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ECONOMIC, POLITICAL AND INSTITUTIONAL CHALLENGES

ECONOMIC INTEGRATION AND  
POLITICAL STRUCTURE

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*Preliminary and incomplete draft*

ECONOMIC INTEGRATION  
AND  
POLITICAL STRUCTURE

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## 1. INTRODUCTION

Globalization is changing economic borders rapidly.<sup>1</sup> Barriers to trade have become lower than ever, allowing the creation of many global goods and asset markets. As a result, the volumes of trade and cross-border financial flows have grown dramatically in the last decades, both among industrial countries and also between industrial countries and developing ones. Moreover, there are also signs that some factor markets are also acquiring somewhat of a global dimension. Advances in telecommunications technology and the standardization of software have allowed some industries to combine physical and human capital located in different regions of the world, thus creating a semi-global market for some specialized workers and types of capital. As a consequence of this increased integration in goods, assets and factor markets, shocks are now propagated across the world with a force and speed that were difficult to imagine only a few decades ago.

And yet globalization is changing political borders only slowly if at all. To be sure, globalization is creating some stress on the world's political structure. In particular, it appears to be fueling two trends that are perhaps more clearly seen in Europe than elsewhere, although there are some signs of them all over the world. On the one hand, there is a tendency to create large supranational entities that assemble various existing states. Naturally, the paradigmatic case example of this trend is the European Union. On the other hand, there is an ongoing process of political fragmentation within many existing states. Here the paradigmatic case, of course, is the re-emergence of intra-state nationalisms and separatist movements inside the borders of many European countries. Although seemingly at odds, both trends can be understood as a consequence of globalization and we shall explain this later. What is important to note now is that both trends are still in their infancy. Despite all the noise, the effective power still lies in the hands of the traditional states that were formed well before globalization was in sight.

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<sup>1</sup> Since globalization means different things to different people, we hasten to say that here we adopt a "technological" definition of globalization, i.e. a gradual reduction in the costs of trading goods and services across the world. Moreover, we also think of globalization as an "exogenous" event, i.e. we analyze its consequences rather than try to explain its causes. This view of globalization is narrow, but this is exactly what makes it useful for our purposes.

This paper weaves together some speculative thoughts on the consequences of this mismatch between economic and political borders created by globalization. In particular, we ask what are the problems that this mismatch creates and how should we (“the citizens of the world”) deal with them. Admittedly, our answers are incomplete as our arguments have some loose ends that we do not know how to tie. Despite this, we do not shy from reaching three robust conclusions that we think constitute a sound starting place for the study of the interactions between economic integration and political structure.

The first conclusion is that globalization is the source of new policy externalities that vitiate governments’ choice of economic policies. The different speeds with which economics and politics react to globalization produce a discrepancy between those jurisdictions that hold the power and those that could effectively use it in a globalized world. Since many markets are becoming truly global some of the effects of economic policies are being felt on the other side of political borders. But the current political structure gives governments the incentives to adopt a regional or local approach to economic policy. That is, the current political structure incentivates governments to disregard the costs and benefits of policies that fall on the other side of the border. These costs and benefits are therefore nothing but policy externalities that scramble the cost-benefit calculations behind policy choices. The result is, of course, a worsening in economic policies that could seriously mitigate the gains from globalization and even turn them into losses.

The second conclusion is that cooperation among existing states is only a partial and inefficient way of coping with these policy externalities. In the short run, globalization has arrived with a fixed (and inappropriate) political structure and the only option to counteract policy externalities is by building institutions that foster cooperation among states. These institutions include international treaties, multilateral organizations and ad-hoc agreements of many sorts. One can in fact think of these institutions as an attempt to create a global market for policies. Unfortunately, this market is not likely to work. This is true even if one is willing to downplay the enormous practical problems of implementing such a market. The reason is that it misses two key ingredients of well-functioning markets. The first one is price-taking behavior, as governments are large agents and are likely to behave strategically. The second ingredient is the existence of a global jurisdiction with the power and the

incentives to enforce the trades that these markets would generate, rendering governments unable to commit to honor the trades that are not self-enforcing. Strategic behavior and limited commitment dramatically limit the scope of a global market for policies and generate various additional sources of inefficiency. Even with the most optimistic expectations, one cannot escape the conclusion that cooperation among states is likely to be a partial and inefficient way to cope with policy externalities.

The third conclusion is that globalization requires a new political structure that redistributes power away from the current centralized jurisdictions or states and towards a new set of overlapping jurisdictions that are both smaller and larger than existing states. Governments provide public goods with different optimal jurisdictions. For instance, the optimal jurisdictions for the provision of education and justice should be geographical areas that share a common language and national identity while the optimal jurisdictions for the provision of monetary policy these should be geographical areas that share the same markets. If the borders of markets and nations do not differ much relative to the economies of scope associated with the provision of public goods, it might be cost-effective to have a system of centralized jurisdictions. But globalization has dramatically widened the gap between the borders of markets and nations. The former are much larger than the latter, and it is no longer efficient to have the world organized into states that are much smaller than markets and still contain more than one nation within them. This is why globalization has is creating forces towards political concentration and fragmentation simultaneously. In the long run, these forces will lead to a radical change in political structure that will allow the world to reap all of the gains from globalization.<sup>2</sup>

In the rest of this paper, we develop each of these three conclusions in more detail.

## 2. GLOBALIZATION CREATES EXTERNALITIES AND WORSENS POLICIES

If economic and political borders coincide, those who decide economic policies also face most or all of their consequences. That is, economic policies do not create externalities

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<sup>2</sup> The theory of optimal political structure that follows is an adaptation of Alesina and Spolaore (2003).

and this is a necessary condition for governments to choose efficient policies.<sup>3</sup> If there is a discrepancy between economic and political borders, economic policies create costs and benefits that are not taken into account by those that choose economic policies. In such an environment, inefficient policies are likely to be chosen.

The first thesis of this paper is that globalization, by creating a mismatch between economic and political borders, is the source of new policy externalities that worsen economic policies. We start by providing two illustrative examples of how this happens.

#### *The Terms-of-Trade Externality and the Size of Governments*

Many expected globalization to reduce the size of governments. This belief was based on the standard theory which tells us that the costs of taxing factors increase with their supply elasticity. In a world with local factor markets, these elasticities are low at least in the short run since changes in factor supplies mostly come from factor accumulation and this takes time. In a world with global factor markets, factor supply elasticities are high even in the short run since changes in factor supplies can be achieved not only through factor accumulation but also through international factors movements. Through this mechanism, taxation creates a positive policy externality since it induces factors to move abroad and this benefits the rest of the world. Based on this observation, many held the view that globalization would increase the domestic cost of taxation and reduce the size of governments below the optimum. That is, the fear was that globalization would lead to “too much” fiscal discipline.

The data has been unkind to this view, however. Cameron (1978) was the first to document that countries that trade more tend to have larger governments. The source of this correlation was unclear however. Cameron’s sample consisted only of eighteen OECD countries and it did not allow him to distinguish the hypothesis that globalization increases the size of governments from other reasonable alternatives. For instance, small economies

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<sup>3</sup> It is obviously not a sufficient condition, since there are other reasons why governments choose inefficient policies, such as lack of commitment or imperfect information.

also tend trade more and have larger governments as a share of income. Is it really trade that increased the size of governments? Or is it the size of the economy that determines both trade and the size of government? With Cameron's small sample, there was no hope of knowing this.

Rodrik (1998) was the first to push the interpretation that it is in fact trade that leads to larger governments. To do this, he used data for a cross-section of about a hundred countries. This sample size allowed him to control for size and many other to potential variables that could affect both trade and government size. He also made an effort to establish that causality goes from trade to government size by using an instrumental variable procedure. One could still argue that, by using a single cross-section, Rodrik analysis was mainly static and could not shed light on the effects of globalization. But Epifani and Gancia (2005) have now re-examined the evidence using a panel of about one hundred and fifty countries. Their work clearly documents that trade increases government size not only "between" countries, but also "within" countries.<sup>4</sup> Moreover, they also find that the relationship between trade and government size is growing stronger over time. The conclusion is clear: the data shows that globalization is leading to larger governments. Although the last word on this empirical relationship has not been written yet, there do not seem to be dissenting voices at this point.

The next step, of course, is to ask why trade leads to larger governments and whether this is an efficient outcome. Here we do find dissenting voices. All of them recognize that globalization has had small effects on factor mobility and this is the reason why arguments based on factor supply elasticities have proved beside the point. All of them also focus on goods trade as the culprit for the increase in government size. But these voices differ when it comes to explaining what is it about goods trade that raises the size of governments.

On one side of the debate, Rodrik has taken the view that globalization is worsening markets and the increase in government size is nothing but a desirable response to this

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<sup>4</sup> In the jargon of econometrics, the "between" finding is that, *when looking at sample averages*, those countries that trade more also tend to have larger governments. The "within" finding is that, *when looking at the average country in the sample*, those years where the country trades more it also tends to have a larger government.

problem. In particular, Rodrik's explanation has two parts. First, increased trade in goods has led to an increase in the risk faced by individuals. Mostly, this increased risk comes from exogenous terms-of-trade fluctuations. Second, asset markets do not work well and individuals cannot insure themselves against this risk. Under these circumstances, governments optimally react by increasing social insurance programs and also by directly substituting the market as producers of goods that are subject to less fluctuations. This is how globalization leads to larger governments.

On the other side of the debate, Epifani and Gancia take the opposite view that globalization worsens governments rather than markets, and the observed increase in government size is undesirable. Their argument also has two parts. First, government spending exhibits a substantial home bias and raises the demand for domestic relative to foreign products, leading to an improvement in the terms of trade. Second, domestic and foreign factors are imperfect substitutes and this improvement in the terms of trade raises domestic factor prices relative to foreign ones. Therefore government spending creates a negative externality as part of its cost is shifted abroad in the form of improved terms of trade. This terms-of-trade externality means that countries do not face all the costs of the size of their governments and this leads to sub-optimally large government sizes. It is straightforward to show theoretically that globalization might even lead to Pareto inferior outcomes as the negative effects on welfare of a deterioration in economic policy more than offsets the positive effects of increased trade. Whether this is also the case empirically needs to be determined yet.

The verdict is still open and, at the end of the day, both explanations might be part of the final story. But Epifani and Gancia have made one observation that strongly suggests that their explanation should be preferred to Rodrik's. In particular, they notice that there is a way to empirically distinguish both hypotheses. It follows from Rodrik's argument that the effects of trade on government size should be stronger in countries with a high elasticity of substitution between imports and exports since this tends to magnify the effects of exogenous terms-of-trade fluctuations. It follows instead from Epifani and Gancia's argument that the effects of trade on government size should be stronger in countries with a low elasticity of substitution between exports and imports since this tend to magnify the

effects of government size on the terms of trade. Epifani and Gancia then go to the data and show that the relationship between trade and government size is strong among the subset of countries where the elasticity is low, but weak or inexistent among the subset of countries where the elasticity is high. It seems therefore that globalization is increasing government size mostly in those countries that can shift a larger fraction of the cost of doing this abroad.

### *The Overborrowing Externality and the Workings of Financial Markets*

Many also expected globalization to improve the workings of financial markets. A first reason is that a reduction in trade costs allows individuals to pool consumption risks for a wider range of goods. This should make consumptions of different countries both more stable and more correlated as globalization proceeds. The former is a direct implication of the law of large numbers, while the latter follows from increased risk sharing. In addition, a reduction in trade costs should increase competition in financial markets leading to the creation of more stable sources of financing. Access to the world's top financial centers should increase financial market stability of financial for two reasons. The first one is based again on the law of large numbers. The larger is the market, the more risks that can be pooled and the lower should be the remaining aggregate risk. The second reason is based on the effects of international competition. Either domestic financial markets improve and stand up to foreign competition or their importance should declines as domestic savers and investors go abroad. In any case, we should expect improved access to foreign financial markets to bring more stability.

Once again, the data has not gone along with these expectations. The evidence is mounting that globalization has increased consumption volatility and reduced consumption correlations across countries (at least, relative to output correlations which is what the theory predicts). See, for instance, Prasad et al. (2003) and Kose et al. (2006). There are also widely held views, although no hard evidence, that consumption volatility has increased at the individual level. These beliefs are so ingrained in popular discourse that many observers

of the world economy take it as an evident fact that globalization has made the world riskier for all.

The notion that sources of financing would be more stable has also proved wrong. Financial markets in countries that have integrated into the world economy have been everything but stable during the last couple of decades. In East Asia, Latin America and elsewhere financial markets have become more vulnerable to shocks and have experienced a flurry of crises. This increased instability can be explained in part by a change in government behavior. Before globalization, governments made substantial efforts to ensure the stability of their financial markets. To be sure, governments have always defaulted on their own debts and this has always led to crises and problems. But at the same time governments also implemented tough (and poorly designed!) regulations limiting the risk that banks and other financial intermediaries could take on and also bailed them out when they were in distress. After globalization, this is no longer the case as governments have largely removed the old regulations restricting risk-taking behavior at the same time that they are letting banks and large firms default on their promises before bailing them out.

What has prompted this change in government behavior? One view is that heavy regulation and bailouts create inefficiencies that are no longer sustainable in an environment in which there is intense international competition among banks and other financial intermediaries. According to this view, globalization is simply raising competition and imposing financial discipline on governments. Financial crises are just an (unfortunate) sign that financial markets are working better and punish those who make bad investments. It is hard however to find any empirical support for this view in light of how inefficient and costly these crises have been for the countries that have experienced them. Moreover, it is hard to explain why improved financial markets would increase overall consumption volatility and reduce international risk sharing. It is no wonder then that this view has been abandoned even by those that believe that markets tend to work well most of the time.

Caballero and Krishnamurty (2001), Tirole (2003) and Broner and Ventura (2006) have argued in different ways that this pattern of instability might be the consequence of an overborrowing externality created by globalization. This externality leads governments to

choose financial regulation and/or a system of contract enforcement that makes the economies sub-optimally exposed to financial crises. This argument starts by noting that financial crises amount to domestic banks (and other intermediaries, of course) defaulting on their creditors, domestic and foreign. The result is a redistribution from these banks' creditors to their debtors, which are usually domestic firms. This redistribution entails costs of various sorts. It increases inequality as small domestic savers end up paying in part the costs of banks making bad loans to firms. Moreover, these crises are often protracted and the financial system is unable to provide additional credit during this period. The leads to a halt on investment and economic growth.

The probability of a financial crisis depends on financial regulations and government's enforcement of contracts. Governments can take actions that lower this probability, but usually this comes at a cost. After all, safety requires foregoing good but risky investment opportunities. The key observation is that globalization changes the mix of bank creditors. In particular, it increases the fraction of foreign to domestic creditors of the domestic financial sector. Governments naturally do not take into account the losses that crises create to foreign creditors. Therefore, globalization is shifting abroad part of the costs of financial crises, leading governments to choose "unsafe" financial regulations. As a result of this overborrowing externality, globalization has led to an increase in volatility and financial crises. Once again, it is easy to show theoretically that globalization might even lead to Pareto inferior outcomes as the negative effects on welfare of a deterioration in economic policy more than offsets the positive effects of increased trade. Once again, whether this is also the case empirically needs to be determined yet.

We have seen how globalization is a source of new policy externalities that lead to sub-optimal choices regarding the size of the government and the workings of financial markets. These are nothing but two illustrations of a general trend. There are many other areas of economic policy where globalization is creating new policy externalities, such as the conduct of monetary policy, the design of anti-trust legislation, the choice of labor market regulations and so on. We could easily expand the list of examples. But the point has already been made. The next question, of course, is how can we deal with these policy externalities.

### 3. A GLOBAL MARKET FOR POLICIES?

In the short run, the world's political structure is not going to change and any attempt to deal with policy externalities must be dealt with by the existing set of states. In the examples above we have implicitly assumed that governments act non-cooperatively and choose their economic policies taking those of other governments as given. Is it possible to eliminate the negative effects of policy externalities if existing states cooperate among them? How can we structure this cooperation to make it successful? In particular, what sort of institutions are needed?

The initial and instinctive reaction of any good economist when it faces a problem of externalities is an appeal to Coase's theorem. According to this theorem, externalities are only a sign that some markets are missing. If we want to eliminate their pernicious effects, we should create the appropriate markets and assign property rights over actions. In our case, we should create a global market for policies. In such a market governments would be able to buy each other's policies. Each government owns its economic policies. That is, the assignment of property rights is such that each government is free to adopt any economic policy it wishes. But then other governments would be able to go to the global market for policies and pay other governments to modify their policies so as to minimize negative policy externalities or maximize positive ones.

At first sight, the notion of a global market for policies might seem farfetched. On second thoughts, it should be obvious that a very limited and imperfect version of this market already exists and goes by the name of "cooperation among states". One can think of international treaties, multilateral organizations and ad-hoc agreements of many sorts as instances of trade in policies. The paramount example is the World Trade Organization (WTO) where governments "buy" tariff reductions from other governments and "pay" with tariff reductions of their own. The IMF can also be seen in this light as a forum in which the international community "buys" specific macroeconomic policies from governments in distress and "pays" them with cheap loans.

It is instructive to think how such a global market would work in the examples discussed above.

### *The Terms-of-Trade Externality*

The problem in this example is that the increase in government size shifts demand from foreign products to domestic ones and this raises domestic factor prices. The reason is that governments tend to have a strong home bias in consumption. The non-cooperative solution leads to all governments to choose too large a size. This is inefficient and governments are willing to reduce their size if all other governments do so. Of course, this could be reached by agreement. But this agreement would have to be enforced by some supranational authority as all governments have incentives to deviate and free-ride on others.

A market that would solve this problem would allow governments to “pay” other governments to consume their goods. That is, the government of country X would pay the government of state Y a certain quantity for each unit government Y consumes of country X’s products. These payments would align governments’ incentives with those of the world as a whole. By either eliminating the home bias in consumption or at least making it costly enough, governments would internalize the effects of their choices on the terms of trade when choosing policies. The result would be governments adopting better policies from a global perspective and, in particular, choosing their optimal size.<sup>5</sup>

### *The Overborrowing Externality*

The problem in this example is that the costs of financial crises are suffered in part by foreign creditors. The non-cooperative solution leads governments to choose financial regulations and legal systems that lead to a too high probability of these crises occurring.

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<sup>5</sup> One practical problem, however, is that this solution consists of subsidizing exports and might therefore be seen as an equivalent to “dumping”. This would go against the rules of the WTO.

Once again, this is inefficient and governments would be willing choose safer financial regulations and legal systems if all other governments do so. Once again, this could be reached by agreement but all governments would have incentives to free-ride by violating it.

A market that would solve this problem would allow governments to “buy” insurance from other governments. That is, the government of country X would buy from the government of state Y insurance that covers the losses that residents in country X have when there is a financial crisis in country Y. These payments would align governments’ incentives with those of the world as a whole. As the governments find that they must pay the costs that financial crises generate on foreigners, they internalize the effects of their choices these losses. The result would be governments choosing the right financial regulations and legal systems for the world as a whole.

These two examples already suggest that the practical costs of setting a global market for policies are likely to be enormous, including the costs associated with monitoring policies and gathering information about their effects. But we shall not dwell on these costs. Instead, we shall focus on two features of this market that constitute serious departures from the paradigm of competitive markets and are likely to be the source of substantial inefficiencies.

The first one is that governments are likely to behave strategically instead of adopting the standard passive price-taking behavior required for markets to be competitive. Since governments are the only sellers of their own policies and they are going to behave as monopolists. That is, governments will have the incentive to restrict sales of their economic policies in order to push up their price. The result is that the global market for policies would only eliminate in part the policy externalities created by globalization. The conclusion is clear: a global market for policies would only be a partial solution to the problems created by globalization. The basic inefficiencies would remain, albeit smaller, and would keep growing with globalization.

This problem might be further exacerbated by the fact that the buyers of policies are a small group and might find it easy to collude and restrict their purchases in order to lower the price. The result is therefore a market for policies be characterized by both monopoly and some degree of monopsony. Both demand and supply are artificially restricted and the result is that the policy externalities remain. Of course, this situation could be resolved by bargaining among seller and buyers. But nothing ensures that bargaining is able to align the incentives of governments with those of the world as a whole just as competitive markets would.

The second departure from the paradigm of competitive markets is that governments cannot commit to future payments and therefore the only feasible trades are those that are self-enforcing. Competitive markets need the support of an “enforcer”, i.e. an institution that has both the power and the incentives to ensure that all trades are carried out as agreed upon. This institution is crucial when governments trade promises rather than goods.

One example of a market where governments would trade promises rather than goods is the insurance market that we have argued would eliminate the overborrowing externality. When a crisis arrives, why would the domestic government make the payment (as agreed) to foreign governments? Since there is no supranational authority that can play the role of “enforcer” in the current world political structure, the only possible answer to this question is: the government will make the payment if and only if it is in its own interest to do this. If this is not the case always, the market is distorted or even missing. As a result, the global market for policies is unable to eliminate the overborrowing externality. The result is that policy externalities remain and the choice of policies is inefficient.

The best way to describe the current environment is as a repeated (or slowly-moving) game in which a small number of governments cooperate or trade actions behaving strategically and in which promises are kept out of the desire to keep a good reputation. We know the sort of equilibria that can arise in such an environment and the inefficiencies that

are generated.<sup>6</sup> To start with, these environments are plagued by multiple equilibria each of them defined by a different set of expectations for each player about the off-equilibrium behavior of other players. That is, actual outcomes of cooperation depend on governments' expectations about what other governments would do if the world were different. These expectations can never be confirmed by the data. Moreover, to the extent that they are volatile and shift over time as a result of sunspots, fashions or changes in government officials, this will be a source of costly volatility in efficiency and welfare.

Even if one is willing to assume that all governments have the best possible set of expectations all the time, the equilibrium outcome is likely to be inefficient. The reason is that governments cooperate and take actions that are costly to them only in the hope of keeping a good reputation and thus convincing other governments to do the same. This incentive to cooperate is likely to be weak if governments have short horizons and/or private information. Taking costly actions today in exchange for a good reputation that will allow for some benefits in the distant future does not seem a promising option for a government that faces reelection in the near future.

What do we conclude then? In the short run, we should create as many possible markets for global policies. But we should not expect this to be a permanent solution, since these markets are likely to be inefficient. In the long run, the solution is to change the world political structure. We move to this question next.

#### 4. A POLITICAL STRUCTURE FOR THE GLOBALIZED WORLD

*[...This section is very rough and incomplete. Sorry. A finished version will be available tomorrow...]*

This section deals with the long run, and asks about the optimal political structure for the globalized world.

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<sup>6</sup> This clearly an overstatement. There are many aspects of the theory of repeated games that are still unclear. Moreover, many existing results have not been extended to the case in which there are state variables that players can manipulate to their advantage.

What is the main point of this section? We have now a system of centralized jurisdictions, i.e. states. These centralized jurisdictions concentrate all the power. This is optimal at low levels of globalization. As globalization advances we should break these centralized jurisdictions and move towards a new set of overlapping jurisdictions that are both smaller and larger than existing states.

Governments provide different public goods. We say that there are economies of scope in the provision of public goods when it is cheaper having a single jurisdiction providing two public goods than having two jurisdictions one for each good.

Assume first that there are no economies of scope. Then, the choice of the optimal jurisdiction for each type of public good should be independent of each other. In such a world, the optimal jurisdiction for the provision of education and justice should be geographical areas that share a common language and cultural heritage. That is, the borders of these jurisdictions should be determined by culture or national identity. Instead, the optimal jurisdiction for the provision of monetary policy and financial regulation should be geographical areas that share the same goods and asset markets. Therefore the borders of these jurisdictions should be determined by markets. Without economies of scope in the provision of public goods, the optimal structure for the world economy would be a complex layer of overlapping jurisdictions, each of them devoted to provide a different public good.<sup>7</sup>

If there are economies of scope in the provision of public goods, it might be cost-effective to reduce the number of jurisdictions and take advantage of these economies of scope even if this leads to a worse provision of public goods. For instance, if cultural borders are not that different from economic borders, it might be optimal to have a single jurisdiction provide education, justice and monetary and financial policies. The costs of this would be an homogenization of education policy and justice administration and/or the creation of policy externalities. But these costs might be small relative to the benefits derived from exploiting economies of scope in the provision of public goods.

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<sup>7</sup> Other public goods, such as the protection of the environment and the conservation of natural resources should be provided by jurisdictions whose borders coincide with geographical borders, rather than economic or cultural borders.

The rest of the analysis in this section follows immediately. Today the world political structure consists of a set of centralized jurisdictions or states that hold all the power within their borders. This is clearly an inheritance from the past. There might have been a time in which economic and cultural borders were close enough to justify the current system of centralized jurisdictions. But globalization changed all of this long ago. Nowadays markets are much larger than nations and it is no longer efficient to have the world organized into states that are much smaller than markets and still contain more than one nation within them.

What we now need is a political structure that can better adapted to the globalized world. This means a supranational authority with effective power to eliminate policy externalities. It also means breaking down existing jurisdictions that do not coincide with cultural borders.

This theory explains the political tensions that globalization is creating. In particular, it is consistent with the observation that globalization is fueling two seemingly at odds phenomena: (1) the creation of strong supranational entities and (2) political fragmentation at the nation-state level. The answer is not to curb these trends, but to reinforce them and shape them in such a way that the conflict they are currently generating is minimized.

## 5. CONCLUDING REMARKS

This paper started with the observation that globalization is changing economic borders very quickly and, at the same time, changing political borders slowly if at all. We have argued that this mismatch between economic and political borders is a source of new policy externalities that vitiate governments' choice of economic policies. In the short run, the world's political structure is given and the only way to deal with this problem is by creating a global market for policies. This market, however, is not likely to work well. IN the long run, we should change the world's political structure moving away from the current system of centralized jurisdictions and towards a new system of overlapping jurisdictions that have both a larger and smaller geographical scope than the current states.

The analysis has been clearly normative, as we have focused mostly on the problems created by globalization and what we think are the best solutions both in the short and long runs. But we have not discussed the details of how to implement these solutions. This is not because we think that those details are unimportant. To the contrary, we think that it is paramount to acquire a true understanding the dangers and opportunities that might appear during the transition towards a new world's political structure. What are the sources of inertia? Which groups are likely to resist change? How can we align their incentives with those of the rest of society? What inefficiencies are likely to arise during the transition? How should we deal with them? Having good answers to these questions would certainly help minimize the time and costs of endowing the world with a political structure that allows us to take full advantage of globalization.

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