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## WHO NEEDS THE NATION STATE?

Dani Rodrik

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Dani Rodrik, Harvard University and CEPR

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Centre for Economic Policy Research  
77 Bastwick Street, London EC1V 3PZ, UK  
Tel: (44 20) 7183 8801, Fax: (44 20) 7183 8820  
Email: [cepr@cepr.org](mailto:cepr@cepr.org), Website: [www.cepr.org](http://www.cepr.org)

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## ABSTRACT

### Who Needs the Nation State?\*

The design of institutions is shaped by a fundamental trade-off. On the one hand, relationships and heterogeneity push governance down. On the other, the scale and scope benefits of market integration push governance up. A corner solution is rarely optimal. An intermediate outcome, a world divided into diverse polities, is the best that we can do.

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Dani Rodrik  
Kennedy School of Government  
Harvard University  
79 John F. Kennedy Street  
Cambridge, MA 02138  
USA

Email: [dani\\_rodrik@harvard.edu](mailto:dani_rodrik@harvard.edu)

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## Who Needs the Nation State?

Dani Rodrik<sup>1</sup>  
Harvard University  
May 2012

### Introduction

The nation state has few friends these days. It is roundly viewed as an archaic construct that is at odds with 21<sup>st</sup> century realities. It has neither much relevance nor much power, analysts say. Increasingly, it is non-governmental organizations, global corporate social responsibility, or global governance on which pundits place their faith to achieve public purpose and social goals. It is common to portray national politicians as the sole beneficiary of the nation state, on which their privileges and lofty status depend.

The assault on the nation state transcends traditional political divisions, and is one of the few things that unite economic liberals and socialists. “How may the economic unity of Europe be guaranteed, while preserving complete freedom of cultural development to the peoples living there?” asked Leon Trotsky in 1934. The answer was to get rid of the nation state: “The solution to this question can be reached ... by completely liberating productive forces from the fetters imposed upon them by the national state.”<sup>2</sup> Trotsky’s answer sounds surprisingly modern in light of the euro zone’s current travails. It is one to which most neoclassical economists would subscribe.

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<sup>1</sup> This is the revised version of the Roepke Lecture in Economic Geography delivered to the Association of American Geographers on February 25, 2012, to be published in Economic Geography in 2013. A version of this paper was also presented as the Arrow Lecture in Ethics and Leadership at Stanford University. I am grateful to Yuko Aoyama and Andres Rodriguez-Pose for their invitation and reactions, Roberto Unger for helpful discussions, John Agnew for very insightful comments, and participants at the Arrow lecture at Stanford University for suggestions.

<sup>2</sup> Trotsky was writing in Foreign Affairs (see <http://www.foreignaffairs.com/articles/136961/how-we-got-here>).

Many moral philosophers today join liberal economists in treating national borders as irrelevant, if not descriptively then certainly prescriptively. Here is Peter Singer (2002, 12):

“If the group to which we must justify ourselves is the tribe, or the nation, then our morality is likely to be tribal, or nationalistic. If, however, the revolution in communications has created a global audience, then we might need to justify our behavior to the whole world. This change creates the material basis for a new ethic that will serve the interests of all those who live on this planet in a way that, despite much rhetoric, no previous ethic has done.”

And Amartya Sen (2009 , 143):

“there is something of a tyranny of ideas in seeing the political divisions of states (primarily, national states) as being, in some way, fundamental, and in seeing them not only as practical constraints to be addressed, but as divisions of basic significance in ethics and political philosophy.”

Sen and Singer think of national borders as a hindrance – a practical obstacle that can and should be overcome as the world becomes more interconnected through commerce and advances in communications.

Meanwhile the economic case against the nation state is that it is itself the source of many of the transaction costs that block fuller global economic integration. This is not just because governments impose import tariffs, capital controls, visas, and other restrictions at the border that impede the global circulation of goods, money, and people. More fundamentally, it is because the multiplicity of sovereigns creates jurisdictional discontinuities and associated transaction costs. Differences in currencies, legal regimes, and regulatory practices are today

the chief obstacles to a unified global economy. As overt trade barriers have come down, the relative importance of such transaction costs have grown. Import tariffs now constitute a tiny fraction of total trade costs. Anderson and van Wincoop (2004) estimate these costs to be a whopping 170 percent (in ad valorem terms) for advanced countries, an order of magnitude higher than import tariffs themselves.

To an economist, this is equivalent to leaving \$100 bills on the sidewalk. Remove the jurisdictional discontinuities, the argument goes, and the world economy would reap large gains from trade, similar to the multilateral tariff liberalization experienced over the postwar period. So the global agenda is increasingly dominated by efforts to harmonize regulatory regimes, everything from sanitary and phytosanitary standards to financial regulations. That is also why European nations felt it was important to move to a single currency to make their dream of a common market a reality. Economic integration requires repressing nation states' ability to issue their own money, set different regulations, and impose different legal standards.

### The continued vitality of the nation state

The death of the nation state has long been predicted. "The critical issue for every student of world order is the fate of the nation-state," wrote political scientist Stanley Hoffman in 1966. "Sovereignty at Bay" was the title of Raymond Vernon's 1971 classic. Both scholars would ultimately pour cold water on the passing of the nation state, but their tone reflects a strong current of prevailing opinion. Whether it was the European Union (which Hoffman focused on) or the multinational enterprise (Vernon's topic), the nation state has been widely perceived as overwhelmed by developments larger than it.

And yet the nation state refuses to wither away. It has proved remarkably resilient, and remains the main determinant of the global distribution of income, the primary locus of market-supporting institutions, and the chief repository of personal attachments and affiliations.

Consider a few facts.

To test my students' intuition about the determinants of global inequality, I ask them on the first day of class whether they would rather be rich in a poor country or poor in a rich country. I tell them to consider only their own consumption level, and to think of rich and poor as referring to the top and bottom ten percent of a country's income distribution. A rich country in turn is one in the top decile of the inter-country distribution of per-capita incomes, while a poor country is one in the bottom. Armed with this background, typically a majority of the students respond that they would rather be rich in a poor country.

They are in fact massively wrong. Defined the way I just did, the poor in a rich country are in fact more than three times richer than the rich in the poor country (Rodrik 2011, chap. 7). The optical illusion that leads the students astray is that the super-rich with the BMWs and gated mansions they have seen in poor countries are a miniscule proportion of the population – significantly fewer than the top 10 percent I asked them to focus on. By the time we consider the average of the top decile as a whole, we have taken a huge leap down the income scale.

The students have just discovered a telling feature of the world economy: our economic fortunes are determined primarily by where (which country) we are born, and only secondarily by our location on the income-distribution scale. Or to put it in more technical but also more accurate terms, most of global inequality is accounted for by inequality across rather than

within nations (Bourguignon and Morrisson 2002). So much for globalization having revoked the relevance of national borders.

Second, consider the role of national identity. One might imagine that attachments to the nation state have worn thin between the push of transnational affinities, on the one hand, and the pull of local connections, on the other. But this does not seem to be the case. National identity remains alive and well, even in some surprising corners of the world.

To see this, let us turn to the 2004-2008 round of The World Values Survey, which covers around 83,000 individuals in 57 countries (<http://www.worldvaluessurvey.org/>). Respondents were asked a range of questions about the strength of their local, national, and global attachments. I measure the strength of national attachments by computing percentages of respondents who "agree" or "strongly agree" with the statement "I see myself as a citizen of [country, nation]." The strength of global attachments is measured in turn by the percentages of respondent who "agree" or "strongly agree" with the statement "I see myself as a world citizen." In each case, I subtract these percentages from analogous percentages for "I see myself as a member of my local community" to provide for some kind of normalization. In other words, national and global attachments are measured relative to local attachments.

Figure 1 shows the results for the entire global sample, as well as for the U.S., the European Union, China, and India individually. What stands out is not so much that national identity is vastly stronger than identity as a "global citizen" – that much was predictable. The surprising finding is how it apparently exerts a stronger pull than membership in the local community, as can be observed in the positive percentages for normalized national identity. This tendency is true across the board, and strongest in the U.S. and India, two vast countries

where we might have expected local attachments to be, if anything, stronger than attachment to the nation state.

I find it also striking that European citizens feel so little attachment to the EU. In fact, as Figure 1 shows, the idea of EU citizenship seems as remote to Europeans as that of global citizenship, despite long decades of European integration and institution building. It bears saying that these survey results pertain to the period before the present crisis. One can safely guess that European attachments have worn even thinner since 2008.

One might object that such surveys obfuscate differences among sub-groups within the general population. We would expect mainly the young, the skilled, and the well-educated to have been unhinged from their national mooring and become global in their outlook and attachments. As Figure 2 indicates, there are indeed differences among these groups that go in the predicted direction. But they are not as large as one might have thought, and do not change the overall picture. Even among the young (less than 25 years old), those with university education, and the professionals, national identity trumps local and -- even more massively -- global attachments. "I was born in Brazil, I was an American citizen for about 10 years. I thought of myself as a global citizen," Facebook co-founder Eduardo Saverin recently said to the *New York Times* (Hardy 2012). But then again he is in a class of his own: not many people stand to gain around \$100 million in taxes by renouncing their U.S. citizenship.

Finally, any remaining doubts about the continued relevance of the nation state must have been dispelled by the experience in the aftermath of the global financial crisis of 2008. For it was domestic policy makers that had to step in to prevent an economic meltdown: it was national governments that bailed out banks, pumped liquidity, provided fiscal stimulus, and

wrote unemployment checks. As Bank of England chairman Mervyn King memorably put it, banks are global in life and national in death.

The International Monetary Fund and the newly-upgraded Group of 20 were merely talking shops. In the euro zone, it was decisions taken in national capitals from Berlin to Athens that determined how the crisis would play out, not actions in Brussels (or Strasbourg). And it was national governments that ultimately took the blame for everything that went wrong – or the credit for the little that went right.

#### A normative case for the nation state

Historically, the nation state has been closely associated with economic, social, and political progress. It curbed internecine violence, expanded networks of solidarity beyond local communities, spurred mass markets and industrialization, enabled the mobilization of human and financial resources, and fostered the spread of representative political institutions (Tilly 1992, Gellner 1983, Pinker 2011, Kedourie 1993 [1960], Anderson 2006). Civil wars and economic decline are the usual fate of today's "failed states." For residents of stable and prosperous countries, it is easy to overlook the role that the construction of the nation state played in overcoming such challenges. The nation state's fall from intellectual grace is in part a consequence of its achievements.

But has the nation state, as a territorially confined political entity, truly become a hindrance to the achievement of desirable economic and social outcomes in view of the globalization revolution? Or does the nation state remain indispensable to the achievement of

those goals? In other words, is it possible to construct a more principled defense of the nation-state, one that goes beyond stating that it exists and that it hasn't withered away?

Let me begin by clarifying my terminology. The nation state evokes connotations of nationalism. The emphasis in my discussion will be not on the "nation" or "nationalism" part but on the "state" part. In particular, I am interested in the state as a spatially demarcated jurisdictional entity. From this perspective, I view the nation as a consequence of a state, rather than the other way around. As Abbé Sieyès, one of the theorists of the French revolution, put it: "What is a nation? A body of associates living under one common law and represented by the same legislature" (quoted in Kedourie 1993, 7). I am not concerned with debates over what a nation is, whether each nation should have its own state, or how many states there ought to be.

Instead, I wish to develop a substantive argument for why robust nation states are actually beneficial, especially to the world economy. I want to show that the multiplicity of nation states adds rather than subtracts value.

My starting point is that markets require rules, and that global markets would require global rules. A truly borderless global economy, one in which economic activity is fully unmoored from its national base, would necessitate transnational rule-making institutions that match the global scale and scope of markets. But this would not be desirable, even if it were feasible. Market-supporting rules are non-unique. Experimentation and competition among diverse institutional arrangements therefore remain desirable. Moreover, communities differ in their needs and preferences with regard to institutional forms. And geography continues to limit the convergence in these needs and preferences.

So I accept that nation states are a source of disintegration for the global economy. My claim is that an attempt to transcend them would be counterproductive. It would get us neither a healthier world economy, nor better rules.

My argument can be presented as a counterpoint to the typical globalist narrative, depicted graphically in the top half of Figure 3. In this narrative, economic globalization, spurred by the revolutions in transport and communication technologies, breaks down the social and cultural barriers among people in different parts of the world, and fosters a global community. This in turn enables the construction of a global political community – i.e., global governance – which underpins and further reinforces economic integration.

My alternative narrative (shown at the bottom of Figure 3) emphasizes a different dynamic, one that sustains a world that is politically divided and economically less than fully globalized. In this dynamic, preference heterogeneity and institutional non-uniqueness, along with geography, create a need for institutional diversity. Institutional diversity blocks full economic globalization. Incomplete economic integration in turn reinforces heterogeneity and the role of distance. When the forces of this second dynamic are sufficiently strong, as I will argue they are, operating by the rules of the first can get us only into trouble.

#### The futile pursuit of hyper-globalization

Markets depend on non-market institutions. That is because they are not self-creating, self-regulating, self-stabilizing, or self-legitimizing. Anything that goes beyond simple exchange among neighbors requires: investments in transport, communications, and logistics; enforcement of contracts, provision of information, and prevention of cheating; a stable and

reliable medium of exchange; arrangements to bring distributional outcomes into conformity with social norms; and so on. Well-functioning, sustainable markets are backed up by a wide range of institutions that provide the critical functions of regulation, redistribution, monetary and fiscal stability, and conflict management.

These institutional functions have so far been provided largely by the nation state. Throughout the post-war period this not only did not impede the development of global markets, it facilitated it in many ways. The guiding philosophy behind the Bretton Woods regime, which governed the world economy until the 1970s, was that nations – not only the advanced nations but also the newly independent ones – needed the policy space within which they could manage their economies and protect their social contracts. Capital controls were viewed as an inherent element of the global financial system. Trade liberalization remained limited to manufactured goods and to industrialized nations; when imports of textiles and clothing from low-cost countries threatened domestic social bargains, those too were carved out as special regimes.

Yet, trade and investment flows grew by leaps and bounds, in no small part because the Bretton Woods recipe made for healthy domestic policy environments. In fact, economic globalization relied critically on the rules maintained by the major trading and financial centers. As Agnew (2012) has emphasized, national monetary systems, central banks, and financial regulatory practices were the cornerstones of financial globalization. In trade, it was more the domestic political bargains than GATT rules that sustained the openness that came to prevail.

The nation state was the enabler of globalization, but also the ultimate obstacle to its deepening. Combining globalization with healthy domestic polities relied on managing this

tension well. Veer too much in the direction of globalization, as in the 1920s, and we would erode the institutions underpinning markets. Veer too much in the direction of the state, as in the 1930s, and we would forfeit the benefits of international commerce.

From the 1980s on, the ideological balance took a decisive shift in favor of markets and against governments. The result internationally was an all-out push for what I have called “hyper-globalization” (Rodrik 2011) – the attempt to eliminate all transaction costs that hinder trade and capital flows. The World Trade Organization was the crowning achievement of this effort in the trade arena. Trade rules were now extended to services, agriculture, subsidies, intellectual property rights, sanitary and phyto-sanitary standards, and other types of what were previously considered to be domestic policies. In finance, freedom of capital mobility became the norm, rather than the exception, with regulators focusing on the global harmonization of financial regulations and standards. A majority of European Union members went the furthest of all, by first reducing exchange-rate movements amongst themselves, and ultimately adopting a single currency.

The upshot was that domestic governance mechanisms were weakened while their global counterparts remain incomplete. The flaws of the new approach became evident soon enough. One type of failure arose from pushing rule-making onto supranational domains too far beyond the reach of political debate and control. This failure exhibited itself in persistent complaints about the democratic deficit, lack of legitimacy, and loss of voice and accountability. These complaints became permanent fixtures attached to the WTO and Brussels institutions.

Where rule-making remained domestic, another type of failure arose. Growing volumes of trade with countries at very different levels of development and with highly dissimilar

institutional arrangements exacerbated inequality and economic insecurity at home. Even more destructively, the absence of institutions that have tamed domestic finance (a lender of last resort, deposit insurance, bankruptcy laws, fiscal stabilizers) rendered global finance a source of instability and periodic crises of massive proportions. Domestic policies alone were inadequate to address the problems that extreme economic and financial openness created.

Suitably enough, the countries that did the best in the new regime were those that did not let their enthusiasm for free trade and free capital flows get the better of them. China, which engineered history's most impressive poverty reduction and growth outcome was of course a major beneficiary of others' economic openness. But for its part, it followed a highly cautious strategy that combined extensive industrial policies with selective, delayed import liberalization and capital controls. Effectively, China played the globalization game by Bretton Woods rules rather than hyper-globalization rules.

#### Is global governance feasible or desirable?

By now it is widely understood that globalization's ills derive from the imbalance between the global nature of markets and the domestic nature of the rules that govern them. As a matter of logic, the imbalance can be corrected in only one of two ways: expand governance beyond the nation state, or restrict the reach of markets. In polite company, only the first option receives much attention.

"Global governance" means different things to different people. For policy officialdom, it refers to new intergovernmental forums, such as the Group of 20 and the Financial Stability Forum. For some analysts, it means the emergence of transnational networks of regulators,

setting common rules from sanitary to capital adequacy standards (Slaughter 2004). For other analysts, it is “private governance” regimes such as fair trade and corporate social responsibility (Ruggie 2004, Mayer and Gereffi 2010). Yet others imagine the development of accountable global administrative processes that depend “on local debate, is informed by global comparisons, and works in a space of public reasons” (Cohen and Sable 2005, 779). For many activists, it signifies greater power for international non-governmental organizations.

It remains without saying that such emergent forms of global governance remain weak. But the real question is whether they can develop and become strong enough to sustain hyper-globalization and spur the emergence of truly global identities. I do not believe they can. I develop my argument in four steps: (1) market-supporting institutions are not unique; (2) communities differ in their needs and preferences with regard to institutional forms; (3) geographical distance limit the convergence in those needs and preferences; and (4) experimentation and competition among diverse institutional forms is desirable.

#### Market-supporting institutions are not unique

It is relatively straightforward to specify the functions that market-supporting institutions serve, as I did previously. They create, regulate, stabilize, and legitimize markets. But specifying the form that institutions should take is another matter altogether. There is no reason to believe these functions can be provided only in specific ways, nor to think that there is only a limited range of plausible variation. In other words, institutional function does not map uniquely into form.

All advanced societies are some variant of a market economy with dominantly private ownership. But the United States, Japan, and European nations have evolved historically under institutional setups that differ significantly. These differences reveal themselves in divergent practices in labor markets, corporate governance, social welfare systems, and approaches to regulation. That they have managed to generate comparable amounts of wealth under different rules is an important reminder that there is not a single blueprint to economic success. Yes, markets, incentives, property rights, stability, and predictability are important. But they do not require cookie-cutter solutions.

Economic performance fluctuates, even among advanced countries, so institutional fads are common. In recent decades, European social democracy, Japanese-style industrial policy, the U.S. model of corporate governance and finance, and Chinese state capitalism have periodically come into fashion, only to recede from attention once their stars faded. Despite efforts by international organizations such as the World Bank and the OECD to develop “best practices,” institutional emulation in fact rarely succeeds.

One reason is that elements of the institutional landscape tend to have a complementary relationship to each other, dooming partial reform to failure. For example, in the absence of labor market training programs and adequate safety nets, deregulating labor markets by making it easier for firms to fire their workers can easily backfire. Without a tradition of strong stakeholders that restrain risk-taking, allowing financial firms to self-regulate can be a disaster. In their well-known book *Varieties of Capitalism*, Peter Hall and David Soskice (2001) have identified two distinct institutional clusters among advanced industrial economies,

which they call “liberal market economies” and “coordinated market economies.” We can certainly identify additional models as well if we turn to Asia.

The more fundamental point has to do with the inherent malleability of institutional designs. As Roberto Unger has emphasized, there is no reason to think that the range of institutional divergence we observe in the world today exhausts all feasible variation. Desired institutional functions -- aligning private incentives with social optimality, establishing macro stability, achieving social justice -- can be generated in innumerable ways, limited only by our imagination. The idea that there is a best-practice set of institutions is an illusion.

That is not to say that differences in institutional arrangements do not have real consequences. Institutional malleability does not mean that institutions always perform adequately: there are plenty of societies whose institutions patently fail to provide for adequate incentives for production, investment, and innovation, not to mention social justice. But even among relatively successful societies, different institutional configurations often have varying implications for distinct groups. Compared to coordinated market economies, liberal market economies, for example, present better opportunities for the most creative and successful members of society, but also tend to produce greater inequality and economic insecurity for their working classes. Richard Freeman (2008) has shown that more highly regulated labor market environments produce less dispersion in earnings but not necessarily higher rates of unemployment.

There is here an interesting analogy to the second fundamental theorem of welfare economics. The theorem states that any Pareto-efficient equilibrium can be obtained as the outcome of a competitive equilibrium, with an appropriate distribution of endowments.

Institutional arrangements are in effect the rules that determine the allocation of rights to a society's resources; they shape the distribution of endowments in the broadest term. Each Pareto-efficient outcome can be sustained by a different set of rules. And conversely, each set of rules has the potential to generate a different Pareto-efficient outcome. (I say potential because "bad" rules will clearly result in Pareto-inferior outcomes.)

It is not clear how we can choose ex ante among Pareto-efficient equilibria. It is precisely this indeterminacy that makes the choice among alternative institutions a difficult one, best left to political communities themselves.

#### Heterogeneity and diversity

Religion and language divide people and prevent a universal monarchy, wrote Immanuel Kant (Kedourie 1993, p. 46). But there are many other things that divide us. As discussed in the previous section, institutional arrangements have distinct implications for the distribution of well-being and many other features of economic, social and political life. We do not agree on how to trade equality against opportunity, economic security against innovation, stability against dynamism, economic outcomes against social and cultural values, and many other consequences of institutional choice. Differences in preferences are ultimately the chief argument against institutional harmonization globally.

Consider how financial markets should be regulated. There are many choices to be made. Should commercial banking be separated from investment banking? Should there be a limit on size of banks? Should there be deposit insurance, and if so, what should it cover? Should banks be allowed to trade on their own account? How much information should they

reveal about their trades? Should executives' compensation be set by directors, with no regulatory controls? What should the capital and liquidity requirements be? Should all derivative contracts be traded on exchanges? What should be the role of credit-rating agencies? And so on.

A central trade-off here is between financial innovation and financial stability. A light approach to regulation will maximize the scope for financial innovation (the development of new financial products), but at the cost of increasing the likelihood of financial crises and crashes. Strong regulation will reduce the incidence and costs of crises, but potentially at the cost of raising the cost of finance and excluding many from its benefits. There is no single optimal point along this trade-off. Requiring that communities whose preferences over the innovation-stability continuum vary all settle on the same solution might have the virtue that it reduces transaction costs in finance. But it would come at the cost of imposing arrangements that are out of sync with local preferences. That is in fact the conundrum that financial regulation faces at the moment, with banks pushing for common global rules and domestic legislatures and policy makers resisting.

Here is another example from food regulation. In a controversial 1998 case, the World Trade Organization sided with the United States in ruling that the European Union ban on beef reared on certain growth hormones violated the Agreement on Sanitary and Phytosanitary Standards. It is interesting that the ban did not discriminate against imports and applied to imported and domestic beef alike. There did not seem to be a protectionist motive behind the ban, which had been pushed by consumer lobbies in Europe alarmed by the potential health threats. Nonetheless the WTO judged that the ban violated the requirement in the SPS

Agreement that policies be based on “scientific evidence.” (In a similar case in 2006, the WTO also ruled against EU restrictions on genetically modified food and seeds (GMOs), finding fault once again with the adequacy of EU scientific risk assessment.)

There is indeed scant evidence to date that growth hormones pose any health threats. The EU argued that it had applied a broader principle not explicitly covered by the WTO, the “precautionary principle,” which permits greater caution in the presence of scientific uncertainty. The precautionary principle reverses the burden of proof. Instead of asking “is there reasonable evidence that growth hormones or GMOs have adverse effects?” it requires policy makers to ask “are we reasonably sure that they do *not*?” In many unsettled areas of scientific knowledge, the answer to both questions can be “no.” Whether the precautionary principle makes sense depends both on the degree of risk aversion and on the extent to which potential adverse effects are large and irreversible.

As the European Commission argued (unsuccessfully), regulatory decisions here cannot be made purely on the basis of science. Politics, which aggregates a society’s risk preferences, must play the determinative role. It is not unreasonable to expect that the outcome will vary across societies. Some (like the U.S.) will go for low prices, others (like the EU) for greater safety.

The suitability of institutional arrangements also depends on levels of development and historical trajectory. Alexander Gerschenkron (1962) famously argued that lagging countries would need institutions – such as large banks and state directed investments – that differed from those present in the original industrializers. To a large extent, his arguments have been

validated. But even among rapidly growing developing nations, there is considerable institutional variation. What works in one place rarely does in another.

Consider how some of the most successful developing nations joined the world economy. South Korea and Taiwan relied heavily on export subsidies to push their firms outward during the 1960s and 1970s, and liberalized their import regime only gradually. China established special economic zones (SEZs) in which export-oriented firms were allowed to operate under different rules than those applied to state enterprises and to others focused on the internal market. Chile, by contrast, followed the textbook model and sharply reduced import barriers in order to force domestic firms to compete with foreign firms directly in the home market. The Chilean strategy would have been a disaster if applied in China, as it would have led to millions of job losses in state enterprises and incalculable social consequences. And the Chinese model would not have worked as well in Chile, a small nation that is not an obvious destination for multinational enterprises.

Alberto Alesina and Enrico Spolaore (2003) have explored how heterogeneity in preferences interacts with the benefits of scale to determine endogenously the number and size of nations. In their basic model, individuals differ in their preferences over the public goods – which we might also think of specific institutional arrangements – provided by the state. The larger the population over which the public good is provided, the lower the unit cost of provision. On the other hand, the larger the population, the greater the number of people who find their preferences ill-served by the specific public good provided. Smaller countries are better able to respond to their citizens' needs. The optimum number of jurisdictions, or nation

states, trades off the scale benefits of size against the heterogeneity costs of public good provision.

The important analytical insight of the Alesina-Spolaore model is that it makes little sense to optimize along the market size dimension (and eliminate jurisdictional discontinuities) when there exist heterogeneity in preferences along the institutional dimension. The framework does not tell us whether we have too many nations at present, or too few. But it does suggest that a divided world polity is the price we pay for institutional arrangements that are, in principle at least, better tailored to local preferences and needs.

#### Distance lives: the limits to convergence

We need to consider an important caveat to the discussion on heterogeneity, namely the endogenous nature of many of the differences that set communities apart. That culture, religion and language are in part a side product of nation states is an old theme that runs through the long trail of the literature on nationalism. From Ernest Renan down, theorists of nationalism have stressed that cultural differences are not innate and can be shaped by state policies. Education in particular is a chief vehicle through which national identity is molded. Ethnicity has a certain degree of exogeneity, but its salience in defining identity is also a function of the strength of the nation state. A resident of Turkey who defines himself as Muslim is potentially a member of a global community, whereas a “Turk” owes primary loyalty to the Turkish state.

Much the same can be said about other characteristics along which communities differ. If poor countries have distinctive institutional needs arising from their low levels of income, we

might perhaps expect those distinctions to disappear as income levels convergence. If societies have different preferences over risk, stability, equity, and so on, we might similarly expect these differences to narrow down as a result of greater communication and economic exchange across jurisdictional boundaries. Today's differences may exaggerate tomorrow's differences. In a world where people are freed from their local moorings they are also freed from their local idiosyncrasies and biases. Individual heterogeneity may continue to exist, but it need not be correlated across geographical space.

There is some truth to these arguments, but they are also counterweighed by a considerable body of evidence that suggests geographical distance continues to produce significant localization effects despite the evident decline in transport and communication costs and other, man-made barriers.

One of the most striking studies in this vein is a paper by Anne-Célia Disdier and Keith Head (2008), which looks at the effect of distance on international trade over the span of history. It is a stylized fact of the empirical trade literature that the volume of bilateral trade declines with the geographic distance between trade partners. The typical distance elasticity is around -1.0, meaning that trade falls by 10% for every 10% increase in distance. This is a fairly large effect. Presumably, what lies behind it is not just transport and communication costs, but also lack of familiarity and cultural differences. (Linguistic differences are often controlled for separately.)

Disdier and Head undertook a meta-analysis, collecting 1,467 distance effects from 103 papers covering trade flows at different points in time, and stumbled on a surprising result: distance matters more now than it did in the late 19<sup>th</sup> century. The distance effect seems to

have increased from the 1960s, remaining persistently high since then (see Figure 4). If anything, globalization seems to have raised the penalty that geographic distance imposes on economic exchange. This apparent paradox is also confirmed by Berthelon and Freund (2008) who found an increase in the (absolute value) of the distance elasticity from -1.7 to -1.9 between 1985-89 and 2001-2005 using a consistent trade data set. Berthelon and Freund show that the result is not due to a compositional switch from low- to high-elasticity goods, but to “a significant and increasing impact of distance on trade in almost 40% of industries” (2008, p. 311).

Leaving this puzzle aside for the moment, let us turn to an altogether different type of evidence.<sup>3</sup> In the mid-1990s a new housing development in one of the suburbs of Toronto engaged in an interesting experiment. The houses were built from the ground up with the latest broadband telecommunications infrastructure and came with a host of new Internet technologies. Residents of Netville (a pseudonym) had access to high-speed Internet, a videophone, an online jukebox, online health services, discussion forums, and a suite of entertainment and educational applications.

These new technologies made the town an ideal setting for nurturing global citizens. The people of Netville were freed from the tyranny of distance. They could communicate with anyone in the world as easily as they could with a neighbor, forge their own global links, and join virtual communities in cyberspace. One might expect they would begin to define their identities and interests increasingly in global, rather than local, terms.

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<sup>3</sup> The following account, based on Hampton (2004), is taken from Rodrik (2011).

What actually transpired was quite different. Glitches experienced by the telecom provider left some homes without a link to the broadband network. This allowed researchers to compare across wired and non-wired households and reach some conclusions about the consequences of being wired. Far from letting local links erode, wired people actually strengthened their existing local social ties. Compared to non-wired residents, they recognized more of their neighbors, talked to them more often, visited them more frequently, made many more local phone calls. They were more likely to organize local events and mobilize the community around common problems. They used their computer network to facilitate a range of social activities, from organizing barbecues to helping local children with their homework. Netville exhibited, as one resident put it, “a closeness that you don’t see in many communities.” What was supposed to have unleashed global engagement and networks had instead strengthened local social ties.

There are plenty of other examples that belie the death of distance. One study has identified strong “gravity” effects on the Internet: “Americans are more likely to visit websites from countries that are physically close than from countries that are far, even after controlling for country-level Internet expertise, language, income, immigrant stock, and many other factors” (Blum and Goldfarb, 2006). For digital products related to music, games, and pornography, a 10% increase in physical distance reduces the probability an American will visit the website by 33% -- a distance elasticity even higher (in absolute value) than for goods trade.

Despite the evident reduction in transport and communication costs, the production location of globally traded products is often determined by regional agglomeration effects. When the *New York Times* recently examined why Apple’s iPhone is manufactured in China

rather than the U.S., the answer turned out to have little to do with comparative advantage. China had already developed a massive network of suppliers, engineers, and dedicated workers in a complex known informally as Foxconn City that provided Apple with benefits the U.S. could not match (Duhigg and Bradsher 2012).

More broadly, incomes and productivity have been diverging across countries, rather than converging, just as markets for goods, capital, and technology have become more integrated. Economic development depends perhaps more than ever on what happens at home. If the world economy exerts a homogenizing influence, it is at best a partial one, competing with many other influences that go the other way.

Relationships based on proximity are one such offsetting influence. Many, if not most exchanges are based on relationships rather than textbook-style anonymous markets. Geographic distance protects relationships. As Leamer (2007) puts it, “geography, whether physical or cultural or informational, limits competition since it creates cost-advantaged relationships between sellers and buyers who are located ‘close’ to one another.” But relationships also create a role for geography. Once relationship-specific investments are made, geography becomes more important. The iPhone could have been produced anywhere; but once relationships with local suppliers are established, there are lock-in effects that make it difficult for Apple to move anywhere else.

Technological progress has an ambiguous effect on the importance of relationships. On the one hand, the decline in transport and communication costs reduces the protective effect of distance in market relationships. It may facilitate the creation of long-distance relationships that cross national boundaries. On the other hand, the increase in complexity and product

differentiation, along with the shift from Fordist mass production to new, distributed modes of learning, increases the relative importance of spatially circumscribed relationships. The new economy runs on tacit knowledge, trust, and cooperation -- which still depend on personal contact. As Kevin Morgan (2004) puts it, spatial reach does not equal "social depth." Hence market segmentation is a natural feature of economic life, even in the absence of jurisdictional discontinuities. Neither economic convergence nor preference homogenization is the inevitable consequence of globalization.

### Experimentation and competition

Finally, since there is no fixed, ideal shape for institutions and diversity is the rule rather than exception, a divided global polity presents an additional advantage. It enables experimentation, competition among institutional forms, and learning from others. To be sure, trial and error can be quite costly when it comes to society's rules. Still, institutional diversity among nations is as close as we can expect to come to a laboratory in real life. Ober (2010) discusses how competition among Greek city states during 800-300 BCE fostered institutional innovation in areas of citizenship, law, and democracy, sustaining the relative prosperity of ancient Greece.

There are nasty sides to institutional competition. One of them is the 19th century idea of a Darwinian competition among states, whereby wars are the struggle through which we get progress and self-realization of humanity (Kedourie 1993, p. 47). The equally silly, if less bloody, modern counterpart of this is the notion of economic competition among nations, whereby global commerce is seen as a zero-sum game. Both ideas are based on the belief that

the point of competition is to lead us to the one perfect model. But competition works in diverse ways. In economic models of “monopolistic competition,” producers compete not just on price, but also on variety -- by differentiating their products from others’ (Lancaster 1971; Dixit and Stiglitz 1977). Similarly, national jurisdictions can compete by offering institutional “services” that are differentiated along the dimensions we have discussed above.

One persistent worry is that institutional competition sets off a race to the bottom. In order to attract mobile resources – capital, multinational enterprises, skilled professionals – jurisdictions may lower their standards and relax their regulations in a futile dynamic to outdo other jurisdictions. Once again, this argument overlooks the multidimensional nature of institutional arrangements. Tougher regulations or standards are presumably put in place to achieve certain objectives: they offer compensating benefits elsewhere. We might all wish to be free to drive at any speed we want, but few of us would move to a country with no speed limit at all where, as a result, deadly traffic accidents would be much more common. Similarly, higher labor standards may lead to happier and more productive workers; tougher financial regulation to greater financial stability; higher taxes to better public services such as schools, infrastructure, parks, and other amenities. Interestingly, as I write this the European debate on bank capital requirements focuses not on ensuring that countries do not undercut harmonized rules, but on ensuring that they do not raise their requirements too far above Basel III norms.

So it is not surprising that the only area where some kind of race to the bottom has been documented is in corporate taxation. Tax competition has played an important role in the remarkable reduction in corporate taxes around the world since the early 1980s. In a study on OECD countries, Devereux et al. (2008) find that when other countries reduce their average

statutory corporate tax rate by 1 percentage point the home country follows by reducing its tax rate by 0.7 percentage points (see also Abbas and Klemm 2012 on developing economies). Interestingly, the Devereux et al. study indicates that international tax competition takes place only among countries that have removed their capital controls. When such controls are in place, capital and profits cannot move as easily across national borders and there is no downward pressure on capital taxes. So the removal of capital controls appears to be a factor in driving the reduction in corporate tax rates.

On the other hand, there is scant evidence of similar races to the bottom in labor and environmental standards or in financial regulation. The geographically confined nature of the services (or public goods) offered by national jurisdictions often presents a natural restraint on the drive towards the bottom. If you want to partake of those services, you need to be in that jurisdiction. But corporate tax competition is also a reminder that the costs and benefits need not always neatly cancel each other. Though it is not a perfect substitute for local sourcing, international trade does allow a company to serve a high-tax market from a low-tax jurisdiction. The problem becomes particularly acute when the arrangement in question has a “solidarity” motive and is explicitly redistributive (as in many tax examples). In such cases, it becomes desirable to prevent “regulatory arbitrage,” even if it means tightening controls at the border.

#### Asserting the right to institutional difference<sup>4</sup>

In Rodrik (2011), one of the principles I propose for a “sane globalization” is that we need to accept the right of individual countries to safeguard their domestic institutional

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<sup>4</sup> This section draws heavily on Rodrik (2011), chap. 11.

choices. The recognition of institutional diversity would be meaningless if nations were unable to “protect” domestic institutions—if they did not have the instruments available to shape and maintain their own institutions.

Advocates of globalization lecture the rest of the world incessantly about how countries must change their policies and institutions in order to expand their international trade and become more attractive to foreign investors. This way of thinking confuses means for ends. Globalization should be an instrument for achieving the goals that societies seek: prosperity, stability, freedom, and quality of life. Whether globalization in fact sets off a “race to the bottom” or not, we can break the deadlock between the proponents and opponents of globalization by accepting a simple principle: countries can uphold national standards in labor markets, finance, taxation and other areas, and can do so by raising barriers at the border if necessary, *when international trade and finance demonstrably threaten domestic practices enjoying democratic support* (Rodrik 2011).

The principle rules out extremism on both sides. It prevents globalizers from gaining the upper hand in cases where international trade and finance are a backdoor for eroding widely accepted standards at home. Similarly, it prevents protectionists from obtaining benefits at the expense of the rest of society when no significant public purpose is at stake. In less clear-cut cases where different values have to be traded off against each other, the principle forces internal deliberation and debate—the best way to handle difficult political questions.

One can imagine the questions a domestic political debate might raise. How much social or economic disruption does the trade in question threaten? How much domestic support is there for the practices, regulations, or standards at stake? Are the adverse effects felt by

particularly disadvantaged members of society? How large are the compensating economic benefits, if any? Are there alternative ways of achieving the desired social and economic objectives without restricting international trade or finance? What does the relevant evidence—economic and scientific—say on all these questions?

If the policy process is transparent and inclusive, these kinds of questions will be generated naturally by the forces of competition among interest groups, both pro- and anti-trade. To be sure, there are no fail-safe mechanisms for determining whether the rules in question enjoy “broad popular support” and are “demonstrably threatened” by trade. Democratic politics is messy and does not always get it “right.” But when we have to trade off different values and interests there is nothing else to rely on.

Removing such questions from the province of democratic deliberation and passing them on to technocrats or international bodies is the worse solution. It ensures neither legitimacy nor economic benefits. International agreements *can* make an important contribution, but their role is to reinforce the integrity of the domestic democratic process rather than to replace it.

Using restrictions on cross-border trade or finance to uphold values and regulations at home must be sharply distinguished from using them to impose these values and regulations on other countries. Globalization’s rules should not force Americans or Europeans to consume goods that are produced in ways that most citizens in those countries find unacceptable. Neither should they require nations to provide unhindered access to financial transactions that undercut domestic regulations. They also should not allow the U.S. or the European Union to use trade sanctions or other kinds of pressure to alter the way that foreign nations go about

their business in labor markets, environmental policies, or finance. Nations have a right to difference, not to convergence.

### Concluding remarks

The design of institutions is shaped by a fundamental trade-off. On the one hand, relationships and heterogeneity push governance down. On the other, the scale and scope benefits of market integration push governance up. A corner solution is rarely optimal. An intermediate outcome, a world divided into diverse polities, is the best that we can do.

Our failure to internalize the lessons of this simple point leads us to pursue dead ends. We push markets beyond what their governance can support. We set global rules that defy the underlying diversity in needs and preferences. We eviscerate the nation state without compensating improvements in governance elsewhere. The failure lies at the heart of globalization's unaddressed ills as well as the decline in our democracies' health.

The answer to my title "Who needs the (nation) state?" is: we all do.

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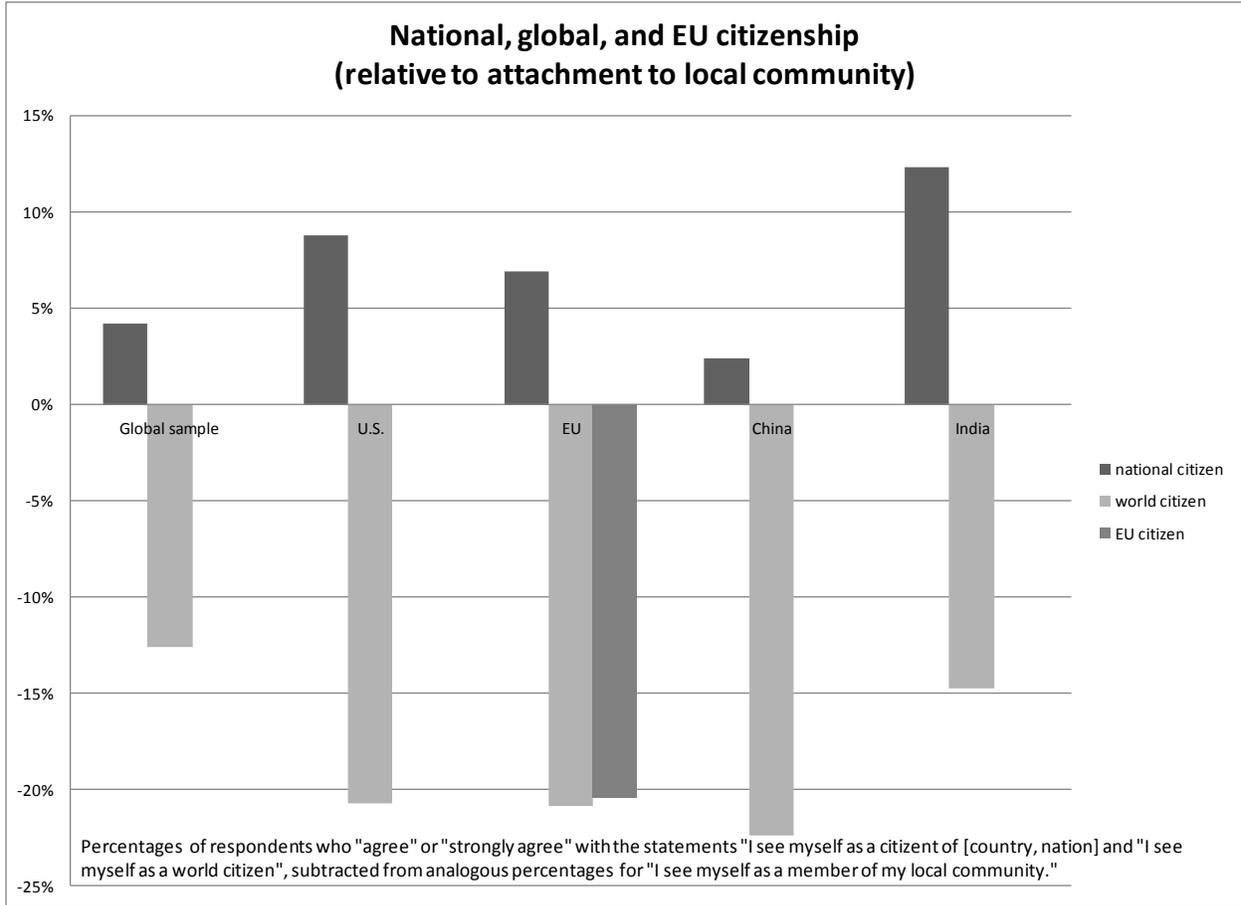
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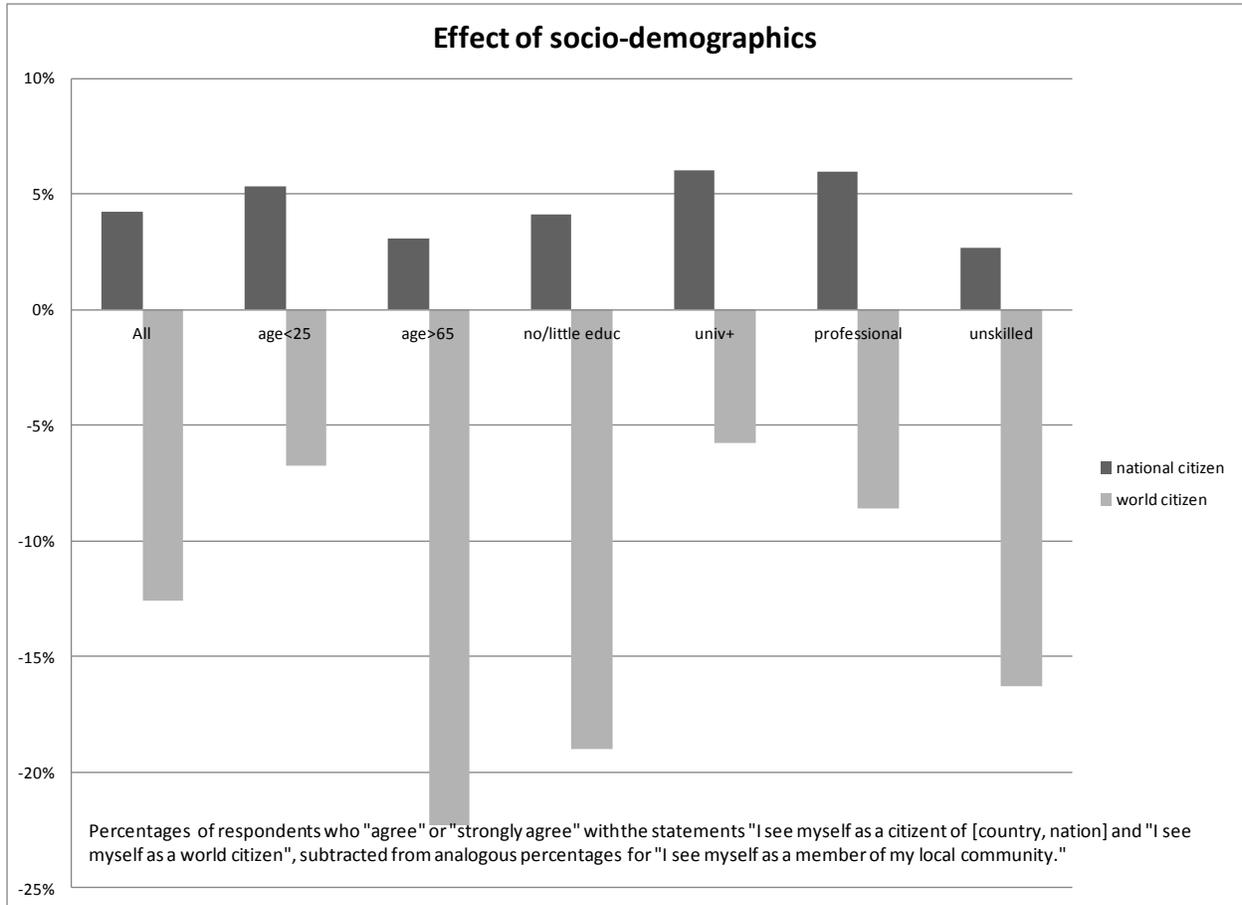
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**Figure 1:** Comparing national and global attachments: survey evidence

**Source:** See text.



**Figure 2:** Comparing national and global attachments: effect of socio-demographics

**Source:** See text.

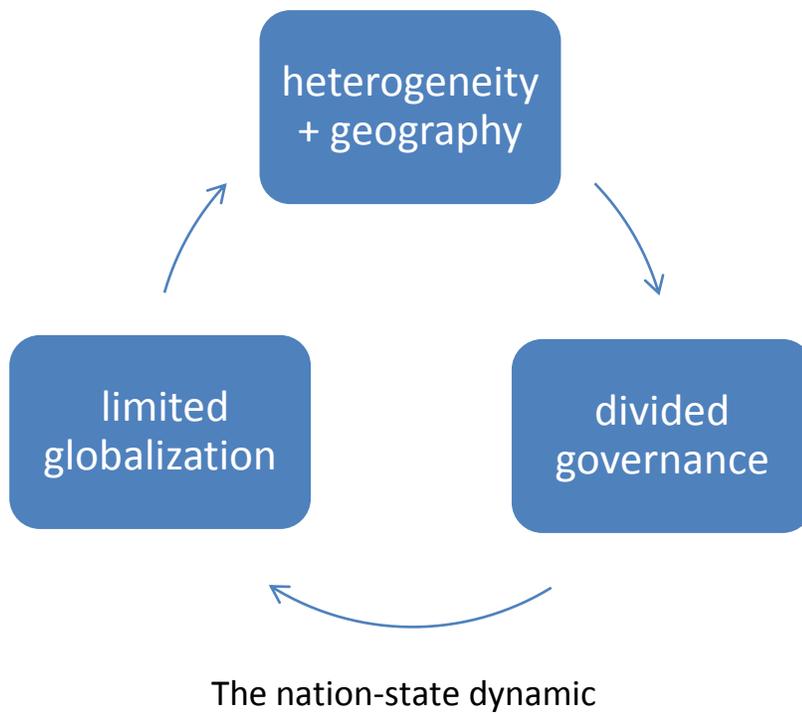


Figure 3: The dynamics supporting the globalist and nation-state equilibria

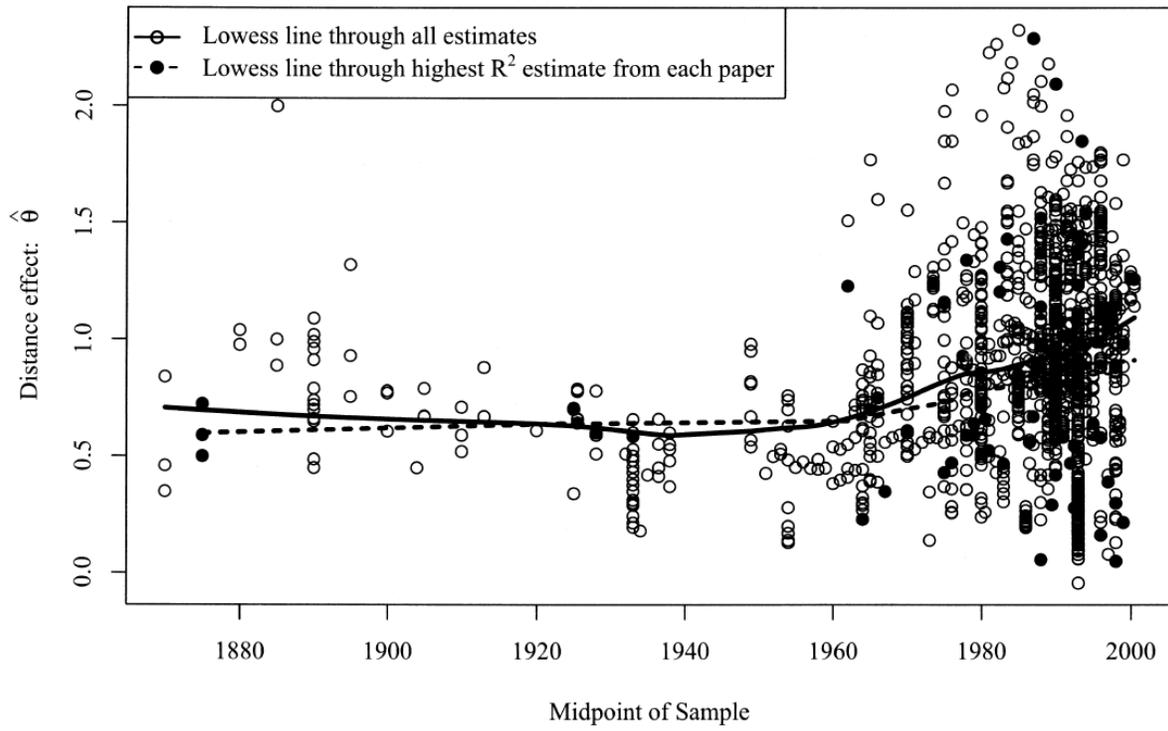


Figure 4: The gravity effect in trade over time

Source: Disdier and Head (2008)