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Governance and Economic Globalization: Continuities and Discontinuities

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Mr. Chairperson, distinguished delegates, ladies and gentlemen. It is a privilege and a great honor to have the opportunity to share my thoughts with the United Nations General Assembly on the challenges posed by economic globalization to national governance. I will briefly cover several points and then expand on them during the last one hour allocated for questions and answers.

Without much ado, let me start with two definitions: the first concerning globalization, and the second, governance. Harold Laski, the famous British philosopher, had once said that socialism is a hat that has lost its shape because everybody seems to be wearing it. I think the phrase globalization falls in the same category. There is much confusion on what exactly globalization is, how to measure it, who caused it, and how it may impact human existence. I propose the following definition of economic globalization: it is a set of processes leading to cross-border integration of factor, intermediate products, and final products markets along with an increasing salience of multinational corporations in economic activity. Three aspects of this definition are noteworthy. First, globalization is best viewed as a set of processes and not as an end state. Second, cross-border economic integration now spans products and commodities that are at various stages of- the value-addition processes. Third, multinational corporations are the main agents of economic integration. In fact, I would submit that the main difference between globalization now and the previous phases of economic integration is the increasing role of multinational corporations.

This leads to the question of how important multinational corporations are in the contemporary economy. Consider the following data:

- Foreign direct investment has surged from $1 trillion in 1987 to $3.5 trillion in 1997.
- Multinationals now directly shape the volume, the direction, and the characteristics of a large proportion of cross-border trade. They derive power from the fact that intra-company trade ~ that is, trade among the various units of these corporations — now exceeds trade with non-company actors, the so-called arm's-length trade.
- At an aggregate level, value chains of multinationals account for about 7 percent of the world's gross domestic product and one-third of world exports.

Clearly, in the last two decades, multinational corporations have come to play an increasingly important role in the global economy. However, the munificence of foreign

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investors is not widely diffused — foreign direct investment flows are concentrated in the so-called triad consisting of North America, Western Europe, and East Asia. Hence, the levels of globalization are uneven both within and across countries. This implies that governance structures useful for highly globalized economies may not be so-useful for the ones that are less globalized.

The second definition I wish to propose concerns the notion of governance. Scholars such as Elinor Ostrom and Douglass North have pointed out that governance should not be equated with government. Governance is simply organizing collective action and entails establishing institutions. Institutions can be viewed as the rules of the game that permit, prescribe, or prohibit certain actions. By altering incentives, institutions facilitate collective action, enabling actors to pursue their individual and communal goals. In contrast to institutions, organizations are physical actors having budgets, headcounts, and resources. To illustrate, the United Nations is an organization while its rules and policies are institutions. So, the relevant question that policy makers need to ask is: how does economic globalization impact various units of governance? For example, how would it impact market governance and systems of industrial organization and what policies can be put in place to increase their capacities to cope with the demands of a globalizing economy.

Having defined globalization and governance, in the remaining time, I will elaborate on the following four themes:

* First, though globalization is redefining the notion of a territorial state, governments retain capacities and incentives to intervene in market processes.

* Second, how governments choose to intervene should be a function of the particular systems of governance institutions that define the relationship among states, societies, and businesses. The one-size-fits-all type of policies will not work. Instead of blindly following the "Washington consensus," policies will need to be developed in specific countries. Also, indulging in the so-called "races to the bottom" by adopting lax environmental and labor standards is not an effective way for governments to attract foreign direct investment.

* Third, as Dani Rodrik has argued, strengthening domestic institutional capacities that afford "voice" to various actors, and therefore increasing the legitimacy of the system, is the key to economic growth. Debates on crony-capitalism and campaign finance reform suggest that many people believe that the economic system favors the rich and the powerful. Thus, new governance structures must ensure that equity concerns are not overlooked.

* Finally, globalization of economics calls for globalization of politics and for multiple supra-national governance structures. These could be provided at multiple levels such as global, regional, and bilateral. What is important is that we do not get fixated at one given level.

Let me start with the first theme. Cross-border economic linkages have existed since time immemorial and so have the debates on their impact on governance. Even Adam Smith, David Hume, and Charles Montesquieu were concerned that capital mobility would restrain governments. As a matter of fact, Adam Smith made a specific mention of this issue in the *Wealth of Nations.*

Based on trade and capital flows, the world economy was perhaps more integrated on the eve of World War I than it is today. In his famous book, *The Great Illusion* that was published in 1910, Norman Angell predicted an end of warfare, especially between the highly integrated economies of Britain and Germany. This book's popularity was unprecedented. It sold more than a million copies, quite an achievement in the days when discount booksellers such as "amazon.com" did not exist. Angell was knighted, even awarded the Nobel Peace Prize. As luck would have it, World War I broke out as Angell's message appeared to gather steam. There are similarities between Angell's predictions and the New World Order notion that was invoked to describe the post-cold war period where economic interests would triumph over ideology and politics. The message therefore is: politics matters and one should not assume that the logic of the market will prevail in all settings.

In the post-world-war two era, regional integration and interdependence debates also examined how economic integration might constrain national governments. Stanley Hoffmann framed the issue as whether governments are "obstinate or obsolete." I am not arguing that the current phase of cross-border integration is nothing new and should therefore be ignored. As noted earlier, the key difference is the role of the multinational corporation in resource allocation. The point I am trying to make is that policymakers should not exaggerate the challenges posed by globalization and over-react to them.

The increasing power of multinational corporations clearly poses new challenges. Governments need to come up with "sensible" policies to attract multinationals. There is a misunderstanding that multinational corporations are abetting races-to-the-bottom and therefore leading to competitive lowering of environmental and labor standards. This is not supported by empirical analysis. For reference, if about two-thirds of foreign direct investment flows within developed countries with comparable environmental and labor laws, then how can developing countries be accused of enticing multinationals with lax regulations. Further, most multinational corporations focus on knowledge-intensive areas that often have low-pollution intensities ~ this is where their comparative advantage lies.

Further, the labor and environmental records of multinationals are now closely scrutinized by citizen groups. The recent experience of the apparel industry indicates that bad publicity about environmental and labor policies can impose significant economic costs on these firms. The implication then is that governments should not take the easy way out by lowering standards to attract multinationals. They need to create infrastructures ~ institutional, physical, and human — that would allow knowledge-intensive firms to leverage their competencies. As I will elaborate in a few minutes, this infrastructure can only be created and sustained in cooperation with non-governmental actors.

It is also important to keep in mind that multinational corporations continue to be associated with specific countries in terms of locating their critical functions. The "stateless" corporation has yet to arrive. Thus, national governments continue to play important roles in championing the interests of domestic firms. Huge trade delegations often accompany politicians. As we have seen during the negotiations over the Multilateral Agreement on Investment, intellectual property rights, and the Kyoto protocol, national governments remain active champions of the commercial interests of home-based firms. It is also clear that human-rights groups, labor groups, and environmental groups are able to have greater impacts on multinationals that are headquartered at home. The implication is clear — multinationals fly the flags of identifiable countries. This means that if national economic institutions are to be designed to serve the interests of multinationals, then countries can potentially barter away their economic sovereignty. Whether the economic benefits of foreign direct investment outweigh the political costs, is an issue that needs to decided by domestic political processes. I am not making an argument against attracting the flows of foreign direct investments. I think multinationals make significant contributions that are often under-appreciated. My point is that societies need to decide what kinds of investment flows are the most appropriate for them and what kinds of political and economic costs should they impose on citizens. After all, this is the essence of democracy.

My suggestion perhaps goes contrary to what the media hype about the inevitability of globalization and the prescriptions of key multilateral organizations regarding the virtues of foreign direct investment. In my opinion, the recent East Asia crises suggests that international institutions and media are fickle friends. When the going was good, there was endless praise about the East Asian miracle. With the onset of the crisis in 1997, suddenly, there was a realization about structural weaknesses, corruption, and the existence of crony-capitalism. In my mind, the message is clear: countries should develop economic policies to suit their needs and not rely exclusively on models developed elsewhere. Especially because the prescriptions of international organizations are not always consistent. Whether or not to attract foreign direct investment and of what kind, should be decided within the domestic political framework. Of course, countries will learn from each other and adopt best practices. Trade and investment flows could also lead to the diffusion of the best models. As long as this is voluntary and does not undermine the democratic process, it should be encouraged. What has been bothersome and continues to be so, is the insistence that there is one correct model of economic governance — either Marxist or the Anglo-Saxon — and that every jurisdiction should adopt it.

Let me now turn to the next issue. I believe that increasing levels of globalization require an active role of the government in economic activity. For one, governments are the primary creators and the guarantors of property rights and therefore play important roles in the functioning of market systems. The Internet revolution and the advances in biotechnology necessitate new rules, new technological standards, and new legal doctrines. All these require leadership by governmental organizations. Arguably, there is an "expertise deficit" within governments and private actors are better equipped to provide such collective goods. However, we must bear in mind that private *legal* regimes operate under the shadow of public law and need legitimacy from governments.

Another issue necessitating government's critical role concerns antitrust and competition policies. Globalization processes have accelerated due to the high costs of research and development coupled with shorter product life cycles. These imply that the minimum efficient scale to amortize large research investments is greater than what any single national or regional market can offer. This partially explains the recent wave in cross-border mergers and acquisitions in sectors such as banking, insurance, chemicals, pharmaceuticals, telecommunications, and recently in commodity metals. Mergers and acquisitions have reduced the number of global players and increased the levels of industry concentration. This has implications for antitrust and competition policies. As David Vogel has argued, the styles of regulations would differ across countries due to institutional imperatives. The crucial challenge is to harmonize domestic needs with economic imperatives. Deregulation and reregulation will have to go hand-in-hand. I do not agree that bigger is always better and that monopolies always arise because of governmental interventions. As the recent lawsuit against Microsoft suggests, anti-trust issues in emerging industries are complex and there is disagreement even among firms on the abilities of markets to regulate themselves. Further, as the data suggests, about 90 percent of antitrust suits are filed by private parties. Thus, there are many reasons to believe that governments will continue to play important roles in ensuring that market processes are not manipulated and continue to serve the broad societal agenda.

Let me now turn to the issue of territoriality and national governance. The Treaty of Westphalia in 1648 laid the foundation of the modern state system. The defining characteristic of this system was the notion of territoriality on which the sovereignty of governments was predicated. Governments were viewed as the main sources for the supply of public goods. Of course, to supply such goods, governments need to raise revenue, primarily through taxes. Some believe that globalization is undermining the governments' abilities to raise taxes in two ways. First, as pointed out earlier, governments are forced to lower taxes to attract and to retain businesses. Second, economic geography may not overlap with political jurisdictions. Consider the case of an individual located in Ljubljana who purchases a book from amazon.com. Assume that the server is located in England, the order is processed in the state of Washington, while the warehouse from which the book is shipped is located in New Jersey. The issue arises as to which jurisdiction has the power to levy a sales tax. As of now, Internet-based trade is exempt from sales tax. However, as the volume of Internet-based trade increases, this will pose a significant challenge to the fiscal well being of various jurisdictions. Of course, one could argue that governments can always shift from indirect taxes to direct taxes — although cyber space is without a nationality, the individuals can invariably be associated with specific jurisdictions. However, as indicated earlier, governments are under tremendous pressure to reduce direct taxes, let alone raise them.

Thus, many developments lead us to believe that the fiscal base of the state is eroding. The issue then is: what should governments do? A favorite remedy is to cut welfare payments. There may be many justifiable reasons for doing so, but the political implications are not adequately appreciated. Let me briefly elaborate on some of these.

Free trade and investment creates "losers" as well as "winners" within and across countries. The Congressional Budget Office's data suggests that in 1997 the richest 1 percent of Americans — 2.7 million in all — received aftertax income comparable to the bottom 100 million. Similarly, the recent Human Development Report suggests, the world's richest 20 percent account for 86 percent of world GDP, 82 percent of exports, 68 percent of FDI, and 93 percent of Internet users. Widening income and wealth disparities are a cause for concern, if nothing else than for their impact on social stability.

The losses from free trade and investment are typically concentrated and occur in the short-run while the gains are diffused and occur in the long-run. Not surprisingly, many citizens are suspicious of free trade. Even in the United States, which is currently at the crest of an economic boom and unemployment is at an all time low, a recent *Wall Street Journal* poll suggests that 58 percent of Americans oppose free trade. Economic and cultural nationalism is on the rise in every part of the world and this should be a cause of concern for policy makers in their thinking of new governance structures.

John Ruggie has pointed out that the post-World-War II economic system based on free trade was predicated on the "embedded-liberalism" compact, whereby governments provided social insurance to people hurt by free trade. I submit that such embedded liberalism is even more important with globalization. Governance institutions must provide for social insurance that empowers all sections of society, not merely the Internet elites, to reap benefits from free trade and investment. However, I must add that such institutions should not convert the provision for social insurance into a blank check, thereby creating moral hazard problems. New governance institutions need to focus on policies that provide skills not doles. Merely reinventing the same structure will not work. Experimenting with new ways to provide social insurance and other collective goods will require active collaboration among governments, private actors, and non-profits. To do this effectively, we will need to outgrow old debates about the relative costs of market failures and government failures. In this regard, Anthony Giddens' notion of a "social investment state" is worthy of examination. In addition to investing in human capital, health, and education, Giddens believes that governments need to provide insurance for entrepreneurs. I will add to Giddens suggestion by including the critical role of non-governmental actors as well in the provision of social insurance. The system should create multiple Bill Gates across countries. Again, as indicated earlier, there is no blueprint on how this is to be done. In some countries, governments could directly fund venture capitals while in others they could create an institutional environment where such funds are created by private actors.

It is also necessary that, for articulating this new vision of economic governance, state bureaucracies have the incentives and the abilities to regenerate themselves. Institutional environments must empower them to overcome the opposition from social actors interested in preserving the status quo. Further, they must have the incentives to actively involve nonstate actors in institutional design and implementation. As scholars at Indiana University, Bloomington have documented, governments can develop capacities to produce collective goods with their citizens. After World-War II, states took upon themselves more functions and responsibilities than they could handle. No wonder, states now face "capacity gaps." Such gaps cannot be bridged by expanding the state.across sectors. Governments need to retreat in some areas, and assert themselves in others where their competencies lie. Further, as I suggested before, we need to go beyond the mind-set of equating governance with governments and look for new ways to create and to tap synergies between private actors, nongovernmental organizations, and governments. The critical role of political leadership is important here. Politicians are invariably criticized and condemned, and perhaps justifiably so. However, some politicians also have the ability to understand the imperatives of the new economy, and at the same time translate this vision into a language that is appreciated by the masses.

Let me now turn to the implications of globalization for supranational governance. By its very nature, globalization implies that scale economies can only be tapped at a supra-national level. This suggests that institutional frameworks governing economic activity should also have a supranational character. Further, there are also many trans-boundary externalities, especially the environmental ones, that require supra-national efforts.

As I indicated earlier, governance is a collective good. Two issues arise in its provision. First, at which levels should such collective goods be provided — bilateral, regional, or global. Further, should these goods be provided through multilateral, minilateral, or bilateral negotiations. Second, how are the existing international organizations positioned to provide and to enforce the new rules of supra-national governance.

I submit that globalization will call for the provision of collective goods at multiple levels. The logic is that the level of aggregation for governance institutions should correspond to the efficient level of economic activity. There would also be multiple negotiation routes to provide these collective goods — multilateralism would flourish along with minilateralism and bilateralism. What is important is that if countries prefer bilateral or minilateral routes, there should be for a where discussions about providing national treatment to or harmonization of disparate rules are possible with an objective to decrease the transaction costs of dealing with different sets of rules.

Most existing multilateral institutions suffer from two major problems. First, there is a the lack of accountability -- the so-called a "democratic deficit." Second, there are multiple veto points that makes them less effective in policy realms. In light of these criticism, the existing institutions can be modified. Their functioning needs to be made transparent and accountable. For example, it is important that the World Bank and the IMF clearly explain why they have drastically revised their assessments of the viability of the East Asian model. Who is responsible for these incorrect assessments and what steps are being taken to ensure that after a few years these organizations do not disown what they are recommending now.

Multilateral institutions also suffer from multi-veto points. Consequently, many have become debating clubs. If these institutions wish to remain key players in a globalizing economy, they will need to adopt different mindsets. Specifically, they must begin to perceive themselves as being in the solution business and providing realistic ideas and road maps on how supra-national problems need to be addressed. An excessive reliance on discredited models or an over-enthusiastic embrace of untested ones could undermine their credibility.

I also believe that we need a new architecture of finance. The East Asian crisis tells us about the fickle nature of short-term capital and the enormous power exercised by the credit rating agencies. As I have argued elsewhere, if firms can be sued for defective products, should not credit rating agencies be held responsible for defective ratings? I also believe that hedge funds need to be regulated. It is surprising that such funds are allowed to operate without much regulatory oversight. As the recent collapse of the Long Term Capital Management suggests, there are enormous moral hazard problems associated with the functioning of such highly leveraged but scantily regulated organizations.

I believe my time is up, so let me conclude. First, governance should not be equated with government. Second, global economic integration is not new. What is different is the role of multinational corporations. These corporations continue to be associated with specific countries. Third, models of national economic governance need to be predominantly developed from within and not exclusively imported from the outside. Fourth, governments and non-governmental actors together need to establish institutions for social insurance. Otherwise, there will be significant opposition to free trade and investment, and result in a protectionist backlash. Finally, the new global economy will require supra-national institutions at multiple levels of aggregation. Existing international organizations can supply these institutions only if they become more transparent and accountable, and adopt a mind-set of providing solutions and not merely describing problems.

Thank you so much for patiently listening to me. I will be delighted to respond to your comments during questions and answers.

Thank you.

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