

# DOES GLOBALIZATION REQUIRE GLOBAL GOVERNMENT?\*

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## *Abstract*

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## I. INTRODUCTION

International trade lies at the heart of globalization. For this reason the topic has captured the attention of some economics' best thinkers. In his recent book, *Globalization and its Discontents* (2002), Joseph Stiglitz takes up this issue and the question of who is to govern expanding world markets. Stiglitz suggests that global government is the most appropriate means to achieve this end. As he puts it, "Unfortunately, we have no world government, accountable to the people of every country, to oversee the globalization process . . ." (2002, pp. 21). Presumably, one major benefit of such a system would be in creating a formal supranational authority for the enforcement of international commercial contracts. As it stands, no such authority exists. In fact, there is not even a universal, formal international commercial law on the basis of which such an authority could adjudicate private international trade disputes if it did.

In this environment it would seem that international traders have little incentive to enter into contractual agreements with one another. The absence of an agency charged with the duty of enforcing such agreements creates a situation of great uncertainty and high transactions costs when dealing with unknown foreign trade partners. For this reason, among others, Stiglitz is not alone in calling for a system that would introduce formal contract enforcement at the international level (see for instance, Soros 2000). What are we to make of this claim? Does globalization require global government?

This paper offers a preliminary investigation into these questions. I use simple cost-benefit analysis to provide some basic insight into the desirability of global government as a means of enhancing global trade. Since data is sparse and assessments of global government's efficiency are necessarily speculative at this stage, my analysis is

unavoidably broad and its conclusions remain tentative. Still, the application of elementary economic logic here provides a useful framework for thinking about the question of global governance and constitutes an important first step in the direction of more definitive evaluations of its economic desirability.

Sections II and III theoretically examine the expected costs and benefits of a world state. In the context of this framework, Section IV considers trade under “international anarchy.” I use recent data from private international arbitration associations that govern international trade under the modern *lex mercatoria* to empirically assess the expected benefits of a world encompassing state. Section V offers some concluding remarks on the efficiency of world government seen from a cost-benefit perspective.

## II. THE EXPECTED COST OF A WORLD STATE

The cost of having any government can be broken into three primary categories. First there is a simple organizational cost of creating a state—the cost of organizing collective action. Concretely, the organizational costs of government include, (a) the decision-making costs of arriving at the specific set of rules the state is to enforce<sup>1</sup> and (b) the external costs of collective decision-making, which result from the fact that the group may sometimes makes choices that are contrary to the interests of the individual. The organizational cost of government thus depends upon, in addition to other possible factors, the form of government or decision-making process that is followed in determining what set of rules the state is to enforce.

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<sup>1</sup> Following Buchanan and Tullock (1962), when I refer to decision-making costs, I am referring to the costs of coming to agreement where more than one individual is required to make a decision.

Because democratic governments require the consensus of multiple citizens rather than the will of one individual, the decision-making cost of democracy is higher than that of an authoritarian arrangement. Clearly, how much higher this cost is depends upon how difficult it is to create laws under democracy. Thus, a democratic government that requires potential rules to receive a supermajority of its citizens' approval before becoming effective, for example, will have a higher decision-making cost than one that requires only majority approval. Because democratic government is based on popular consensus, its decision-making cost is also higher where the population is larger and where the members of this population are socially distant and thus less likely to agree.

Authoritarian government avoids these cost-raising factors because it circumvents the need to receive popular support for the rules it establishes. The external cost of government, however, will be lower under arrangements that require the approval of a larger number of individuals in the collective decision-making process. Thus, democratic regimes will have lower external costs than authoritarian ones, and within democratic regimes, those that require supermajorities to make rules, for instance, will have lower external costs than those that only require a simple majority for such rules.

The second cost of government is the cost of enforcing decided upon rules. These costs are expenditures associated with creating and maintaining police and military forces, and a court system. Enforcement costs are increasing in population size, as it is more expensive to police 1000 people, for instance, than it is to police ten.

The third cost of government includes what I will call the "public choice costs" of having a state.<sup>2</sup> These costs are those associated with the predatory activities of self-

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<sup>2</sup> For an excellent discussion of the public choice costs of government in its capacity as the definer of property rights, see Anderson and McChesney (2003).

interested political rulers and will be affected by the form of government that is selected. In authoritarian regimes, for instance, they would include the expropriative activities of the government, and in democratic ones, they would include the rent-seeking and deadweight losses created by political activities directed at catering to special interest groups.<sup>3</sup>

Within each of these broad forms of government, public choice costs will of course vary depending upon the particular system involved. For example, a democratic government that adopts a constitution may reduce its public choice costs by binding the hands of political agents in their attempts to cater to special interests (Buchanan and Congleton 1998). Similarly, a democratic government that utilizes bicameralism may reduce its public choice costs as well through making it more difficult (i.e., more costly) for private agents to effectively rent-seek.

While these variations may mitigate some of the public choice costs of democratic government, they are unable to reduce these costs to zero. For instance, despite the presence of constitutions in many democracies, especially in transitioning economies, we know that rent-seeking activities remain rampant. In some instances, variations that reduce the public choice costs of democratic government may even raise the other costs associated with having a state. For example, while bicameralism may reduce the public choice costs of democratic government, it raises the organizational cost of government by making it more costly to enact rules.

These three factors together determine the cost of the state. The proponents of global government tend to place great value on the democratic decision-making process

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<sup>3</sup> This is not to suggest, however, that democratic regimes cannot or do not engage in expropriative activities. It is only meant to highlight what seem to be the more dominant costs of having government under these two alternative organizations.

and so call for the democratic rather than authoritarian variety (see for instance, Stiglitz 2002; Soros 2000). Thus, in what follows I restrict my comments to the expected costs of a world government that is democratically organized.

In light of the factors enumerated above, what can be said about the expected cost of a global state? Without getting too specific, the following general items seem fairly clear:

(1) Because we are dealing with nearly 6.5 billion people, the expected decision-making costs of one world government are enormous. At the voter level, consider the massive amount of resources that would be necessary to organize a majority coalition for the purpose of electing representatives (assuming we are dealing with a representative democracy). The same could be said of the amount of resources required for decision-making processes at the representative level. The considerable increase in legislators needed to represent each of the relevant political districts in the world (from national downward) would mean a substantial increase in the costs of securing agreement among representatives. Furthermore, by making government world encompassing, a more ethnically, religiously, socially, and economically diverse group of individuals on both the voter and representative levels are necessarily included in the political decision-making process. In many cases, this diversity would be dramatic. Such increased social distance between political decision makers would further contribute to extremely high decision-making costs, as the cost of coming to agreement when individuals have very different beliefs, values, and backgrounds is very large.

(2) For the same considerations of population size, the enforcement costs of world government are likely to be exorbitantly expensive. Consider, for instance, the costs of a

world police strong enough to effectively police the globe. At the size necessary to effectively govern the entire world, any economies of scale in having centralized police and courts that normally exist on the national level are overwhelmed by the diseconomies of an encompassing world state.

Like all non-market entities, government also lacks a profit and loss mechanism to govern the allocation of resources internally. The resulting inefficiencies are tolerable when governments operate at the national level. Overall it may be cheaper to organize activities internally than to use the market for this purpose. As government grows beyond its optimal size, however, the weight of increasing inefficiencies that stem from organizing activities this way overcome its benefits. In other words, just as such diseconomies limit the optimal size of firms, so too do they limit the optimal size of governments.

(3) The public choice costs of a government large enough to effectively govern the globe are also likely to be tremendous. When the size and scope of government grows, as would be necessary to oversee the world, so too do the benefits from rent-seeking and the opportunities for self-serving behavior by political agents at the public's expense. Consider for a moment the size of the bureaucracy and the tremendous source of public choice problems this would present for a global state. Or imagine the amount of resources the members of an industry would expend to obtain global monopoly privilege for the production of their product—resources that from society's perspective represent sheer waste.

Similarly, the size of such a world encompassing state would leave most voters so far removed from their public representatives (at least at the highest level) that voters

would be unable to effectively monitor the behavior of these representatives. This would (a) decrease voters' ability to hold unscrupulous politicians unaccountable, and (b) encourage political agents who are aware of this to engage in additional unscrupulous behavior. In this way, the public choice costs of government would increase even further.

Thus, while I cannot say definitively that one world government's cost would be prohibitive, it is reasonable to conclude, at the very least, that it would be *extremely* expensive to create and maintain such a state. The relevant issue for determining global government's efficiency, however, is its cost relative to the benefits it would provide. I now turn my attention to a discussion of these benefits.

### III. THE EXPECTED BENEFIT OF A WORLD STATE

The presence of government on any scale is typically justified by reference to the fact that a formal legal system (i.e., laws, courts, etc.) is uniquely capable of enabling a large number of diverse individuals to realize the gains from widespread exchange. As previous work has shown, in the context of small homogenous groups, private, informal institutional arrangements enable people to realize the benefits of trade by supporting self-enforcing exchange and preventing potential conflict (see for instance, Greif 1993; Ellickson 1991; Clay 1997; Landa 1994; Milgrom et al 1990; Greif et al 1994). These arrangements, such as the use of multilateral punishment among small groups via ostracism, boycott, or the emergence of conflict inhibiting social norms, operate primarily through mechanisms of reputation.

For the most part, however, reputation mechanisms successfully secure exchange without formal enforcement only among small, close-knit communities. Their ability to enable agents to realize the gains from trade, it is argued, is therefore severely limited (see for instance, Dixit 2003; Greif 1993, 2002; Zerbe and Anderson 2001). By introducing formal enforcement then, it is usually reasoned, individuals will be secure in engaging in trade with agents outside their social networks. In this way, formal enforcement promotes cooperation and leads to increasing social wealth.

As I noted previously, the world currently operates in the context of what might be called “international anarchy.” There presently exists no public supranational institution of contract enforcement for commercial transactions between members of different countries.<sup>4</sup> In principle, if parties from different nations have a contractual dispute, they may use the state court of one or the other to settle the disagreement. However, there are several problems with this solution.

First, how are agents to decide whose state court will be used? Different national legal systems will arrive at different conclusions regarding disputes. Parties to these disputes therefore have an interest in determining which state’s court will be used. In particular, each is likely to prefer that the dispute be settled in his nation’s court and very much desire to avoid winding up in the state court of the other party. Foreign courts mean foreign, unknown procedure, laws, language, and contractual interpretation. Thus, there is a significant “home court” advantage to having the matter resolved through one’s own national court. There is also some evidence that state courts tend to favor the home

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<sup>4</sup> The European Court of Justice is intended to resolve disputes between member states of the European community regarding matters of “European community law.” The International Criminal Court applies to private individuals, but only for criminal matters, not commercial ones. The International Court of Justice is for resolving disputes between governments, not private individuals.

party in such disputes, creating an even larger incentive to avoid an outsider's court system (see for instance, Finger 1992). Second, when it comes to international trade, it is very difficult, if not impossible in some cases, to effectively enforce a foreign court's decision. Why? The assets of the violating party are often located in a different country, making them costly and difficult to extract. For these reasons, public courts do not for the most part form an effective means of settling disputes that emerge in the process of international exchange.

The primary economic benefit of a global state would thus be its ability to enable a large number of socially disparate individuals to realize the widespread gains from exchange by providing an overarching, supranational system of formal adjudication and contract enforcement. The presence of such an institution would reduce the uncertainty of interacting for the purposes of trade, increasing international exchange and along with it social wealth. Just as the benefit of government at the national level has traditionally been construed in terms of government's ability to enable agents within its domain to capture additional benefits from trade, so too would the benefit of a world state be found in this capacity.

However, what if the international arena had *informal* institutional arrangements that enabled large numbers of socially heterogeneous agents to realize the gains from widespread exchange? In this event, the expected benefit of introducing world government would diminish considerably, if not entirely. Conventional wisdom suggests that such arrangements will operate successfully only among small, homogenous groups. Is there any reason to think that such institutions function smoothly, or even exist, on the international level?

#### IV. TRADE UNDER INTERNATIONAL ANARCHY

Historical and contemporary evidence suggests there is. Modern-day international trade is based largely on the set of informal institutions that governed such exchange when it first emerged on a significant scale in 12<sup>th</sup> century Medieval Europe. This set of informal institutions is called the *lex mercatoria*, or law merchant.

The law merchant is a complex polycentric system of customary law that arose from the desire of traders in the late 11<sup>th</sup> century to engage in cross-cultural exchange. In the absence of formal enforcement this custom-based system relied on private arbitration for resolving disputes.<sup>5</sup> Between the early 12<sup>th</sup> and late 16<sup>th</sup> centuries, virtually all European trade operated this way with great success.<sup>6</sup> This system enabled large numbers of merchants to expand trade significantly and realize substantial additional gains from international exchange.

Contemporary international trade continues to make wide use of private arbitration as a means of settling disputes. In the early 1990s, at least 90 percent of all international trade contracts contained arbitration clauses (Volckart and Mangles 1999). Indeed, private international arbitration is unquestionably the foremost method of dealing with disagreements arising in the course of international commerce (see for instance, Casella 1996). In addition to *ad hoc* international arbitration, well over 100 international arbitration institutions located throughout the world perform this function. Among the most notable of these include the International Chamber of Commerce (ICC), the London Court of International Arbitration (LCIA), the American Arbitration Association's

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<sup>5</sup> For a superb account of the medieval law merchant, see Benson (1989). Volckart and Mangles (1999) also provide an excellent account.

<sup>6</sup> As Benson notes, "In fact, the commercial revolution of the eleventh through fifteenth centuries that ultimately led to the Renaissance and industrial revolution could not have occurred without . . . this system" (1990, pp. 31).

International Center for Dispute Resolution (ICDR), and the Arbitration Institute of the Stockholm Chamber of Commerce. In 2001 nearly 1,500 parties from over 115 nations across the globe utilized the services of the ICC alone (ICC Bulletin 2001). The amounts in dispute varied from \$50,000 to more than \$1 billion, with over 60 percent of all disputes involving sums of money between \$1 million and \$1 billion (ICC Bulletin 2002). Similarly, the ICDR arbitrated a caseload in 2001 worth more than \$10 billion involving parties from 63 countries across the globe (ICDR 2002).

These arbitration associations rely heavily upon evolved customary law that dictates how exchange disagreements are to be settled and awards established. These “arbitral awards are most generally promptly and willingly executed by business people” (David 1985, p. 357).<sup>7</sup> Indeed, virtually “[e]very research into the practice of international arbitration shows that by far the great majority of arbitration awards is fulfilled without the need for enforcement” (Böckstiegal 1984, p. 49). In a study published in 1981, for instance, a survey of international oil traders indicated that over 88 percent of all contracts entered into were carried out without dispute. Of the remaining 12 percent, respondents indicated that 76 percent of disputes were arbitrated successfully by private adjudication (Trakman 1983, p. 53). Similarly, the world’s largest

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<sup>7</sup> Several multilateral treaties now enable international arbitral awards to be enforced in national courts. By far the most important of these is the United Nations New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. According to this treaty, signing nations agree to enforce international arbitration decisions rendered outside their territories in their national courts subject to reciprocity from other signing nations. Three items regarding this issue are important to note: (1) Prior to this Convention in 1958, no such mechanism for the enforcement of international arbitral awards in state courts was available. (2) Despite the Convention, there is no formal authority that can compel states to enforce such international arbitration rulings. (For various reasons not considered here, the United Nations International Court of Justice cannot be said to provide formal enforcement for this Convention). A state’s decision to do so is voluntary and can be revoked at any time without formal retribution. The only penalty is that other nations may refuse to award international arbitration settlements rendered in the “defecting” country in the future. That is, there is a tit-for-tat mechanism at work rather than a system of formal enforcement. (3) Almost no international arbitration decisions are ever challenged in state courts. For instance, only about 6 percent of ICC decisions have been challenged by the losing party (Mattli 2001, p. 937).

international arbitration association—the ICC—estimates that over 90 percent of all of its decisions are voluntarily carried out (Craig et al 2000).

Equally astounding is the law merchant’s ability to enable exchange among socially disparate people. Consider Table 1, which breaks down the regional origins of parties to arbitration through the ICC in 2000.

TABLE 1. HETEROGENEITY AND THE LAW MERCHANT: EVIDENCE FROM THE ICC

| Party Origin<br>(by region)        | Absolute % of Total Parties | Region GDP Adjusted %<br>of Total Parties |
|------------------------------------|-----------------------------|---|
| Africa                             | 6.4                         | 38  |
| North America                      | 14.5                        | 4   |
| Latin America and the<br>Caribbean | 8.7                         | 12  |
| Asia                               | 15.2                        | 6   |
| Australasia                        | 0.9                         | 12  |
| North and West Europe              | 46.8                        | 14  |
| Central and East Europe            | 7.5                         | 18  |

Notes: Absolute % of total parties based on data from the ICC Bulletin Vol.12/No.1-Spring 2001. Region GDP adjusted % of total parties calculated using 1999 GDP data of countries composing the relevant regions from World Development Indicators (2001).

As the “absolute percentage of total parties” column indicates, just below 40 percent of all ICC users in 2000 came from outside North America and North and Western Europe. The raw figures indicate a considerable degree of heterogeneity among

parties to international arbitration. However, these numbers tend to overstate the number of parties from North America and North and West Europe, which constitute fairly homogeneous interactions, and understate the number of parties from everywhere else, which constitute fairly heterogeneous interactions. The proportion of total arbitration parties originating from North America and North and West Europe is larger than it is elsewhere because the volume of exchange in these two regions is significantly larger than it is in the rest of the world.

To get a better picture of the diversity of ICC users then, we must adjust for the volume of exchange in their respective regions of the world. I use 1999 regional GDP in U.S. dollars calculated using World Bank data (World Development Indicators 2001) to proxy the volume of exchange. The GDP-adjusted percentages in column two better indicate the true composition of international arbitration parties. After adjusting, the percentage of parties from North America and North and Western Europe drops substantially to only 18 percent—about the same percentage of parties from the other regions of the world. One notable exception is Africa, a region well known for its extreme internal heterogeneity. After adjusting for volume of exchange, its proportion of total parties to international arbitration rises to 38 percent.

Evidence from another of the world's largest private international arbitration associations illustrates a similar pattern. Table 2 breaks down the origins of parties to arbitration through the London Court of International Arbitration (LCIA) in 2001, both in absolute and in region GDP-adjusted terms.

TABLE 2. HETEROGENEITY AND THE LAW MERCHANT: EVIDENCE FROM  
THE LCIA

| Party Origin<br>(by region)        | Absolute % of Total Parties | Region GDP Adjusted %<br>of Total Parties |
|------------------------------------|-----------------------------|---|
| Africa                             | 6                           | 16  |
| North America                      | 10                          | 1   |
| Latin America and the<br>Caribbean | 11                          | 7   |
| Asia                               | 11                          | 2   |
| Australasia                        | 11                          | 62  |
| North and West Europe              | 42                          | 6   |
| Central and East Europe            | 6                           | 6   |

Notes: Absolute % of total parties based on data from LCIA, “Director-General’s Review of 2002.” The figures in this column do not add to 100% because a 3% “other” category from the LCIA breakdown was excluded. Region GDP-adjusted % of total parties calculated using 1999 GDP data of countries composing the relevant regions from World Development Indicators (2001).

The presence of informal institutional arrangements in the international sphere, such as private arbitration and reliance upon customary law, enables a substantial amount of trade between international parties despite the absence of global government. Consider for a moment the staggering level of international trade. In 2003, world exports of merchandise and commercial services alone exceeded \$9.5 trillion (World Bank 2005). Apparently, the persistence anarchy in the international sphere has not done much violence to international trade. Indeed, since 1960, the real value of world merchandise

exports has grown nearly 13 fold (World Bank 2005).<sup>8</sup> Even more striking, this tremendous growth in international exchange occurred along with tremendous growth in worldwide diversity. For instance, since 1960, the number of member states in the UN has nearly doubled from 99 to 191 (United Nations 2002). The creation of these new states occurred as social groups decided that they were significantly different to warrant their own territories. Among members of the UN, “multiethnicity is the rule” (Williams 1994, p. 50) and today there are an estimated 1600 distinct cultural groups (Levinson 1991-1993) and over 600 languages worldwide (Grimes 1988). Thus, despite the growing heterogeneity of agents in the international sphere, interaction between these agents is flourishing.

The evidence just presented strongly suggests that the benefit of introducing world government—at least in terms of enabling large numbers of socially heterogeneous agents to realize the gains from exchange—would be minimal at best. International trade is thriving, and the informal institution of the law merchant seems to be doing an excellent job helping it do so. While the future will undoubtedly bring new challenges for agents operating under the auspices of the law merchant, we have every reason to believe that the flexible, spontaneous, and evolving organic body of custom and procedure that composes the law merchant will adapt to meet these challenges. This is, after all, what the long history of the *lex mercatoria* has borne witness to thus far.

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<sup>8</sup> This growth should not be attributed to the existence of inter-governmental organized regional trade zones such as NAFTA or the EU. Recent work by Rose and Engel (2002) finds no systematic effect of membership in such regional trade agreements on the pattern or volume of international trade. O’Loughlin and Anselin (1996) more strongly reject the idea that preferential trade regions have simply lead to more trade among closely geographically situated countries. They provide evidence that the trend in international trade is, if anything, moving in the direction of greater *extraregional* exchange.

## V. CONCLUDING REMARKS

I have only briefly considered the expected costs and benefits of introducing world government. My analysis necessarily left many important considerations to the sidelines. For instance, I examined only “economic” components in my discussion, leaving out significant political components. The desirability of world government from the perspective of international relations or “social justice,” for example, was excluded from my discussion.

Nevertheless, my analysis lays bare some fundamental issues surrounding the economic desirability of global government. What specifically does my cost-benefit analysis tell us? It tells us that for the reasons outlined above, world government is likely to be an inefficient political arrangement. The expected costs of such a state are prohibitively costly when considered in light of the minimal benefits a global state could provide in terms of increased exchange opportunities. Even if it is true that by establishing formal enforcement for exchanges on the international level world government could increase the amount of trade between socially heterogeneous agents, the evidence considered in Section III suggests that this increase would be very small indeed. Since, as Section II indicated, the cost of world government is likely to be massive, this small benefit is insufficient to justify its creation. In short, from a cost-benefit perspective, global government is inefficient. On these grounds at least, it seems that calls for a world state to oversee globalization are unjustified, or at a minimum premature. The increasing globalization of the economy is doing fine by itself.

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