World Trade Organization nonmember, disputes between members with shading indicating 0, 1, or >100 cases. Source: To be added]
military interventions between 1990 and 2002. The map suggests that economic engagement and military trouble tend to be substitutes: if you don’t get the one, you get the other.

Thomas Barnett, a U.S. military strategist who originally drew the dashed line, moved to the U.S. Defense Department in the wake of September 11, 2001, where he devised a set of rules for the “Functioning Core,” the relatively secure countries outside that line, to deal with the “Nonintegrating Gap,” the more troubled countries within it:

First, we need to improve our immune-system response to 9/11-like shocks to the system that I like to call System Perturbations . . . Second, we need to firewall the Core off from the Gap’s worst exports, like drugs, pandemics, terror . . . Third and most important tenet: the Core’s big powers must come together to shrink the Gap progressively by tackling bad actors and security “sinkholes.”

This security-first approach did supply a geopolitical justification for the Iraq war, but partly as a result, there seems to be little appetite for further investments in “exporting security” to the Gap. That leaves open the option of stressing economic integration instead—the approach advocated in this book. Such integration may not work everywhere in the Gap but it can be pursued selectively: there is a world of difference between, say, Somalia, which is stuck in World 0.0, and Senegal. Progress might help reduce annual global military spending of $1.6 billion, or 2.7 percent of global GDP. Not to mention risks to life and limb. These and other political benefits of openness will be elaborated—and political fears dispelled—in chapter 10.

In conclusion, recall that cultural and political suspicions about globalization—as well as about markets and other economic institutions—tend to vary inversely with how well people think they are doing economically. So tapping some of the potential gains from globalization that World 3.0 flags and that this chapter has tried to characterize more fully may be the best softener, in the long run, for general attitudes towards globalization.
All Together Now

Figure 4-3 summarizes the discussion so far as well as two additional considerations that favor further opening up. Let’s examine these considerations in turn. First, pursuing more integration along one particular dimension can make it advantageous to push farther along other dimensions as well. While several such complementarities have already been mentioned in passing, it might help to look at a particular example in more detail. Take the link between trade and migration. One study suggests that doubling the number of immigrants from a particular country is associated with 9 percent higher imports from that nation. This is a substantial effect given the typically small shares of migrants in the total population. It implies that labor liberalization, in addition to producing large direct gains, would also generate substantial indirect ones by boosting trade. Yet the latter don’t figure in the estimated gains from labor liberalization cited earlier in this chapter.

**FIGURE 4-3**

**ADDING value by opening up**

- Adding economic value through merchandise trade
- Adding economic value through services trade
- Adding economic value through other cross-border flows
  - Capital
  - People
  - Knowledge
- Adding value culturally and politically
  - + complementarities
  - + commitment
More broadly, the existence of complementarities means that piece-meal evaluations of gains miss out on valuable cross-effects. To the extent that complementarities are important, the estimates discussed so far in this chapter are likely to understate the true potential associated with opening up further.

A second broad consideration that favors opening up further also involves links across choices—in this case, over time—in the form of a psychologically powerful commitment to reducing trade barriers. The nations of the world have sustained this commitment through several decades of global trade negotiations, a fact that in itself paves the way for future negotiations. Anything that would significantly impair this commitment—a failure to reach even a scaled-back agreement in the Doha trade talks would comprise a particularly symbolic and therefore significant event—would likely cause a damaging psychological shift, in addition to whatever direct benefits it denied the global economy.47

In fact, given high unemployment and other macroeconomic pressures, the alternative to conclusion of the Doha round or, more broadly, continuing to move to increase cross-border integration might not be stagnation but reversion toward World 1.0. Illustrating the potential ramifications is a recent study that found that the costs of intensified protectionism might be “almost five times greater than the gains realized from trade creation resulting from the DDA [Doha].”48 Because of large past reductions in tariffs, losses from rolling them back loom much larger than gains from further tariff reductions (although as noted earlier, many, many sources of gains other than tariff reductions exist).

Summing up, I reckon that the considerations covered in this chapter increase estimates of the potential for globalization-related gains from 0.5 percent of global GDP to more than ten times that. But the precise numbers one ends up with are highly subjective. More robustly, I hope I have established that the usual economic models miss many of the ways freer trade can create economic benefits, and they barely begin to account for the ways that freer flows of capital, people, and knowledge would increase world prosperity. It’s also important to remember that the gains aren’t all about economics: more cross-border exchange also
offers cultural and political benefits. And complementarities and com-
mitment are other factors to consider.

Particularly at a time when the general economic outlook remains
weak, this creates a strong temptation to simply push the pedal to the
metal. But not so fast. The discussion in this chapter has focused, as
mentioned at the outset, on the potential gains from globalization, par-
ticularly those left out of CGE models. We also need to consider the
omitted factors whose inclusion might tilt things the other way if we
want to assess net gains rather than just upside potential.

One type of generalization emerges when we recall that CGE models
assume perfect markets. They do not offer much of a basis, therefore,
for addressing the fundamental question with which this book began:
should the rediscovery of market failures—factors that can lead unregu-
lated markets to inefficient outcomes—affect how we view the cross-
border integration of markets?

The first few chapters of part II of this book start to answer this ques-
tion by analyzing how globalization affects standard types of market
failures. Specifically, chapter 5 focuses on how globalization affects con-
centration problems; chapter 6 studies global externalities; chapter 7
delves into informational imperfections and their risk implications.
Then chapter 8 looks at a nonstandard type of failure, global imbal-
ances, in line with concerns that the financial crisis stirred about the
self-stabilization properties of markets.

A second type of generalization involves market outcomes that,
while unrelated to standard market failures, spark widespread concerns
or, frankly, fears about globalization. As an empirical matter, these fears
mostly seem to focus on deprivation of various sorts: economic, politi-
cal, and cultural. Instead of simply shrugging off such fears, I consider
them at some length. Chapter 9 focuses on globalization and economic
inequality; chapter 10 on political fears about globalization that all
involve political disenfranchisement or dependence in some sense; and
chapter 11 on cultural fears, particularly fears of homogenization.

The tack taken in all the chapters in part II is frankly empirical.
While there are trade-theoretic models relevant to the issues discussed,
they tend to suffer from the same basic problem as the CGE models discussed earlier: their emphasis on embedding market interactions within a general equilibrium framework limits their ability to treat market failures and fears. Thus, models that don’t allow for concentrated market structures can’t shed much light on whether openness might exacerbate producer concentration. Models of pure exchange with no money or capital offer no visibility into issues of capital contagion. Models in which trade always ends up being balanced do not lend themselves to exploration of the risks, if any, associated with imbalances. Models featuring full or at least fixed employment cannot credibly address concerns that openness will lead to domestic job losses. And so on, although work is underway on each of these problems.

Recognizing these limitations, I haven’t attempted in this book to cite or test deductions from trade theory. Rather I’ve worked inductively through specific cases of market failures and fears, examining how they affect or are affected by a range of cross-border flows, including trade. In other words, I have used the case method developed at Harvard Business School, but with “cases” focused on specific issues that instantiate broader failures and fears—for instance, global warming as an example of the worst kind of externality or food price spikes as a particularly worrying example of the risk of global contagion. The point is not just to come up with specific policy recommendations grounded in reality for the issues considered, but to uncover broader patterns in the nexus between cross-border flows and market failures.

Of course, I’m not an expert on all the issues covered in chapters 5–11; in fact, the issue of global concentration that is addressed in chapter 5 is the only one on which I am recognized as an authority of any kind. Why read the other chapters? They offer concise, and I hope even-handed treatments of some of the key issues of our times—anchored in and illuminated by the worldviews discussed in chapter 1. They therefore constitute a train of argumentation that readers who disagree or want to go farther can follow at least part of the way. And as noted above, they are an essential complement to the argument in this chapter that trade experts tend to think of the potential benefits from globalization
too narrowly. Since trade models typically ignore market failures, it is plausible that they underestimate the potential costs of globalization as well as the benefits, leaving a bias of indeterminate direction—unless we actually try to size up the issues discussed in part II.

To provide a brief preview of the conclusions: the bottom line from part II is that the market failures and fears commonly cited as reasons to curb cross-border integration are overblown—and that where real dangers exist, so do preventive and corrective measures that typically do not involve closing off borders.