Global Capital and National Governments

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National Governments and Global Capital

A RECASTING

> More recently, however, as the downward-ratcheting logic of electoral politics has placed a death grip on their economies, they [states] have become – first and foremost – remarkably inefficient engines of wealth distribution.... Moreover, as the workings of genuinely global capital markets dwarf their ability to control exchange rates or protect their currency, nation-states have become inescapably vulnerable to the discipline imposed by economic choices made elsewhere by people and institutions over which they have no practical control.... Second, and more to the point, the nation-state is increasingly a nostalgic fiction.[1]

> For creditor states, global finance is an opportunity moderated by a measured risk. For debtor states, it can be the new tyrant.[2]

When throngs of protestors mobilized around the Free Trade Area of the Americas (FTAA) summit in Quebec, the World Bank/International Monetary Fund (IMF) meetings in Washington and Prague, and the World Trade Organization (WTO) ministerial meetings in Seattle, their target was economic globalization. Although these activists represented a variety of interests and viewpoints, they shared a refrain: a narrow set of political elites, corporations, and investors were directing globalization and global economic institutions, making them unaccountable and inherently undemocratic. In the financial realm, protestors contend that government economic policies are chosen largely by an "electronic herd."[3] This herd represents the twenty-first century analog to the British prime minister Harold Wilson's "gnomes of Zurich" (an epithet for Swiss currency traders, said to necessitate the 1967 devaluation of the pound) and to the 1980s'

[1] Ohmae 1995, p. 12.
[2] Pauly 1999, p. 416.
[3] Friedman 2000.

"bond market vigilantes." The electronic herd's detractors claim that it constrains all governments, but that the poorest nations experience the most severe tyranny.

For international and comparative political economy as well, the validity of the protestors' claim is a central issue. To what extent and in what ways do international financial markets influence, or even dictate, government policy choices? As antiglobalization activists have been quick to note, in an era of economic internationalization, private capital markets can appear to wield tremendous influence over national governments. For instance, dramatic capital market crises in Asia and Latin America in the 1990s prompted many governments to announce extensive pro-market reforms.

Whereas the impact of international capital markets on national governments may be most obvious in times of financial crises, many scholars maintain that financial markets also play a powerful role in routine government policymaking. For instance, a sizable body of recent scholarship argues that traditional social democracy is dying, *and* that the cause of death is the increased integration of national capital markets. This assertion is based on the assumption that global capital markets dislike – and react strongly against – key elements of redistributive, welfare-statist policies, such as high taxes and a high degree of public sector activism.

Looking at the recent growth of global capital and product markets, some observers have noted a new "impossible trinity." We can have integrated national economies, we can have sovereign and autonomous nation-states, or we can have responsive and effective domestic policymaking, but we can have no more than two of the three. The continued progression of international economic integration spells either the end of mass politics or the end of autonomous nation-states.[4] This possibility is one that may play out in coming decades, as we face choices not unlike those faced by governments and citizens at the turn of the twentieth century.[5] The more immediate question, however, is what the current implications of financial openness are for nation-states and for welfare state policies: in a period of high, albeit not complete financial openness, what can national governments achieve?

In this book, I argue that international financial integration does not necessitate the death of social democratic welfare states. Capital market openness does allow financial market participants to react swiftly and severely to changes in government policy outcomes. In the developed world,

[4] This revision of the "impossible trinity" is found in Rodrik 2001.
[5] E.g., Polanyi 1944.

however, capital market participants consider only a small set of government policies when making asset allocation decisions. They pay little attention to many other aspects of government policy, so that governments retain a significant degree of policy autonomy. Governments that conform to capital market pressures in select macroeconomic areas, such as overall government budget deficits and rates of inflation, are relatively unconstrained in supply side and microeconomic policy areas. As a result, international financial market forces have not rendered social democratic welfare state policies obsolete. Therefore, despite financial internationalization, we observe – and are likely to continue to observe – a significant amount of cross-national policy divergence among advanced industrial democracies. Moreover, when governments are faced with the choice between invoking the wrath of global capital markets and abandoning certain domestic policies, they do not always choose the latter. As a consequence, the diversity of national political alignments, political institutions, and economic profiles generates a multiplicity of responses to global capital market pressures.

In the developing world, however, the influence of financial markets on government policy autonomy is more pronounced. The risk of default in developing nations renders financial market participants more likely to consider a wide range of government policies when making investment decisions. Developing – or emerging market – nations are, by definition, lacking in capital endowments. They have greater needs to attract investment from abroad and, therefore, are more susceptible to capital market pressures. It is in the developing world, then, that antiglobalization activists' concerns about equity and accountability are most legitimate. Even this conclusion, however, must be tempered with awareness that governments retain some measure of choice. As in developed nations, the formulation of public policies reflects not only external financial market pressures but also domestic distributional considerations.

States and Markets: Convergence, Divergence, and the Need for Microfoundations

Structural Dependence and Interdependence

Although the contemporary era of financial internationalization is, in some aspects, historically unique, the general relationship between national states and private markets is of long-standing interest to scholars and policymakers. International economic relations, in one mode or another, always have affected the control and authority of national states.[6] In the *Wealth of Nations*, Smith points out that the imposition of taxes by national governments can provoke capital flight.[7] And in *The Great Transformation*, Polanyi argues that high levels of international economic openness are politically sustainable only when governments insulate and compensate vulnerable groups in society, by embedding market relations in a set of social institutions.[8] Without such intervention, societies choose to close their economic borders, as they did in the 1920s.

More recently, in the 1970s, comparative political economists turned their attention to the impact of domestic asset-holders on governments. The structural dependence hypothesis suggested that domestic capital holders occupied a privileged position in societies and, therefore, in policymaking. Because investment in the domestic economy is the path to economic growth, and because economic growth is the path to reelection, governments are particularly attentive to the demands of business. Different variants of structural dependence theory attributed varying degrees of influence to capital. Marxist-oriented theorists argued that capital owners possessed veto power, whereas neopluralist theorists assigned business a lesser degree of influence.[9] Later work assessed empirically the structural dependence argument by examining the responsiveness of government policy to investment patterns. For instance, Duane Swank investigates whether, when faced with low rates of domestic investment, governments respond to capitalists' activities by reducing corporate tax burdens. These studies conclude that there is some, but by no means an overwhelming, influence of business preferences on government policy outcomes.[10] Although structural dependence theorists addressed the influence of capital within polities, most[11]

[6] Krasner 1999.

[7] Smith 1776, book II, sections 373–379, pp. 848–849.

[8] Polanyi 1944, p. 140. More recent statements of this argument are found in Dryzek 1996 and Soros 1998, among others.

[9] Block 1977 exemplifies Marxist-oriented structural dependence theory, whereas Lindblom 1977 argues that governments need only provide a minimal level of benefits to capital owners, "without simply turning policy over to them lock, stock and barrel" (p. 183). Also see Bates and Lien 1985, Dryzek 1996.

[10] Przeworski and Wallerstein 1988, Swank 1992. More recently, Smith 1999 uses data from the United States to assess whether business exerts an overwhelming influence on public policy during economic downturns. He concludes that the structural power of business has been exaggerated.

[11] Block 1977 mentions the international dimension of capital but does not consider this dimension in his analysis. Wallerstein and Przeworski 1995 do expand their previous work to

assumed that capital owners faced a choice only between investing and not investing in their own economy, rather than between investing at home and investing abroad.

At the same time, scholars of international political economy examined the trend toward greater economic openness, labeled "interdependence," which signified changes in the capacity and roles of national states. Keohane and Nye described the "control gap" generated by transnational relations: national policymakers were less able to exercise authority over political and economic outcomes than they were in the 1950s and 1960s.[12] In such an environment, the cross-national coordination of economic policies became a functional imperative.[13] The capacity of national firms to relocate, for example, limited governments' choices over economic policies.

Contemporary Literature

The literature of the late 1960s and 1970s said little, however, about the specific causal relationships between economic interdependence and national policy outcomes; nor did it detail the interaction between international economic phenomena and domestic politics. In the mid-1980s, Peter Katzenstein's examination of small, trade-dependent European nations provided one means of integrating domestic political and international economic phenomena.[14] During the last decade, scholars devoted substantial attention to specifying the impact of economic globalization on national policy choices.[15] This theme has attracted interest not only in the academic realm, but also within media and policymaking circles. Much of the popular literature on the subject offers grim prognoses for government policymaking autonomy.

include international capital flows; they conclude that, if the cost of investment is deductible, governments retain the ability to collect taxes on uninvested profits.

12 Keohane and Nye 1977.

13 Morse 1969. Similarly, Richard Cooper suggested that, although international economic activity generated benefits, these benefits were derived at the expense of national policy autonomy. Cooper 1968, Cooper 1972, Dell 1987.

14 Katzenstein 1985. In Katzenstein's account, small states are constrained substantially by the international economy, as they have little choice but to engage in trade. But at the same time, historical differences in domestic institutions generate cross-national variation in political–economic strategies.

15 See Cohen 1996, Drezner 2001, Evans 1997, Garrett 1998c for comprehensive reviews of this literature. Sobel 1994 looks both to international and to domestic factors to explain changes in national securities market regulation. Like Cohen 1996, Garrett 2000b reviews several arguments regarding the causes of economic globalization and, specifically, the agency of national governments in the process.

The academic literature falls into two broad groups – convergence and divergence. Predictions of convergence rely on the imperatives of cross-national competition and economic efficiency; the type of convergence predicted tends to be downward, rather than a common trend toward an intermediate position.[16] Predictions of divergence, meanwhile, are based on the continued diversity of national institutions and on domestic demands for compensation. Much of this work glosses over the multifaceted nature of the globalization process, treating as similar the impacts of trade, direct investment, and portfolio capital movements.

It is important analytically, however, to distinguish among various types of economic internationalization and their effects. Trade openness and capital mobility do not necessarily covary,[17] and national resource endowments differ, so that some nations are quite open to trade but are less open to financial flows, and others are exactly the opposite. Additionally, trade flows and capital flows have different impacts on domestic economies: trade can result in increased output volatility; capital flows can induce greater volatility in investment but also can allow for consumption spending.[18] Moreover, different types of flows can generate different types of shocks. Thus, it is useful to consider the specific causal mechanisms through which capital market openness – as opposed to economic openness in general – can affect government policymaking autonomy.

Globalization, Convergence, and Efficiency

Convergence scholars argue that growing trade and financial internationalization seriously curtail government policy autonomy.[19] As governments and societies attempt to compete in an increasingly global marketplace, they reduce public involvement in the private sector. The driving force behind convergence accounts is efficiency: traditional welfare state policies are economically uncompetitive, so governments are quick to abandon them. Governments become leaner, embracing a neoliberal model of state–economy relations. They abandon the post–World War II compromise of embedded liberalism, in which governments combined increased

[16] On the multiple meanings of *convergence* see Kitschelt et al. 1999.
[17] Burgoon 2001, Cerny 1999, Garrett 1998c, Garrett and Mitchell 2001, Garrett and Nickerson 2001.
[18] Frankel 1986, Keohane and Milner 1996, Maxfield 1997, Maxfield and Hoffmann 1996, Sobel 1999.
[19] See Andrews 1994, Cerny 1995, Dryzek 1996, Rodrik 1997, Schwartz 1994.

openness to international trade with increased domestic protection for those dislocated by trade.[20] At the extreme, a race to the bottom ensues,[21] and global markets become masters over governments, eviscerating the authority of national states. Along these lines, Susan Strange maintains that

> the impersonal forces of world markets . . . are now more powerful than the states to whom ultimate political authority over society and economy is supposed to belong. Where states were once the masters of markets, now it is the markets which, on many crucial issues, are the masters over the governments of states.[22]

Some of the convergence literature predicts not only growing cross-national similarities, but also – because financial markets have become a structural feature of the international system – a transfer of authority from national governments to private actors.[23]

In the realm of capital markets, the capacity for exit, and the political voice it confers on investors, is central to convergence-oriented accounts. While capital market openness provides governments with greater access to capital,[24] it also subjects them to external discipline. Governments must sell their policies not only to domestic voters, but also to international investors.[25] Because investors can respond swiftly and severely to actual or expected policy outcomes, governments must consider financial market participants' preferences when selecting policies.[26] Investors' credible threat of exit – assumed in the structural dependence literature but guaranteed by international capital mobility – greatly increases their voice.[27]

20 Ruggie 1982, Rodrik 1997.
21 See also Garrett 1998c and Garrett and Mitchell 2000 for a summary of the race to the bottom logic.
22 Strange 1996, p. 4.
23 Andrews 1994, Germain 1997. Similarly, Sassen 1996 argues that the current dynamics of the global economy threaten to undo "the particular form of sovereignty and territoriality embodied in the modern state." Also see Cerny 1999, Friedman 2000, Germain 1997, Porter 1999, Strange 1996. Sinclair 1994 suggests that a good deal of authority in international finance belongs now to credit ratings agencies rather than to national governments or to intergovernmental organizations. Ohmae 1995 labels the nation-state as "increasingly a nostalgic fiction" (p. 12). Dombrowski 1998 provides a different viewpoint, suggesting that states continue to shape outcomes in the area of international finance.
24 See Garrett 2000b, IMF 1997b, Quinn and Inclan 1997, Quinn 1997.
25 Burtless et al. 1998, Haggard and Maxfield 1996, Moses 1994, Pringle 1992, Simmons 1999, Strange 1996, Tanzi and Schuknecht 2000.
26 Obstfeld 1998, Sassen 2000. Likewise, Mueller 1998 suggests that, with international factor mobility, governments' ability to impose involuntary redistribution is curtailed sharply.
27 Hirschman 1970.

In this vein, Paulette Kurzer argues that financial markets harshly punish social democratic welfare policies and, therefore, render expansionary public programs obsolete:

> In the past, governments could spend lavishly on public programs to reconcile the conflicting demands of labor and business. However, such expansionary programs produce expectations among financial asset holders that future inflation rates will drift above the rates of the country's main trading partners. This perception triggers capital outflows and foreign currency speculation. . . . Governments must reverse their policies to arrest future outflows.[28]

Philip Cerny offers a similar forecast: "Currency exchange rates and interest rates are increasingly set in globalizing marketplaces. . . . Globalization has undercut the policy capacity of the national state in all but a few areas."[29] Traditional welfare state policies are unlikely to withstand market participants' negative evaluations.[30] The prognosis is particularly dim for left-of-center governments, which receive the most unfavorable evaluations from financial asset-holders.[31]

These efficiency-based views predict a wide-ranging cross-national convergence of public policy outcomes, toward smaller governments, reduced government provision of social services, lower levels of taxation, lower levels of regulation, and lower levels of unionization. Proponents of the convergence hypothesis cite as evidence, inter alia, the rise of neoliberal policy programs and the advent of welfare state retrenchment in the 1980s in the United States, Britain, New Zealand, and Australia as evidence.[32] For at least some observers, the constraints emanating from financial openness are beneficial: they check the temptation of policymakers to "exploit a captive domestic capital market" or to pursue "unsound policies."[33] For other observers, these constraints are inherently undemocratic: national governments are accountable to a "global, cross-border economic

[28] Kurzer 1993, p. 12. Block 1996 characterizes this situation as "the dictatorship of financial markets" (cited in Evans 1997, p. 67).

[29] Cerny 1995, pp. 609, 612. Also see Grabel 1993.

[30] Germain 1997. For similar views from policymakers, see James Carville, quoted in *Economist*, October 7, 1995 survey, p. 5; Reich 1997, p. 64.

[31] Helleiner 1994, p. 296. Also see Cerny 1999, Sinclair 1994, 2000.

[32] On welfare state retrenchment and the impact of domestic political institutions on that process, see Clayton and Pontusson 1998, Dryzek 1996, Esping-Andersen 1996, Pierson 1994, 1996, Ross 1996, Tanzi and Schuknecht 2000. Germain 1997 posits that, although the constraining effect of financial market orthodoxy is most easily observed in developing nations, it is "equally at work" in industrialized countries (p. 135).

[33] Obstfeld 1998, Obstfeld and Taylor 1998.

electorate" consisting of "inflation-obsessed bondholders," rather than to citizens.[34]

Divergence, Compensation, and Domestic Institutions

The alternative perspective, which predicts continued cross-national diversity in economic policies and institutions, relies on two arguments. First, in the face of economic globalization, sustained variation in domestic institutions is not merely likely, but also possibly beneficial. The logic of comparative advantage, along with Tiebout's pure theory of local expenditure,[35] suggests that national specialization is possible within globalization. Firms and consumers have different preferences over taxation, services, and regulation; governments offer different combinations of these goods; and consumers and firms locate in the jurisdiction that best matches their preferences.[36] In the words of a former British Labour MP,

> The fact is that different countries – for that matter, different regions or even different cities in the same country – can pursue competitive advantage in the global marketplace in different ways. Cost-cutting, tax-cutting, deregulation, and the rest of the Thatcherite armoury may lead to success in markets for the cheap and the shoddy.... By the same token, low real wages paid to badly trained workers are not the only attraction for inward investors. It is also possible to attract them with crime-free streets, with high quality education and training, and with a clean environment.[37]

Similarly, endogenous growth theory highlights the positive impact on economic performance of some types of government spending;[38] therefore, a large government–high-growth economy might coexist alongside a small government–high-growth economy.[39] A senior official with a major

[34] Sassen 1996, pp. 40, 50; also xiv, 38, 39.
[35] Tiebout 1956. Also see Hall and Soskice 2001, Mueller 1998.
[36] See Berger and Dore 1996, Garrett 1996, Kitschelt et al. 1999, Pierson 2001, Rogowski 1998. On diversity in production regimes, see Soskice 1999, Weiss 1998.
[37] Marquand in Radice 1996, p. 76.
[38] Alesina and Perotti 1996c, Barro and Sala-I-Martin 1995.
[39] In a slightly different vein, Iversen and Wren maintain that the most important change in advanced capitalist societies has not been economic internationalization, but the shift toward service sector–oriented economies. Where services, rather than manufacturing, dominate the economy, governments choose from a menu of goals, including budgetary restraint, income equality, and employment growth. Governments are able to achieve two, but not three, of these goals; divergence in government policy occurs as a result of variation in this political choice. Iversen and Wren 1998. Also see Iversen and Cusack 2000.

European bank summarized this viewpoint:

It's ludicrous to suggest that all governments must have the same macroeconomic policies. All companies aren't run the same way just because they all have investors, and different companies turn in good performances.[40]

Second, economic globalization serves to heighten, rather than to reduce, pressures for government intervention. This compensation-based argument, which draws on the embedded liberalism notion, implies expanded or sustained domestic demands for government intervention. Governments have domestic political incentives to insulate individuals from externally generated insecurity and volatility; governments might pay an external economic price (in higher interest rates, for instance) for maintaining welfare state policies, but this price is offset by the internal political benefits of compensation.

The compensation view predicts a persistence of cross-national divergence in institutions and economic policy outcomes.[41] In support of this argument, for a sample of 100 nations, Rodrik finds a positive correlation between the level of a nation's exposure to international trade and the size of its government. And a nation's degree of trade openness in 1960 is a statistically significant predictor of the expansion of government size during the next three decades.[42] Rodrik's findings are rendered more convincing by his provision of several phases of evidence for the compensation mechanism.[43]

A cross-national mixture of policy outcomes also is theoretically consistent with open-economy models of aggregate fiscal and monetary policymaking. The Mundell–Fleming conditions detail the relationship between

[40] Interview 41. To preserve guarantees of confidentiality, I identify financial market interview subjects by interview number. A list of market participants' firms and interview dates is provided in Appendix 2.1. In a similar fashion, government officials are identified by agency and country.

[41] See Cameron 1978, Garrett 1998a, 1998c, Garrett and Mitchell 2000, Mueller 1998, Rodrik 1997. Adserà and Boix 2002 suggest that compensation is one mechanism (along with protectionism and political exclusion) through which governments can respond to increased trade openness; the compensation mechanism is more common at higher levels of democratization.

[42] Rodrik 1998. Rodrik reports that the correlation between trade and government size holds for most measures of government spending, as well as in low- and high-income samples. The result also is robust to the inclusion of a variety of control variables.

[43] For instance, Rodrik 1997 finds that external risk is positively and significantly associated with income volatility; that the effect of trade openness on government consumption is strongest in countries with more concentrated exports; and that past exposure to external risk is a statistically significant determinant of government consumption.

economic openness and the efficacy of national fiscal and monetary policies.[44] A nation may have two of the following three: open capital markets, fixed exchange rates, and an autonomously determined monetary policy. With capital market openness, a government with fixed exchange rates loses monetary policy autonomy and effectiveness. Interest rates and the money supply must be used to maintain the exchange rate peg. Fiscal policy, however, remains an effective tool for influencing domestic economic conditions, at least in the short run. On the other hand, a government with floating exchange rates retains monetary policy autonomy: interest rate policy is not subsumed to the goal of maintaining a particular exchange rate and so can be used to affect domestic demand. But, at the same time, fiscal policy loses efficacy.[45]

Open-economy models remind us that prior government decisions regarding exchange rates and capital market openness influence policy efficacy and, therefore, policy choices. If governments make similar choices regarding exchange rate regimes and capital market openness, international capital mobility reduces cross-national differences. But where governments make different choices, room for divergence remains.[46] Nations with fixed exchange rates converge in terms of monetary policy, whereas nations with flexible exchange rates should converge on fiscal policy. The loss of policy autonomy associated with capital market openness may have a greater impact on social democratic governments, as these governments traditionally employ fiscal *and* monetary policy to achieve full employment.[47] The more general point, however, is that, in a Mundell–Fleming framework, all governments face a mixture of constraint and autonomy, and this mixture varies across economic regimes.[48]

Divergence, Convergence, and the Empirical Record

Given the theoretical tension between convergence- and divergence-oriented accounts, what does the empirical record suggest about the impact

[44] Fleming 1962, Mundell 1963; also see Clark and Hallerberg 2000, Oatley 1999b. Similarly, Cohen 1996 describes an "unholy trinity," consisting of exchange rate stability, capital mobility, and national policy autonomy.

[45] See Mussa 1979, cited in Keohane and Milner 1996, p. 17, for a discussion of the standard open economy macroeconomic model. Also see Bisignano 1994.

[46] Notermans's 2000 account of the history of and prospects for social democracy is informed by such a view of externally generated constraints.

[47] Keohane and Milner 1996.

[48] Notermans 2000.

of financial openness on government policies? Recent empirical work assessing the validity of the convergence and divergence hypotheses, particularly in the advanced capitalist democracies, reveals a mixed pattern. Substantial cross-national diversity remains in areas such as government consumption spending, government transfer payments, public employment, and the public taxation,[49] but growing cross-national similarity exists in aggregate monetary and fiscal policies.[50] The latter often is associated positively with economic internationalization; the former reveals the continued influence of domestic politics and institutions.[51]

For instance, in the area of taxation, Swank finds that overall effective corporate tax burdens have not fallen in response to capital and trade internationalization. Many governments reduced marginal corporate tax rates but simultaneously broadened the tax base by closing various loopholes.[52] In fact, Swank finds a positive and statistically significant association between capital mobility and the effective tax rate.[53] Similarly, in their examination of the determinants of changes in marginal tax rates in OECD nations, Mark Hallerberg and Scott Basinger find that, although international economic openness had an indirect effect on tax changes during the 1986–1990 period – via tax competition and past economic

[49] Also see Boix 1997a, 1997b, 1998, Garrett and Lange 1991, Kopits 1992, Quinn 1997, Scruggs and Lange 2002, Stephens et al. 1999, Swank 1998a. On the importance of separating the effects of globalization into macropolicy and micropolicy areas, see Cohen 1996.

[50] See Frieden 1991a, Garrett and Lange 1991, Garrett 1998a, Goodman and Pauly 1993, Huber and Stephens 2001, Stephens et al. 1999. Garrett and Lange also maintain that the pursuit of different economic strategy profiles does not appear to affect economic performance.

[51] One recent example, with such mixed results, is Garrett and Mitchell's study of economic policies in 18 OECD nations during the 1961–1994 period. The reported statistical relationships between economic globalization and government spending tend to support the efficiency or convergence view, whereas the statistical relationships between economic globalization and taxation lean toward the compensation or divergence view. On the specific issue of capital mobility, Garrett and Mitchell 2001 find "scant evidence" that changes in cross-border capital flows have prompted a race to the bottom in welfare state effort. For a similar study encompassing developing as well as developed nations, see Garrett and Nickerson 2001.

[52] The net effect has been a maintenance of, or even an increase in, government revenues from corporate taxation. Kopits 1992, Swank 1998a.

[53] Swank 2001 also finds evidence of continued partisan differences in taxation: left governments rely more heavily on capital taxation; right governments tend toward higher taxes on labor.

performance – the most important influence was the structure of political institutions.[54]

Similarly, empirical studies in the Mundell–Fleming tradition reveal a mixture of convergence and divergence. In a study of 13 developed democracies for the 1968–1994 period, Oatley finds that partisan differences in economic policies do exist, but that these differences depend on the exchange rate regime and the degree of capital mobility.[55] Under fixed exchange rates, left governments run larger budget deficits than right governments, and these governments use capital controls to reduce interest rate premia. Under floating rates, monetary – rather than fiscal – policy is the preferred partisan instrument: left governments pursued looser monetary policies than right governments. In the 1990s, these partisan differences weakened; Oatley attributes this change not to a general increase in economic internationalization, but to the recession of the early 1990s and the push toward Economic and Monetary Union (EMU).[56] Recent research[57] suggests, then, that although there has been a cross-national convergence toward lower inflation rates and smaller budget deficits in the advanced capitalist democracies, divergence remains in supply-side areas. Many of these studies imply that international economic constraints are relatively small, and domestic political pressures and institutions remain central to the selection and implementation of government strategies. Nevertheless, theoretical and empirical gaps continue to characterize the field.

Far fewer empirical studies, for instance, have examined cross-national evidence from the mid- and late 1990s or focused on developing nations. Skeptics of the divergence–compensation perspective point out that although divergence persisted into the 1990s, financial globalization inevitably will produce greater cross-national policy convergence. For

[54] Nations with lower numbers of legislative and cabinet veto players enacted more sweeping tax changes. See Hallerberg and Basinger 1998. On the importance of separating the effects of globalization into macropolicy and micropolicy areas, see Cohen 1996.

[55] Oatley 1999b.

[56] Clark and Hallerberg also investigate the interaction between economic policymaking and Mundell–Fleming characteristics. Like Oatley, they find that government policy choices – specifically, preelectoral expansions – are constrained by exchange rate regimes and capital market openness. Unlike Oatley, however, Clark and Hallerberg 2000 do not find significant partisan influences on the use of fiscal and monetary policy.

[57] For other research that finds cross-national divergence, see Boix 1997a, 1997b, 1998 on privatization and government capital formation; Scruggs and Lange 2002 on union membership; and, more generally, the contributors to Kitschelt et al. 1999.