Globalization and Political Structure

Gino Gancia¹, Giacomo Ponzetto² and Jaume Ventura³

CREI, Barcelona GSE and CEPR

February 2014

Extended Abstract

At the beginning of the 19th century, the world was made of 118 sovereign states. By the end of the first wave of globalization, in 1914, the number of countries had fallen to 58, less than half of the initial level. The interwar period witnessed a reversal of these trends: trade collapsed and the number of independent states started to rise. In 1945, there were 74 countries and until then, political and economic integration had proceeded together. Yet, the end of World War II marks the beginning of a new era. The second wave of globalization that started after 1945 has led trade between nations to flourish to levels never seen before. But this time the process of economic integration was accompanied by different changes in the world political structure. On the one hand, the number of countries has risen to a record high of more than 200, suggesting that more trade is now accompanied by political fragmentation. On the other hand, however, there has been a proliferation and growth of international treaties and unions, with the United Nations, the WTO and the European Union among the most prominent examples.

In this paper, we argue that globalization can provide a simple and yet powerful explanation for these phenomena. To show this, we develop a stylized model of a world with many localities. Each of them is a geographical unit with a distinct culture. To study the interactions between globalization and political structure, we extend Krugman’s (1991) model of trade blocs in three directions. First, we add a continuum of industries and define globalization as the share of these industries that are traded. Second, we add public goods and provide a tractable model of cultural differences. Finally, we introduce political structure and the possibility that the state be organized into centralized or overlapping jurisdictions.

We then characterize the optimal political structure for this world, and explore conditions under which the principle of self-determination of localities implements it. This principle

¹ ggancia@crei.cat
² gponzetto@crei.cat
³ jventura@crei.cat
implies that each locality is sovereign and free to choose its political status. We call this a Wilsonian equilibrium since President Woodrow Wilson was the first to propose national self-determination as the key principle of international relations. We study how this equilibrium changes with globalization and the extent to which it helps us understand the empirical patterns described above.

We then examine violations of the principle of self-determination. First, we study the case in which sovereignty is not held by localities but instead by states. Second, we study the case in which localities can lose their sovereignty through war. In both cases, the equilibrium political structure is sub-optimal. We then explore how globalization exacerbates or mitigates the inefficiencies associated with these violations. We also show that these violations are useful to explain the evidence.

Finally, we use the model to interpret a variety of specific historical experiences.

Our research fits in the broader context of the literature on fiscal and political federalism. The classic economic analysis of federalism (e.g., Oates 1999) focuses on two rationales for centralization: economies of scale and benefits from policy coordination. We study the evolution of both these technological features in the wake of globalization. Political-economy analyses have emphasized that a countervailing cost of centralization is the reduced ability to tailor policy choices to local tastes (Lockwood 2002; Besley and Coate 2003). In keeping with this insight, preference-matching is the main advantage of decentralized policy-making in our framework.

This paper is particularly related to a recent literature on the economic incentives for countries to integrate or separate. In particular, we build on the seminal contributions of Alesina and Spolaore (2003) and Alesina, Spolaore and Wacziarg (2000, 2005). These authors propose a theory of country formation where globalization, by creating large international markets, lowers the benefit of having a large domestic market and thus leads to political fragmentation. Their premises are that (i) small local governments can better cope with preference heterogeneity; (ii) economies of scale calls for large domestic markets; and (iii) globalization lowers the importance of domestic markets. They then show that, in a world of sovereign countries, economic integration leads to political fragmentation.

Our analysis builds on these frameworks, but it will differ in two key aspects. First, none of these papers considers supra-national authorities. The main novelty of our work will instead be to study the emergence of a richer political structure involving different layers of possibly overlapping jurisdictions. Second, these papers abstract from what is instead a central idea of our theory: the mismatch between political and economic borders created by globalization and the international policy externalities that follow.

We are currently in the process of writing the first draft of the paper and we expect it
to be ready before the SED 2014 Annual Meeting.

**JEL Classification:** D71, F15, F55, H77, O57

**Keywords:** economic integration, political integration and separation, international unions, nation-states

REferences


