The paradox of globalisation is that pushing it too far undermines its own institutional foundations

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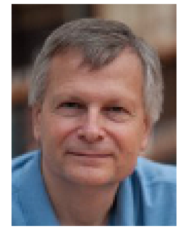

Is there a paradox in globalisation? **Dani Rodrik** *writes that a delicate balance exists between democracy and processes of globalisation. He notes that as different societies have different needs and preferences in terms of how they structure the institutions required to ensure markets function correctly, democratic pressures are likely to lead to a variety of different institutions across different territories. This diversity inhibits the global integration of markets by raising transaction costs across jurisdictions. Consequently, a world which is fully responsive to democratic preferences will be unable to achieve full globalisation.*

The argument in my book *The Globalization Paradox: Democracy and the Future of the World Economy* can be expressed in the form of a syllogism.

1. Markets require a wide range of non-market institutions (of regulation, stabilisation, and legitimation) in order to work well and remain socially sustainable.
2. These institutions do not take unique forms, in the sense that ultimate goals such as efficiency or stability can be achieved under a variety of designs and blueprints.
3. Different societies, organised around their own states, have patently different needs and preferences regarding the shape that market-supporting institutions can take.
4. A world that is sufficiently responsive to democratic preferences will therefore be one of institutional diversity and heterogeneity rather than institutional harmonisation and convergence.
5. Since institutional diversity inhibits the global integration of markets by raising transaction costs across jurisdictional boundaries, a world that is sufficiently responsive to democratic preferences will also be one that falls short of full globalisation.

To illustrate the argument, consider two sets of institutions, one needed for ensuring economic performance, the other for ensuring solidarity.

Regulation

In the aftermath of the global financial crisis, it has become apparent to most that financial markets require adequate regulation. In the absence of appropriate regulation, asymmetric information, agency problems, systemic risk and bubbles can too easily overwhelm the operation of financial markets, producing boom and bust cycles and financial crises. The more overgrown and interconnected the financial system, the larger the cost of the eventual financial busts.

The practical question is what form financial regulation should take. This is a hard question, which does not have a unique answer. Part of the problem is that even if we all shared the same values, needs, and preferences, we might differ as to our views on how the world really works – on whether, for example, the efficient market hypothesis really applies, or how severe agency problems are in the real world. In the presence of such disagreements, we would be collectively better off in a world where a certain degree of heterogeneity and experimentation with respect to financial regulation is the norm. This way we could learn about which type of regulation works better and is more robust by observing how each works in practice.

This argument for regulatory diversity presumes convergence in the long run, as we learn more. Of course, the long run could be a very distant long run, especially if the state of the world keeps changing. But there is a second argument for diversity that generates no convergence. Different societies, organised around different political systems, may well have distinct needs and preferences with regard to what they desire from a financial system. Some societies may value financial stability over financial innovation and will desire a tighter regime of regulation, willingly giving up on some financial innovation. Others will want greater financial innovation, and may prefer a lighter regulatory touch. There is nothing *a priori* that makes the first choice less desirable than the rest. Each society deserves the institutions that fit its values best.

Similarly, some poor countries may want to use their financial system more actively in a developmental way, by allowing financial cross-subsidisation or directed lending. Others may think this is too interventionist and prefer more market-based systems. Again, both of these choices are defensible on *a priori* grounds.

For either set of reasons, a single global regime of financial regulation is not desirable. Regulatory diversity means that the full benefits of financial globalisation cannot be reaped. It also means that complicated problems of regulatory arbitrage will arise. I discuss both sets of issues at length in my book. The general point is that a sane global financial system is one that falls short of full financial integration.

Solidarity

Every society has rules about what kind of competition is fair and legitimate. I am allowed to drive you out of business – regardless of the costs to you, your family and your workers – if I work harder, invest more or come up with better products. But I cannot outcompete you by requiring that my workers work 12-hour days, depriving them of their collective bargaining rights or by employing child workers. Notice that these labour-market rules interfere in what might otherwise be mutually-desirable exchanges. As a worker, you may well be willing to work for 12 hours. But the law prevents you from doing so, and me from taking advantage of your willingness to do so. The reason, presumably, has to do with levelling of the bargaining field and preventing lack of coordination among the powerless to be exploited by the powerful. Needless to say, there is considerable variation across societies on the precise rules that are applied.

Most forms of international trade do not directly impinge on the social bargains reflected in such rules. But some do. Suppose I outsource some of my domestic production to a Bangladeshi subcontractor whose factory is a fire hazard. Is this any different from my importing Bangladeshi workers and putting them to work directly at home under hazardous conditions? From an economic standpoint, the answer is no. From an ethical standpoint, we may split some hairs, but the answer is also no to a first order of approximation. Why should trade allow me to do something that domestic regulations explicitly forbid?

The point is that international trade occasionally serves to undermine long-standing social bargains reflected in domestic regulations. While we cannot immediately jump from this to the conclusion that such trade ought to be restricted, it would be equally wrong to assume that free trade should always be the norm.

Maximum globalisation would get us to one particular point on the global efficiency frontier. The trouble is that other societies may prefer different efficient points. Moreover, societies have other goals besides efficiency that may well require that they select a point *inside* the efficiency frontier. Ultimately, markets need to be embedded in institutions of collective deliberation and social choice for making such tradeoffs. For good or ill, democracy is the only institution that we have for this. Weakening democracy in the quest for deeper globalisation is one of the worst bargains we could strike.

Economists know that life is full of tradeoffs and that extreme outcomes – “corner solutions” – are rarely optimal. The same goes for globalisation too. The paradox of globalisation is that pushing it too far undermines its own institutional foundations.

Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.

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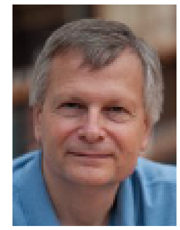

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