Globalization and Governance

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1 Global governance

A relational contracting approach

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Governance and globalization have long been central concerns of international relations. Throughout the history of the discipline, scholars have examined how states, groups, corporations, and other actors organize themselves politically within the international arena. This concern was most recently manifested in the literature on international regimes (see Krasner 1983 and Keohane 1984). The end of the Cold War, the apparent growth of supra-national institutions in Europe, and rising concerns with environmental degradation and other transborder externalities are now sparking a broader inquiry into global governance. Likewise, for decades, scholars have studied how economic flows, migration, and other interactions shape international politics, first in the work of Karl Deutsch and his collaborators (see Deutsch, *et al.* 1957) and, later, in the literatures on transnational relations and interdependence (see Keohane and Nye 1972 and 1977). The explosion in the frequency, types, and magnitudes of transborder activities over the last decade has stimulated new interest in globalization.

These two concerns are increasingly seen as linked. Globalization, it is commonly averred, is breeding new forms of governance, either in the guise of impersonal markets (Strange 1996) or private, "sovereignty-free actors" such as multinational corporations, transnational societies, and international organizations (Rosenau 1990). While globalization is no longer expected to render states obsolete (contrary to Kindleberger 1969 and Vernon 1971), many analysts have nonetheless concluded that political authority within the international system is becoming more diffuse. Susan Strange (1996, 84) argues that "the reality of state authority is not the same as it once was." Jessica T. Mathews (1997, 50) writes that:

> National governments . . . are sharing powers – including political, social, and security roles at the core of sovereignty – with businesses, with international organizations, and with a multitude of citizens groups. . . . The steady concentration of power in the hands of states that began in 1648 with the Peace of Westphalia is over, at least for a while.

Richard Rosecrance (1996) wryly observes that we now live in the age of the "virtual state."

Despite this long history and growing academic attention, the concept of governance and its relationship to globalization remain poorly understood. This paper offers a framework for thinking about issues of governance and globalization, and provides an interpretation of current and future trends in both domains. The analysis is intended to be suggestive rather than definitive, to place the study of governance and globalization on the right track rather than steer it into the final station. In this chapter, I develop three themes, taken up section-by-section below. All run contrary to the current conventional wisdom.

First, as a discipline, international relations typically employs an extremely attenuated definition of governance. Both yesterday and today, there is a wide variety of governance structures in international relations, including a fair number of hierarchies.

Second, current studies of global governance, embodied in the literature on international institutions, are plagued by selection bias. Once the full range of governance structures is properly conceptualized and a model developed, it becomes clear that we cannot generalize from international institutions to the larger question of global governance without taking this bias into account.

Third, globalization is the product of a particular form of governance rooted in the domestic political economies of the early industrializers. Based upon a "watchman" state, this domestic governance structure has been generalized to, and has created a large sphere of private activity within, the international arena. Together with the permissive conditions of a world system broken into separate, national "sovereignties" and technological change that reduces the costs of communication and transportation, this governance structure provides the foundation for globalization. In turn, there are immense sources of inertia in our present form of global governance. If some more hierarchic form of global governance were to emerge, it would encroach upon and possibly undermine the conditions necessary for globlization. By itself, globalization has little potential for transforming international relations.

What is global governance?

The term global governance lacks any accepted definition. As one analyst puts it:

> The word . . . presents dangers and opportunities to anyone who would reopen the question of global governance, though the term itself lacks in precision what it offers in its novelty. It is quite certain in most people' s minds that *governance is not government*. . . . But beyond that negative

> stance, the concept of global governance needs to be clarified, amplified and, if thought desirable, made operational.
>
> (emphasis in original; Desai 1995, 7)

The Commission on Global Governance (1995, 2) defines their subject as "the sum of the many ways individuals and institutions, public and private, manage their common affairs. It is a continuing process though which conflicting or diverse interests may be accommodated and co-operative action may be taken." Leon Gordenker and Thomas Weiss (1996, 17) define global governance as "efforts to bring more orderly and reliable responses to social and political issues that go beyond the capacities of states to address individually." Oran Young (1994, 15), in turn, defines governance as

> the establishment and operation of social institutions (in the sense of rules of the game that serve to define social practices, assign roles, and guide interactions among the occupants of these roles) capable of resolving conflicts, facilitating cooperation, or, more generally, alleviating collective-action problems in a world of interdependent actors.

James N. Rosenau (1992: 5) offers the most succinct and, in some ways, most insightful definition: "governance is order plus intentionality."

These definitions properly direct our attention to the interdependent nature of decision making and the attempt by actors to "manage" or produce more "orderly" responses to common problems. Nonetheless, they blur two analytically distinct political processes: bargaining, which divides the available costs and benefits between actors, and contracting, which enforces the bargains reached. It is the enforcement of bargains that we intuitively mean by the term governance.[1]

It is the design, construction, and maintenance of mechanisms to enforce agreed upon behaviors that lies at the heart of contracting, as a process, and governance, as both an analytic concept and the set of mechanisms actually employed. All contracts, or governance structures, include provisions for monitoring the behavior of others and safeguards for altering the incentives of others and, frequently, oneself (Williamson 1985). Governance structures may be formal, as found in written constitutions or ratified treaty documents, or informal, as in unwritten constitutions based on common law and precedent or some international regimes (Lipson 1991).

Bargaining and contracting are obviously related, with each dependent upon the other (see Fearon 1998). Some feasible bargains may lack any effective contract, and thus are impossible to reach in practice; knowing that the bargain cannot be enforced, actors will not agree to that division in the first place. The initial and on-going costs of the contract may also be greater than the joint gains, again rendering any bargain impractical. Different bargains, in turn, may require different sorts of contracts, and in a world of limited options the nature of the contract may follow simply from the bargain reached. Given the necessary relationship between bargaining and contracting, the two processes will often, in practice, unfold simultaneously. Moreover, since contracts will often determine which bargains are feasible, much of the negotiation or apparent "bargaining" between the actors may well be over alternative contracts, which then logically produce different substantive outcomes with different distributional consequences. Nonetheless, bargaining and contracting are analytically distinct processes. Contracting and governance are concerned not with the substance of agreements but with securing and enforcing those agreements.

Contracts specify, implicitly or explicitly, the rights of residual control retained by each party to the contract. This is a central feature of all governance structures, and it is the primary dimension of variation that I focus on in this chapter. In a world of bounded rationality or costly information, all contracts are necessarily incomplete (Williamson 1985). It is either impossible or too costly to specify actions required by the parties in all possible states of the world. Rights of residual control determine who decides what in these unspecified or unspecifiable futures (see Grossman and Hart 1986). It is important to emphasize that the term "right," as used here, does not necessarily imply a formal recognition by the parties to a contract of the authority to exercise control over the residual areas of decision; it can simply reflect an informal ability by one party to control the behavior of the other over some areas. Rights differ from mere influence, however, by constituting an enduring pattern of control within an on-going relationship.

Sovereign states, whatever agreements they may enter into, retain all residual rights of control; this is the "constitutional independence" that Alan James (1986) sees as the defining characteristic of sovereignty. Thus, states may agree to come to one another's aid in case of attack by a third state, but each is free to determine whether an attack has in fact occurred and how it will respond. Again, it is this vesting of residual rights in the contracting parties themselves that classifies states as independent or, in international relations terminology, sovereign. In an empire, on the other hand, all residual rights of control are vested in the imperial state. However extensive the autonomy granted to the colony, the imperial center retains the right to determine actions by the subordinate colony outside the designated areas. It is the lodging of residual rights of control in only one party to the contract that creates a hierarchy.

Rights of residual control also differ within states. Unlike in more centralized regimes, rights of residual control are divided across many actors in the United States, creating a decentralized or comparatively "flat" and "anarchic" political system. The tenth amendment to the constitution clearly specifies that all rights not otherwise specified "are reserved to the States, respectively, or to the people." Most state constitutions contain a similar provision. Thus, by design, residual rights of control are divided between "the people" and, in defined areas, the states or the federal government. These rights have also evolved over time, gradually shifting to the federal level. An important basis for this shift has been the vesting of the right to interpret the federal constitution in an entity of the federal government, namely the Supreme Court. Through the interpretations of the Court, the residual rights of the federal government have been progressively expanded and the rights of the states correspondingly shrunk.

Although the language of "contracting" is often understood to imply voluntary agreements between actors, governance and especially rights of residual control are highly political and intimately related to issues of power.[2] Power can be disaggregated into capabilities – the raw materials of power – and decision-making ability. Although international relationists, in general, tend to ignore the second attribute of power, both are necessary to its effective use. Capabilities matter only when the actor has the ability to decide to manipulate its resources to its advantage.

Residual rights of control, in turn, define the what the actor can and cannot decide, and thus are central to the structure of power and its use. For example, the trade dependence of an imperial state upon its colony gives the latter the capability to impose punishments or rewards upon the former, but the colony lacks the ability to decide to exercise that influence. Without an independent state to define autonomous goals and implement strategies, the colony lacks the ability to "decide." This formulation of power parallels definitions of structural or the second face of power (Lukes 1974). Politically weak and disenfranchised actors often have the capability to wield substantial influence, but in the absence of any political apparatus they lack the ability to choose to exercise their power; thus, their influence remains latent.

In addition, contracts are often founded on and maintained by coercion – further reflecting their basis in power.[3] Coercion can be understood as a substitute for the compromises that would be necessary in otherwise "voluntary" negotiations. In order to ensure that it cannot be exploited in the future by its partner, a state may insist upon detailed contractual provisions that ensure its ability to monitor and enforce an agreement. When faced with a coercive threat from its partner, however, that same state may capitulate and accept a much "weaker" contract – or even be forced into a relationship against its will. Even possible threats – the "shadow of force" – can alter the terms of a contract. As a result, contracts both aim to alter the incentives of the actors, and thus are an exercise of power, and reflect the power of the actors. In the presence of coercion, contracts need not be "fair," "equal" or pareto-improving. Indeed, although the subordinate party will seek to limit its exploitation as much as possible through the contract, the contract itself may be an instrument of its own subordination.

Implications

This conception of governance has at least three implications for our understanding of international relations. First, as frequently noted in the existing literature, governance is not equivalent to government or formal institutions. As Young correctly notes, there is nothing in the concept of governance "that presupposes the need to create material entities or organizations (that is, governments) to administer the rules of the game that arise to handle the function of governance" (1994, 15–16; see also Rosenau and Czempiel 1992). All contracts, whether formal or informal, constitute governance.

Second, governance is a variable. Anarchy, which vests residual rights in states, is but one form of international governance; hierarchy is a second form, and there are mixed types in-between (see Lake 1996 and 1999). Along this continuum, relationships vary in the rights of residual control retained by the actors. As relations move from anarchy to hierarchy, actors are ceding greater rights over more issue areas to their dominant partners. Even within states, moreover, variations in governance can occur, providing a useful basis for diachronic and synchronic comparisons. There is no reason, even within systemic theories of international relations, to treat anarchy as a constant and unchanging feature of the global environment. Nor does the distinction between hierarchy and anarchy cleanly distinguish domestic from international political systems (contrary to Waltz 1979; see Milner 1991). There are elements of anarchy in nearly all polities, just as there are elements of hierarchy in world politics. Both domestic and international political systems should be understood as varying along a continuum.

Empirically, and limiting ourselves to traditionally "international" interactions, there has been a wide variety of relations. Even in the security arena, where states might be expected to worry most about hierarchical ties, we observe historically a range of relationships, some of which – like spheres of influence – have long been part of international relation's lexicon but have not been integrated in our theoretical paradigms in any consistent way. Elsewhere, I have posed a continuum of security relationships, defined by decreasing rights of residual control possessed by the subordinate polity (Lake 1996 and 1999). This continuum ranges from anarchic *alliances* (each party remains fully sovereign), to *spheres of influence* (the subordinate member gives up the right to ally with states other than the dominant party), to *protectorates* (the subordinate member cedes rights over its foreign policy), to *informal empires* (a broad range of residual rights are transferred to the dominant state), to *empire* (nearly all rights of residual control are vested in the dominant state).

While examples of alliances and empires come readily to mind, the range of intermediate relationships is actually quite broad and almost obvious once depicted in these terms:

- under the aegis of the Monroe Doctrine, the United States has possessed a sphere of influence (at least) over all of Latin America from early in the nineteenth century;
- during the Persian Gulf War, the United States created a protectorate over Saudi Arabia and the other Gulf states; once American troops were deployed in the kingdom, the Saudis lost their ability to conduct an independent foreign policy toward Iraq;
- following World War II, the Soviet Union established an informal empire over the nominally sovereign but subordinate states of Eastern Europe; this informal empire collapsed only in 1989.

All of these examples are typically treated as anarchic relations, but simultaneously recognized as somewhat anomalous. The Warsaw Pact, for instance, was called an alliance by the member states and Western analysts, but the latter, at least, typically recognized that the label fitted poorly; the Soviet Union intervened deeply into the domestic political and economic affairs of the subordinate members. As these examples suggest, once we begin to look for variations in rights of residual control, we can readily see that, at least at the dyadic level, anarchy is not a constant. Instead, international politics can be more properly seen as a rich tapestry of relations of varying degrees of hierarchy.

Third, global governance is not limited to contracts between states. Two examples can help make this clear. Considerable attention has recently been devoted to the role of non-governmental organizations (NGOs) in monitoring international accords, particularly in the areas of the environment and human rights (for instance, Weiss and Gordenker 1996, Salamon 1994). Far from anomalous, using private groups to gather information and pull "fire alarms" (McCubbins and Schwartz 1984) is standard operating procedure for governments around the world – both in their domestic affairs and foreign relations. Rather than undertaking periodic monitoring themselves ("police patrols"), governments often empower groups and design political structures to induce groups with strong interests to perform this role. Affected economic groups, human rights organizations, and environmental activists (see Haas, this volume) all play important roles in monitoring national compliance with international commitments and, as such, are properly understood as part of the international contract regulating behavior in those areas.

Multinational firms have proliferated over the last fifty years through informal contracts with their home governments to secure their property rights abroad and often more formal contracts with host governments. Typically, agreements now cover a range of issues from ownership to export quotas and the training and promotion of local personnel. In the not too distant past, foreign direct investment often required hierarchical governance structures, especially in plantation agriculture and mineral extraction (Frieden 1994). With insecure property rights, large site-specific investments, but few firm specific assets, primary and raw material production was an easy target for nationalization. As a result, foreign investment required either direct or indirect rule by an investor country. Thus, foreign investment in extractive industries tended to occur within colonial or neo-colonial relationships, internalizing the investment in a formal or informal imperial relationship. As foreign investment in manufacturing increased over the early decades of the twentieth century, however, the need for political hierarchy diminished. Such investments were often not site-specific (the "footloose" multinational) but were highly firm-specific, resting on proprietary technology, firm reputation, or integration into a global production and marketing strategy. Since firm specific assets cannot be appropriated as easily by foreign governments, nationalization became far less effective and, therefore, less common. Multinational firms and governments, thus, could now contract independently over those aspects of the investment and production process that were more readily monitored and regulated by national authorities. Foreign direct investment ultimately became based on anarchic contracts between private firms and national governments (these agreements are possibly being codified into a multilateral agreement; see below).

Explaining global governance

Whenever actors cooperate, they must choose a relationship along the continuum of anarchy to hierarchy to govern their interactions. In this section, I briefly summarize a theory of relational contracting in international relations and discuss its implications for how we should study the effects of international institutions. Although I have developed the argument most fully for security relations (Lake 1996, 1997, 1999), I believe the theory is applicable also to cooperation in economic, environmental, and other affairs.

A theory of relational contracting

Theories of relational contracting, first developed in economics to explain the firm, are general theories of social relationships and, as such, can also be applied to politics (see Keohane 1984). As used here, the theory is informed by a central metaphor, namely, that the government is a firm producing goods and services in exchange for revenue. Whenever a government chooses to produce a good or service in association with another polity, it must choose a relationship to govern that cooperative enterprise. In this metaphor, an alliance is analogous to an arm's length contract between separate firms, while an empire is akin to integration within a single firm. The decision to cooperate and, if so, the choice between alternative governance structures, I argue, is a function of three main variables.[4]

Joint production economies determine the gains from cooperation, and thus form a crucial determinant of whether polities act unilaterally or pool their resources and efforts with others. Joint economies derive from technological scale economies, the division of labor, and positive externalities. They are always at least as great in cooperation as in unilateralism, but some technologies are utilized properly only in conjunction with others, the division of labor is possible only with partners, and actors can reduce redundant efforts only when positive externalities are "internalized" in some cooperative relationship. The greater the joint economies, the greater the resources saved by cooperation. Joint economies, in turn, are partly endogenous to the relationship; the less opportunistic their partners, the more deeply actors will invest in technologies, divisions of labor, and positive externalities that are contingent on the actions of those partners.

All actors are opportunistic, or self-seeking with guile (Williamson 1985). In any relationship, actors will seek to manipulate its terms to their advantage, abandoning, entrapping, or exploiting their partners whenever possible. The cost to an actor of opportunistic behavior by its partner is determined by the extent of its relationally specific assets (Klein *et al.* 1978). If it has incurred investments that are of value only in that relationship, such as dedicated plant and equipment for firms or overseas bases for states, opportunism will be very costly. The probability that a partner will act opportunistically, however, is a function of the governance structure or relationship the parties construct. Given some set of behaviors required by a contract, the ability to act opportunistically is determined by the rights of residual control. If the actor has no rights of residual control – no ability to decide anything outside the immediate terms of the contract – it cannot (or is significantly less able to) behave opportunistically; the decision whether to honor the contract and what to do when the contract does not specify action under some circumstance is entirely in the hands of the dominant partner. Thus, hierarchy reduces the probability that opportunism will occur. The *expected* costs of opportunism, holding joint production economies constant, decline as relations move from anarchy to hierarchy, creating an incentive for actors to create hierarchies when the potential costs or risks of opportunism are large.

Governance costs arise from the direct and indirect value actors place on the residual rights of control. In international relations, rights of residual control – embodied in the concepts of freedom, independence, and autonomy – are often valued on their own terms, as arguments in an actor's utility function. Residual rights of control may also be valued for their incentive effects. For a subordinate actor, any residual rights it cedes to a dominant actor will, presumably, be exercised to choose behaviors that it alone would not select. Any gains it receives from cooperation dependent upon the transfer of residual rights, therefore, will be less valuable to it, in the short run, and may lead to secondary distortions in its incentives in the long run. In order for the subordinate actor to cede rights to the dominant actor, it must either be compensated for the loss in autonomy and the distortions that are engendered by the dominant actor, or coerced, both of which, paradoxically, transfer the costs of hierarchy onto the dominant actor. The dominant actor, in turn, may also be required to bind itself not to act opportunistically toward the subordinate actor, reducing the value of the residual rights transferred to itself. In order to gain the compliance of the subordinate actor, the dominant actor may restrict its own powers or send some costly signal, imposing costs on itself in order to secure hierarchy over the other. Arising from both the need to compensate or coerce the subordinate actor and tie its own hands, the governance costs to the dominant actor escalate with hierarchy and deter actors from pursuing such governance structures.

As the expected costs of opportunism decline with hierarchy, while governance costs rise with hierarchy, there must exist some optimal relationship along the continuum defined above. The net gains from the optimal relationship are then assessed against the baseline gains from unilateralism. The greater the joint economies, the lower the expected costs of opportunism, and the lower the governance costs, the more likely actors will be to choose some form of cooperation. The lower (greater) the expected costs of opportunism or the greater (lower) the governance costs, the more likely actors will be to choose relatively anarchic (hierarchic) relations.

International institutions and governance

By focusing almost exclusively on anarchic international institutions, a specific form of governance, analysts have unwittingly created a significant selection bias in their studies of international relations. The theory just summarized implies clearly that conclusions based on extant international institutions cannot and should not be generalized to global governance (contrary to Murphy 1994, 1).[5]

Realists claim that international institutions are epiphenomenal (Krasner 1983; Strange 1983, and Mearsheimer 1994–95). Institutions do not prevent states from "defecting" and pursuing their self-interest whenever it serves their purpose. When institutions do appear to be effective, on the other hand, it is because the interests of states actually coincide. Likewise, neoliberal institutionalists have not been able to demonstrate conclusively that international regimes matter.[6] These conclusions are highly circumscribed.

As explained above, states enter into anarchic relationships only when the gains from cooperation are sufficiently large, the expected costs of opportunism by their partners are sufficiently low, and the costs of constructing more hierarchical structures are sufficiently high. In other words, we observe anarchic relations – e.g., international institutions – only when states reach the conclusion that an anarchic contract is the most cost-effective way to preserve the gains from cooperation against opportunism by their partners. When examining international institutions, then, we are selecting one of two sets of conditions.

In the first instance, the gains from cooperation are large and governance costs rise rapidly with hierarchy. Attracted by the gains from pooling resources and efforts with others, but repelled by the high costs of building and maintaining hierarchy, states choose anarchic relationships and accept high expected costs of opportunism by their partners. In this case, states anticipate that they will be exploited by their partners, but they also calculate that, on balance, the gains from cooperation are worth the risk. In this case, the institutions are not expected to be very constraining; that we observe lots of opportunistic behavior here is not surprising.

In the second instance, the gains from cooperation are low, but the expected costs of opportunism are even lower, perhaps because the interests of states are closely aligned, the realist case, or few specific assets are at risk. Under this circumstance, anarchy is sufficient because states believe it is unlikely that their partners will act opportunistically or, if they do, it will not be very costly. Thus, an anarchic form of cooperation is selected by states precisely because there is not much at risk. That the self-interests of states do not lead them to defect under this circumstance should not be surprising.

By examining the effects of extant international institutions on cooperation, then, we are selecting instances in which states are expected to defect, but the gains are nonetheless worth the risk, or the weak constraints of an anarchic governance structure are sufficient to safeguard the agreement. In both cases, we would draw the correct conclusion that institutions do not "matter," but it would be a mistake to conclude that governance, more generally, is unimportant. By examining international institutions, we do not observe cooperation that requires and occurs only within more hierarchic governance structures. Similarly, we do not observe cooperation that fails to occur because the gains are too small, the expected costs of opportunism are too large, or the governance costs of hierarchy rise too rapidly. Cooperation that occurs within extant international institutions is a product of the very features realists rely upon to demonstrate the epiphenomenal nature of institutions.

By similar logic, international institutions will have only a minimal effect on "transactions costs," an ambiguous label used in the literature to refer to both the expected costs of opportunism and governance costs. Wayne Sandholtz (this volume) and others criticize new-institutionalist accounts of international regimes because there is little direct evidence that transactions costs are reduced by such cooperative agreements. While transactions costs are notoriously difficult to measure, the selection bias introduced by studying only anarchic international institutions suggests a second and equally important problem. International institutions are likely to exist precisely in those areas where transactions costs are relatively modest, and thus hardest to observe. In the first instance noted above, the expected costs of opportunism may be large, but the governance costs in anarchy are comparatively low – each type of transactions costs offsets the other. In the second instance, both the expected costs of opportunism and governance costs in anarchy are negligible. Analysts look for the transactions costs-reducing effects of international institutions exactly where they are hardest to find.

If we want to observe where global governance and relational contracting matters most, we need to expand our analytic horizons beyond existing international institutions to empires; multinational states, like the Soviet Union, that subsume numerous would-be polities; private actors, such as MNCs or NGOs; and other, more hierarchic entities. We also need to probe more effectively plausible counterfactuals: for instance, why are the United States and Canada two separate states or, for that matter, why is the United States not fifty independent countries? We have failed to look for such relationships and ask such questions only because of our collective fascination with and acceptance of anarchy as the organizing principle of international relations not only at the systemic level, where it of course still holds, but in the relations between states and other international actors. To see governance in action, we need a broader lens. The narrow one commonly used distorts our vision.

Governance and globalization

Globalization is one of the dominant trends of our time. Although, again, there is no consensus on what is meant by this term, it is usually associated with the following sorts of developments: the growth of political and economic interdependence at the world level; the erosion of space and local time as structures of economic life; and the homogenization of social life – especially at the elite level – through universal standards, products, and culture (see Mlinar 1992, 19–22; Boyarin 1994; Giddens 1990).

For many, globalization and global governance are intimately connected. As globalization occurs, states lose control over their destinies, problems become "bigger" than the capacities of individual governments, and states must delegate and possibly abdicate political authority to supranational entities with powers that more nearly coincide with the scope of the issues and actors to be managed. Thus, in this common view, globalization is a primary motor behind current trends toward expanded global governance (see Cerny 1995). In this section, I question this link between globalization and global governance and, in fact, reverse the causal arrow.

There are three necessary and, together, sufficient factors driving the process of globalization. First, as long recognized by world systems theorists, the rise of a global capitalist system was contingent upon the fragmentation of the international political system into competing states (Wallerstein 1979). The division of political authority into numerous units allowed private actors with non-site specific assets (i.e., internationally mobile assets) to "escape" national jurisdictions and play one state off against another, using the possibility of exit to negotiate for greater political freedom and larger rights of residual control (Bates and Lein 1985).

Second, until quite recently, most factors of production enjoyed only limited international mobility, restraining the process of globalization to small segments of the economy and society. Over the twentieth century, and over the last decade in particular, technological changes have reduced the costs of communication, transportation, and travel over distance, exposing much larger segments of the economy and society to deeper international interactions (see Kobrin, this volume; Mathews 1997).

Third, and perhaps most important for the purposes of this chapter, the domestic governance structures of the early industrializing states first created spheres of private activity and then helped generalize these spheres to the international arena. As I attempt to suggest in this final section, this particular form of domestic governance underlies globalization in a way that is seldom appreciated. These private actors are the prime movers behind globalization, integrating markets and societies, breaking the constraints of space and time, and erasing local variations. Multinational firms are exemplars, and under their actions globalization has reached farthest in the economic arena. Many NGOs, however, are also drivers of globalization; human rights organizations, for instance, propagate a universal standard of political and civil freedom that also reduces local variations in politics, societies, and cultures. To understand globalization, we must first understand how private actors established themselves within the domestic political economies of leading states.

I suggest below that there are, today, powerful vested interests who gain from this governance structure and, in turn, globalization. While globalization might appear to require new governance structures, there are important sources of inertia that thwart efforts to construct greater hierarchy at the global level. Somewhat paradoxically, were greater hierarchy to be achieved this would actually impede and possibly reverse the conditions for globalization.

The political origins of globalization

Private actors are central to the phenomenon of globalization. To probe the relationship between globalization and governance, therefore, it is appropriate to begin with an understanding of what we mean by "private." In terms commensurate with the conception of governance posed above, private actors can be defined by their possession of substantial rights of residual control. Just as we can distinguish between two separate firms and a single firm with two subsidiaries by who holds the rights of residual control, we can also distinguish between private and public actors by the vesting of these rights. While private actors may have many contractual obligations to the state, up to and including general loyalty, they nonetheless possess substantial residual rights. Public actors, on the other hand, lack such residual rights; they may have substantial authority delegated to them by the state, but residual rights are located in the state, not in the actors themselves. Between these two extremes, we can envision a continuum of quasi-public actors who have greater or lesser residual rights; "state-owned" firms, for instance, may have rights over pricing and production decisions, but not over wage, employment, or location determinations.

The predominance of private actors is, in part, a consequence of early industrialization in Britain and the United States and the generalization of this model of political organization to the international economy under their respective hegemonic reigns. As Alexander Gerschenkron (1962) first recognized, early industrialization required only a minimalist state. Recasting his argument in the terms of the theory above, early industrialization was led by small firms that generally lacked specific assets (see Kurth 1979; Landes 1998, 213–75). Without significant market power or strong incentives to exercise power, these early industrializing firms could not act opportunistically toward other social actors (such as labor) or the state itself. No strong political hierarchy was necessary to reduce the expected costs of opportunism or, to put it another way, increased hierarchy was more costly than the expected reduction in the costs of opportunism. Given the absence of large specific assets, anarchic state–society relations were sufficient. This resulted in a large private sphere that vested enormous residual rights in economic actors and produced the so-called liberal model.

As Gerschenkron also shows, late industrialization required larger scale economies within individual firms, which in turn produced significant firm specific assets and oligopolistic market structures. To achieve these greater scale economies required greater centralized direction of investment, thereby creating a role for the banks, in the case of Germany, and the state, in Russia and elsewhere. The presence of firm specific assets, however, also created a substantial risk of opportunism between firms and other social groups, especially labor, and firms and the state, all of whom could attempt to exploit each other. Thus, if late industrialization were to occur, the high expected costs of opportunism required a more hierarchical governance structure, a shift in the residual rights of control to the banks in Germany, who exercised control through firm debt, or to the state in others.[7] In the late industrializers, then, the private sphere was significantly smaller and economic actors retained substantially fewer rights of residual control. This model reached its extreme in the Soviet Union, as Gerschenkron also notes, where the state came to own all factors of production. In short, the firm specific assets characteristic of large-scale, late industrialization required more hierarchical governance structures within the domestic political economy.

Partly resting on the superior competitive abilities of their private firms, the hegemonies of the early industrializers helped to generalize their model of domestic governance to the international arena. Supporting their firms and, at least at the margin, helping to open foreign markets for their goods and investments, Britain and, later, the United States led the creation of "level playing fields" in which their producers could prosper (Gilpin 1977). In turn, the large private sphere of authority characteristic of their domestic governance structures was replicated at the international level, supporting and supported by a set of liberal rules governing exchange and factor movements (see Sandholtz, this volume).

Inertia

Governance structures within and between states endure because actors make ever greater relation-specific investments, and thus develop an interest in preserving the current structure (see Gourevitch 1999). As contracts, governance structures can and should be renegotiated as conditions evolve, depending on the rate of environmental change and the transactions costs of bargaining out a new set of rules and safeguards. Yet, we know that governance structures, particularly at the global level, are not continually renegotiated, even when conditions advance rapidly. The accumulation of relation-specific investments creates an important source of political inertia.[8]

Governance structures set the terms of political interaction between actors. They also produce sets of policies that may have differential rewards for investors. Anticipating the rules of the political game and the sets of policies they produce, actors make investments premised on their expectations of the future. If actors expect a large sphere of private activity, for instance, they will invest in assets which are most productive in that sphere. In making such investments, in turn, the actors acquire an interest in preserving the governance structure and the set of policies that follow from it. In other words, investors acquire specific assets – or "vested interests," in common parlance – based upon the current system and they will act politically to preserve that system. The *ex post* and *ex ante* political interests of investors differ and – although collective action problems also matter (see McGinnis, this volume) – it is this wedge that creates political inertia.

To help make this point clear, consider an example from American domestic politics. Following World War II, the United States government sought to encourage individual home ownership; accordingly, it offered a federal income tax deduction for interest paid on home mortgages, and millions of taxpayers took advantage of this incentive to purchase their own homes. Having made such a purchase, the incentives of these taxpaying voters changed: where prior to the policy they might have been agnostic if not hostile to tax incentives for home ownership, after their purchases they became vigorous advocates of continuing the deduction. Today, even the most strident advocates of tax reform usually recognize the political necessity of maintaining the home mortgage interest deduction.

At a more macro level, this same *ex ante* interest is reflected in the persistence of the early industrializing model in the United States, despite later challenges. Premised upon a large private sector that reflected the early American economy, the constitution left large residual rights of control to individuals and the states (see above). This large private sphere, in turn, was well suited for the requirements of early industrialization. Actors based their investments on the assumption of large residual rights of control, and subsequently acted to defend those rights when they later came under assault.

As scale economies increased with industrialization in the late nineteenth century, however, large firms and concentrations of economic power began to emerge. Although similar developments were occurring simultaneously in the late industrializers, either as cause or effect of greater state strength, in the United States the governance structure did not adapt. This was a particularly contentious period in American politics. Populists fought the trusts, especially the railroads, progressives attempted to mobilize the government to regulate business practices, and labor struggled to organize and bargain collectively (see Hofstadter 1955). Each group, in turn, won some successes: America's nearly unique anti-trust legislation was passed, some of the more egregious business practices of the era were mitigated, and the right to unionize was eventually recognized. However, the victories were limited. The watchman state was unable to obtain significantly greater control over the economy or adapt to the concentration of business. Big business used the existing rights of the already large private sphere to defend itself against greater public control, thereby retaining powers that in the late industrializers were being ceded to or exercised by the state. In addition, the opponents of business "pulled their punches." They wanted to preserve the large private sphere which was generally advantageous to them in other ways, so they limited their demands to those intended to counterbalance economic power but they never challenged the governance structure itself. Workers, for instance, demanded the right to organize and lobbied for new government regulations on business, but comparatively few became revolutionaries.[9] Thus, despite the changing nature of the economy, state and society remained autonomous and, at least compared to other countries going through similar economic transformations, relatively anarchic (Katzenstein 1978).

The same inertia that prevented the United States from developing greater "state capacity" is today preventing the realization of greater or more effective global governance. The private actors prospering in the interstices of political authority are not leading the charge for supra-national entities designed to regulate their behavior more effectively. They have grown out of and adapted to the current governance structure, and have little interest in seeing it overturned or even significantly modified. The already large private sphere, in turn, gives these international actors considerable leverage, which they can and will use to thwart efforts at fundamental reform.

Indeed, growing business and developed-country support for increased regulation of world markets can be understood not as a movement toward greater governance but as an attempt to expand further and solidify the large private sphere that already exists. This can be seen most clearly, perhaps, in the Multilateral Agreement on Investment (MAI), negotiated under the auspices of the Organization for Economic Co-operation and Development (OECD) and, at the time of writing, in diplomatic "limbo" due to stiff opposition from outside the business community.[10] The MAI is intended to be a comprehensive agreement covering all economic sectors and all forms of international investment. The MAI further seeks to ensure legal guarantees for investments against encroachments from all levels of government, including central, federal, state, provincial, and local authorities.

Much like the market-based legal systems of Britain and the United States, where laws are designed and intended to apply broadly to all members of particular classes, the MAI emphasizes the principles of non-discrimination and national treatment – that is, governments pledge to treat foreign investors and their investments no less favorably than they treat their own investors. In this way, the MAI seeks to level the playing field for domestic and foreign firms alike.[11]

At its core, the MAI seeks to prevent governments from exercising sovereign powers and intervening in markets for or against particular firms (or classes of firms). As the OECD itself recognizes, "as with all binding international agreements, this will moderate the exercise of national authority to a degree." At the same time, however, the MAI does not transfer powers to any authority higher than the state. Although the agreement is likely to contain a mechanism for dispute resolution that will follow judicial procedures, it is designed to adjudicate disagreements not to create new decision-making authorities. In short, the MAI constrains national governments and enlarges the private sphere within the international economy. It does not undermine the current system of international governance but actually serves to reinforce its anarchic structure.

What is true for the MAI holds equally for the new World Trade Organization and various regional trade agreements, such as the North American Free Trade Agreement. Governments are constrained from exercising sovereign powers but no higher authorities are created – in each case, further widening the private sphere within the international economy. Globalization and the regulation of international markets may constrain states and limit the policy instruments at their disposal, but the beneficiaries of this process are not clamoring for greater supranational authority and policy discretion. Quite the contrary.

The primary opponents of globalization, in turn, are those national actors who are disadvantaged by the new global trends. Even so, they too have vested interests in existing governance structures and are unlikely to support radical change. National governments have little incentive to give up their current rights of residual control to some new supranational authority; they may seek to seize or reclaim in the future rights now enjoyed by private actors, but they are unlikely to cede those rights to some other entity. National groups that are politically powerful enough to compel states to transfer residual rights to a supranational authority are likely to be the beneficiaries of existing national governance structures. Like the opponents of business in turn-of-the-century America, these powerful national actors have been privileged by the current governance structure and, though they may seek reform, they too will not seek revolution.

Ironically, those states most threatened politically by the large private sphere inherent in globalization – fundamentalist regimes, such as Iran, and their supporters – are the least likely supporters of more hierarchic global governance, at least until such structures can be made to mirror their own internal characteristics. Such states are, indeed, the potential revolutionaries who can gain only by seizing the levers of power and transforming governance structures. In this way, globalization exacerbates the "clash of civilizations," but not for the reasons usually given (Huntington 1993).

Finally, if supranational entities were to acquire some significant residual rights and a measure of hierarchical control, against expectations, this authority would likely impede further globalization. Globalization rests, at least in part, on the fragmentation of sovereignty. Consolidating political authority into new supranational structures would infringe upon the private sphere, restrict the residual rights of private as well as state actors, and thereby undermine the basis for globalization.

Globalization clearly does create transnational externalities of high political salience, including environmental degradation, worsening global distributions of income and wealth, ethnic conflicts and refugee problems that spread across national borders, and more (see McGinnis, this volume). It is the desire to cope more effectively with such problems that prompts demands for "greater" governance or more hierarchical structures. Developing an ability to cope more effectively with such problems, however, would give a new governance structure the simultaneous ability to control the actions of the private actors now prospering in the anarchic international system; mitigating environmental degradation, for instance, virtually requires such constraints. Were such restrictions to pass, however, investment in the activities that today underpin globalization would become less attractive compared to other alternatives. Far from being mutually reinforcing, globalization and global governance may well stand opposed to one another. We can expect the present structure of global governance to endure long into the future.

This is not to conclude, however, that our present governance structure is well suited for coping with the ever more complex world before us (see McGinnis, this volume). Along with globalization has come a variety of political, economic, and environmental externalities that increase the need for international cooperation (Cerny, this volume). Some form of supranational governance may well be necessary to deal with human migrations, economic crises, or environmental degradation. The vested interests of private actors and states, however, will prevent them from supporting new governance structures. In the future, states will find themselves both challenged to respond to common problems and constrained by the large private sphere deeply embedded into the current structure of global governance.

Contrasts, no conclusions

Relational contracting theories have been criticized for their functionalism (or their emphasis on "efficiency"), their inability to give precise operationalizations for key variables – such as transactions costs or information asymmetries (see Sandholtz, this volume), and their non-falsifiability. It is relatively easy – and many analysts have given in to the temptation – to concoct *post hoc* stories about why observed relationships and institutions are "efficient" for the parties involved. The real test of a theory of relational contracting comes from specifying concretely the range of institutional alternatives and the determinants of efficiency – around which there continues to be substantial debate and, thus, multiple theories united by a common approach. Such a test, however, does not require precise measures of transactions costs or information (contrary to Sandholtz, this volume). Rather, the relational contracting approach proceeds by identifying observable variables, such as specific assets, deducing behavioral consequences, and then testing these consequences against actual events. One need not observe gravity to verify its existence; it is known only by its effects. Likewise, social scientists do not need to observe the effects of each link in a causal chain. No theory can meet that standard, not even the constructivist approaches often favored by critics of rationalism, in general, and relational contracting, in particular.

In this chapter, I have emphasized problems of selection bias in the study of international institutions and, in turn, the need to consider alternative governance structures in any theory of governance. Only when the costs and benefits of alternative governance structures are understood can extant structures be explained. The analytic role of alternatives is, perhaps, one of the most important divisions between rationalist approaches to international politics, of which relational contracting theory is one variant, and constructivist approaches (see the chapters by Sandholtz and Haas, this volume). Rationalist theories are premised on the explicit contrasting of alternatives. While critics are correct that individuals and organizations may lack the cognitive capabilities assumed by some rationalists, the search for alternatives and the assessment of their relative costs and benefits constitutes the core of rationalist theories (Bueno de Mesquita 1996). When they arise, problems of selection bias, like that discussed above, are typically unintentional, caused more by the limitations of individual analysts who fail to consider the full range of possible outcomes than by the approach itself.

Problems of selection bias, however, are inherent in constructivism. This poses something of a paradox, of course, as constructivism arose partly in reaction to rationalism's privileging of existing institutions (e.g., anarchy, the state). Constructivists have been effective at problematizing extant institutions, but they have neither posed alternatives nor a theory of why only certain alternatives are chosen or constructed. They offer possibilities – arguing that different institutions might have been chosen – but not a theory of probabilities. This paradox, in turn, is rooted in the presumption found in most constructivist work that theory must incorporate and align itself with the self-understandings of the actors themselves. It is the practice of actors – and as Sandholtz (this volume) reminds us, the meaning attached by actors to practice – that guides their choices. In grounding theory in the self-understanding of actors, analysis itself becomes limited by that self-understanding. While the study of practice holds out the possibility that, for instance, states might have chosen to conduct themselves differently even under anarchy (Wendt 1992), the self-understanding of states cannot itself identify the range of possible alternatives to power politics – which by definition are not even envisioned by states. This suggests that constructivism, despite aspirations to the contrary, is fundamentally conservative in the classic sense of that term. Although they differ over the purpose of theory, rationalism and relational contracting theory – with their emphasis on alternatives taken and not taken – may have more in common with critical theories of international relations than commonly assumed.

Notes

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1 As the editors of this volume correctly note, my definition of governance is narrower than the organization of collective action, which includes both bargains about who bears what cost for the action and how to enforce the agreement. Nonetheless, their definition of governance as the "organizing [of] collective action" is quite close to my concept of contracting. Any institutionalized "rules of the game that permit, prescribe, or prohibit certain actions" have a formal or informal contract at their core (Prakash and Hart, Introduction, p. 2).

2 On "power" versus "efficiency" conceptions of contracting, with particular reference to hierarchy, see the exchange between Charles Perrow, Oliver Williamson and William Ouchi, and Alfred Chandler, reprinted in McCraw 1988, 432–64.

3 In his essay for this volume, Michael McGinnis implies that the continuum of anarchy to hierarchy developed here is defined by the level of coercion. Although hierarchy may often require some measure of coercion, anarchy, hierarchy, and the relationships in between are defined only by the rights of residual control retained by the parties to the contract.

4 McGinnis (this volume) adds the dimensions of consent and legitimacy to this analysis and, in turn, reaches different conclusions.

5 Downs *et al.* (1996) make a similar point about the depth of cooperation.

6 For a discussion of both problems of research design and successes to date, see Keohane and Martin 1995, 46–50.

7 There is a "chicken-and-egg" problem in Gerschenkron's analysis that is reproduced here: did late industrialization produce hierarchical political economies or did pre-existing hierarchies allow late industrialization to occur in some places but not others? While I lean toward the latter position, the answer to this puzzle does not affect the interpretation offered here.

8 On the problem of maladaption costs more generally, see North 1990. McGinnis, this volume, sees institutions as being very sticky and path dependent. Sandholtz, this volume, finds the source of inertia in rules which, in turn, shape other rules. Given that relationally specific assets, sticky institutions, and rules all point to the preservation of our current international governance structure, the existence of inertia itself cannot differentiate between these analytic alternatives.

9 This might be contrasted with Europe, where late industrialization and correspondingly greater concentrations of economic and political power created a deeper and more "revolutionary" struggle to control the state itself.

10 On the regulation of international business, see Graham 1996; and Rugman and Verbeke 1998. On the MAI, see the OECD's webpage at http://www.oecd.org/daf/cmis/mai/mainindex.htm.

11 Attempts to regulate markets even in an "even-handed" fashion will inevitably privilege some firms at the expense of others (see Stigler 1971; Peltzman 1976) That support for the MAI originates largely in the developed countries and in the largest international firms is not surprising, as these countries and enterprises will be the largest beneficiaries from "equal treatment."

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