Decentralizing Governance¹

Excellencies and distinguished delegates:

This is a truly extraordinary time. The open liberal democratic market system that brought the world enormous prosperity in the six decades or so after the Second World War is now under attack. The loudest critics are not the usual radical academics or leftist leaders. Instead, they come from the administrations of some of the most prosperous nations in the world, nations that have benefited tremendously from the open world order. Emerging markets and developing countries will have to take more responsibility in the fight to keep the world open. To have a chance of succeeding, though, the disparate effects of globalization and technological change, within and across countries, will have to be managed better. We may even need to contain some aspects of globalization to preserve an open world. Let me explain.

For many decades, we in the developing world were told that we should join the global trading system, and be open to foreign direct investment. While we recognized that this would affect some of our people adversely, we were pressed to see this as an inevitable cost of development. Perhaps because democracy was still nascent in our countries, we implemented this advice, overriding domestic opposition wherever it emerged. We recognized that becoming part of global supply chains would be a way for our industrial sectors to be pulled into the twenty first century. And at a macroeconomic level, it has worked. Global trade and investment, and global competition more generally, has enhanced prosperity in many developing countries.

The rising tide has not lifted everyone, of course. Studies show that in trade-affected districts in India, the incidence of poverty was relatively higher, as was violent crime and property crimes.¹ The reality is that trade, while typically beneficial overall, has a distributional impact, creating winners and losers. That implies we have to work harder, whether in developing countries or industrial countries, to help the affected adjust. It is not, however, a license for protectionism.

Yet that is indeed what we see arising in parts of the industrial world; as developing countries have learned to play by the rules of the open world order, industrial countries claim they are cheating, and want to change the rules. Undoubtedly, there is some cheating. But why not tackle it directly instead of changing the rules?

Protectionism is self-defeating because, almost surely, the future interests of all industrial countries lie in having an open world. Protectionism does not really help preserve jobs – in this competitive world, jobs gained by a country in the protected sector are often lost in other sectors that are now rendered uncompetitive because they pay higher prices for inputs. Also, protectionism offers little defense against the job-destroying effects of automation and AI, which often are the larger source of job losses. The only guarantee against redundancy is to help the workforce stay ahead through constant retraining. Moreover, as populations age in industrial countries, more of them will become reliant on foreign demand from younger countries to boost growth. Is it wise to block imports today from the very countries you will have to export to in the future? Probably not!

¹ Delivered by Raghuram Rajan, professor at the University of Chicago Booth School, at the United Nations on 15th April 2019. The speech draws on The Third Pillar: How Markets and the State leave the Community behind.
At the same time, industrial countries cannot afford to ignore the democratic reaction from those left behind by globalization and technological change. Neither should developing countries. If we want to address their concerns while preserving an open world, what should we do?

We should start by recognizing that the globalization of trade and investment flows has disempowered people and their communities. There is nothing sinister about this, it is a consequence of market integration. As markets expand across political borders, participants prefer a common governance structure that eliminates annoying regulatory differences and transaction costs. Historically, such integration happened within countries -- as inter-regional trade within a country increased, demands for seamless regional borders and harmonized national regulation became louder. National governments therefore increased their powers and functions at the expense of regions and local communities.

In turn, as globalization accelerated in recent decades, national governments acceded to international agreements and treaties that limited their sovereign powers. For example, the European Commission’s harmonization of economic regulations across the European Union limits the regulatory discretion of individual member states. This has catalyzed movements seeking to reclaim national sovereignty, like that of the Brexiteers.

But even as power (and often funding) has moved from local to national and then the international level, the impact of globalization and technological change has varied greatly across communities in industrial countries, much as it did in developing countries. Mega-cities such as New York have prospered while semi-urban communities such as steel-making Granite City, Illinois have experienced diminishing economic activity and opportunity.

That there are islands of economically depressed communities in industrial countries is not new. What has changed is that the ongoing information and communications technology revolution has now made a very good education or highly developed skills a prerequisite for well-paying jobs. And in communities hit by economic adversity, it is much harder for young people to acquire capabilities; widespread local unemployment, with little hope of economic revival, frequently leads to a precipitous decline in the quality of local institutions such as schools, as well as social breakdown – broken marriages, teenage pregnancies, and substance abuse. The most able people escape the sinking community, leaving the rest further mired.

Such vicious cycles – economic hardship causing social decline causing yet further economic adversity – create additional impediments like local crime that block the community from participating in national growth. As jobs disappear and local institutions like schools decay, people in these communities lose hope for themselves and even their children. No wonder they are angry and clutch at straws like protectionism. In sum, the de-industrialization of large areas of the industrial world, and the political disturbances it is creating, has become an important challenge to global prosperity.

What is to be done? At one level, people want more democratic control over their futures. If we are to preserve the global integration of markets, we may have to give up the hyper-integration of governance. We may have gone too far toward standardizing and harmonizing laws and regulations across countries in an effort to accommodate market integration. In this age of artificial intelligence, companies and traders can surely handle some national regulatory differences. Could we not bring more powers back to the country level, provided global markets remain open?
Yet, the devolution of power cannot stop at the national level. Paraphrasing Tolstoy, every unhappy local community is unhappy in its own way. Policies to stimulate national growth have little effect on these disconnected, depressed communities. Mainstream economists have therefore started calling for more targeted “place-based” policies that would channel economic activity to these areas.

Often, this simply means offering tax incentives for investing in an economically depressed area. However, such policies may be no solution for the local community -- even an investment creating good well-paying jobs may be wrong for a community. For example, Amazon's decision to site its HQ2 in Queens, promising 25000 new jobs paying an annual average salary of at least $150,000, was the ideal outcome of “place-based” tax incentives. Yet, local politicians rejected it – possibly because too few in the community had the skills to get the jobs, while the influx of skilled outsiders could have raised rents and property taxes, pushing out old-time residents.

More generally, when projects and policies are determined far away from the end beneficiaries, they tend to flounder on the hard-to-map shoals of local conditions. To revive a community, success stories suggest “place-based” policies have to come from within – much as the policies for countries in the audience that have succeeded in growing out of poverty have come from within.

Often, driving the turnaround is a motivated local leadership team, which assumes responsibility, takes stock of the community’s capabilities and deficiencies, identifies hidden resources as well as critical impediments, then by trial and error, expands activity. The key is to empower and motivate such leadership and to restore links to the thriving national and global economies, so the community can piggy-back on broader growth.

While community leadership should drive the efforts, coordinating between local institutions, business, and national government, none of this is to suggest they can do it all on their own. The national government can help declining communities hold on to talented people, from whose midst leadership could emerge. More untied funding can be devolved to the local community so that the community can invest in necessary projects. Data on new metrics such as the community’s use of funds, the quality of local jobs, and the flows of residents can be collected, monitored, and used in deciding further support. And, of course, the government can provide for infrastructure like physical connectivity and broadband access, tying the community in with the larger national and global market.

In sum then, we must preserve a world open to trade and investment. To do so with democratic support, we must follow the principle of subsidiarity more strictly – decisions should be taken at the lowest level consistent with effective governance, though of course, taken responsibly keeping in mind spillovers on everyone else. Given the very different impact of globalization across countries and within countries, we must create more room for countries to choose their unique way of coping. And countries themselves will have to further decentralize power so that differentially affected communities can chalk out their own paths. This is as much a developed country problem as a developing country problem. Globalization of markets may, paradoxically, require far more localization of governance.

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