

“The Moral Hazard Problem in Global Economic Regulation”

Professor Frank J. Garcia
Boston College Law School

IALS Conference on
The Law of International Business Transactions: A Global Perspective
Bucerius Law School
Hamburg, Germany
April 10-12, 2008

Global regulation of international business transactions presents a particular form of the moral hazard problem. Global firms use economic and political power to manipulate state and state-controlled multilateral regulation to preserve their opportunity to externalize the social costs of global economic activity with impunity. Unless other actors can effectively counter this at the national and global regulatory levels, globalization re-creates the conditions for under-regulated or “robber baron” capitalism at the global level. This model of economic activity has been rejected at the national level by the same modern democratic capitalist states which currently dominate globalization, creating a crisis of legitimacy and, ultimately, security for the international economic system. Enlightened self-interest dictates that home countries and their citizens address this dualism underlying contemporary globalization.

I. Definition of Globalization

One of the most common definitions of globalization is the elimination of time and space as a factor in human social relations. Due to revolutions in computing and telecommunications, it is now the case that information and ideas (and even money) can move with unprecedented speed around the world, creating the possibility of virtually instantaneous real time global exchanges. Understanding the implications of this shift is one of the chief tasks of the liberal arts and social sciences today.

Transposing that to our present context, we might say that globalization involves the elimination of time and space as factors in international economic relations, specifically in international business transactions. Now, at first glance, this would seem fanciful, if not mistaken. Who better than global entrepreneurs knows that time and space are still factors in the global production, transportation and sale of goods, services, capital, labor, and even knowledge. Certainly, the travel weary global executive is very much aware of the immediate personal effects of time and space. However, I would assert that the definition is still relevant, and suggestive, for international business transactions in two ways, one affecting markets and one affecting regulation.

When one looks at economic globalization one can distinguish two core aspects: “market globalization” and “regulatory globalization.” Market globalization focuses on the increased volume of transactions in which goods, services, labor and capital cross

national boundaries, facilitated both by technological change and decreasing tariff and non-tariff barriers, such that these transactions taken as a whole begin to resemble those of a single market spanning the globe. This characterization of globalization begins with the fact that there has always been transboundary economic activity, and argues that such activity is increasing both in scope and scale such as to warrant a new name: "globalization." Thus market globalization asserts in essence that globalization is a quantitative rather than a qualitative change.

This common approach to defining economic globalization, however, represents only one aspect of economic globalization. Another definition, which shall be termed "regulatory globalization," includes the quantitative changes highlighted in market globalization, but emphasizes a qualitative change in the nature of our regulation of markets. In particular, regulatory globalization focuses on the complex social processes which have led to the regulation of markets for goods, labor, capital and services at new levels, levels which require formalized interstate cooperation through new and powerful institutions like the WTO, and which may, in certain cases, transcend nation-state control to a significant degree, as in the case of the European Union.

II Regulatory Globalization and the Moral Hazard Problem

It is this aspect of globalization, regulatory globalization, and its effects on international business transactions, which I would like to focus on in these brief observations. The move to a global market has highlighted shortcomings in the Westphalian system of national regulation, as well as deficiencies in the current level of multilateral or global regulation.

The central social problem posed by market-led globalization is that of externalities. Historically, regulation is the chief restraint on firms' tendencies to externalize costs. However, when markets outstrip regulation, as they are doing in current forms of globalization, we create the conditions for increased externalization by multinational firms of the social costs of economic activity, increasing the demand for effective regulation at the global level. For example, we need multilateral regulation of foreign investment to address problem host states face in seeking to regulate the social costs of foreign investment, such as the regulation of labor and employment conditions

However, this is precisely what host states by themselves cannot do. States face a collective action problem as long as they are forced to attempt individually to regulate the conditions for multinational economic activity. Thus territorially-based jurisdiction is inadequate to address many of the challenges of economic globalization. However, global regulation today is underdeveloped. Existing multilateral regulatory bodies such as the WTO and the IMF have to a significant degree been captured by precisely those states which also are the home states of the powerful multinational enterprises. When regulation is directly or indirectly in the hands of a few powerful home states, there is the risk of self serving regulation.

This is the moral hazard of global regulation today: powerful multinational enterprises are essentially regulating themselves, through the interventions of the states which they influence in the multilateral regulatory bodies which such states have captured. In private law, we generally think of moral hazard as a perverse effect of certain contracts, such as insurance contracts, which can incentivize insured parties to engage in risky behavior they otherwise might not engage in but for the insurance itself. In the global economic regulatory context, I am suggesting the same dynamic is at work: powerful global firms use their leverage over home state regulation, and over the multilateral institutions which their home states dominate, to create rules which eliminate the legal risks to their activities. Since host jurisdictions already face almost insurmountable collective action challenges to effective regulation of foreign firms, this means that powerful global firms are essentially regulating themselves.

This creates a problem of legitimacy, in addition to the problems which externalities themselves create (pollution, social welfare costs, etc) for those who suffer them. This legitimacy problem has two aspects. First, as long as regulation is controlled by powerful home states and their firms, and the rest of the world consists of host jurisdictions without the power to effectively regulate by themselves, economic globalization means that most of the world will be subject to forms of economic activity which they have not in any meaningful way consented to. Under the liberal principles of justice which powerful home countries claim allegiance to, this is a serious compromise to the legitimacy of the resulting global regulatory system.

Second, the global market is currently being regulated by the market actors themselves. Globalization thus re-creates the conditions for under-regulated or “robber baron” capitalism at the global level. This model of economic activity has been rejected at the national level by the same modern democratic capitalist states which currently dominate globalization. This is a further challenge to legitimacy: there is no effective rule of law when the powerful make their own rules. Moreover, it is a form of hypocrisy unfortunately common in international relations: we export what we reject at home.

Enlightened self-interest dictates that home countries and their citizens address this dualism underlying contemporary globalization. The nature of globalization not only intensifies problems of externalities and the challenge of legitimate, effective regulation, but also the public perception of externalities, the firms which create them, and the host countries which facilitate this. Put short, information globalization means there are fewer and fewer places to hide externalities from your shareholders, your customers, and the citizen/consumers of your home jurisdiction.

The changes in telecommunications and information flow which propel globalization, have also influenced our understanding of the economic effects of globalization on those far from the power centers. In the same way that television during the Viet Nam war permanently altered the domestic US politics of war, information globalization is permanently changing the politics of global business. Problems of development, inequality and justice are not “safely” behind transportation and communication barriers – they are immediately present in the news and on the Internet.

This means that, contrary to past practice, firms and countries cannot as easily externalize social costs with impunity. However, therein lies an opportunity; as traditional folk wisdom says, “the medicine is in the poison.”

III Strategies

In order to address this moral hazard problem, we must bypass the institutions which themselves are embroiled in it, and alter the economics and politics of regulation at the national and global levels. One set of strategies is itself market-based. Attempts to mobilize consumers in powerful home jurisdictions to incorporate social concerns into their consumption decision, can affect the market incentives for multinational corporations to alter their externalization policies.

Another set of strategies involves domestic politics in both home and host jurisdictions. Like-minded citizens can organize networks between consumer-citizens in both home and host jurisdictions, bypassing territorial political boundaries to create global constituencies. These constituencies can coordinate efforts to influence domestic regulation in both home and host jurisdictions, and alter the incentives for states to act at the global regulatory level as well. Multinational corporations should not be able to profit from information asymmetries and territorial jurisdictional boundaries; instead, networks of citizen-consumers can themselves use globalizing information flows to counter the information advantages of multinational corporations and eliminate the veils of secrecy which shield overseas externalities from affluent citizen consumers in home jurisdictions.

Such networks can also support coalitions among host jurisdictions which can effectively demand global regulation addressing the social costs of global capitalism. This approach can minimize collective action problems so host jurisdictions can become rule makers and not just rule takers.

IV Conclusion

Externality-driven globalization clearly threatens the social well-being of the many people trapped in host jurisdictions. The current international climate demonstrates how economic exploitation and failures of legitimacy threaten the stability and security of the entire global system - home and host jurisdictions alike. Information globalization makes it clearer to home country citizens how this current model of globalization threatens their security and well-being as well: their profits as mutual fund shareholders, their prosperity as workers, their affluence as consumers. To the extent that citizens of home jurisdictions mobilize, they are, in the end, only helping themselves.