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In this essay, I will attempt in a preliminary manner to consider sovereignty from an economic perspective.[1] Most, although not all, commentary on sovereignty comes from a political perspective, and within the international law community, is dominated by the more political side of international law, public international law. This public international law perspective emphasizes issues such as secession, human rights and humanitarian intervention. I will examine sovereignty from an international economic law standpoint, focussing on issues of economic regulation such as extraterritoriality and subsidiarity.

This essay revolves around three epithets: sovereignty, extraterritoriality and subsidiarity. Each lacks content — none can, simply by its invocation, indicate the course of decisions. In intergovernmental negotiations, or in domestic negotiations regarding international policy, claims of "sovereignty," "extraterritoriality" and "subsidiarity" should be greeted with suspicion, if not derision. While the issues that they raise are the most important and difficult in social science, these words do not answer questions, but only raise questions. Each relates to claims of a state, or claims against the state. Each of these epithets can be seen as a conflict of laws problem. "Extraterritoriality" raises the question of horizontal conflict of laws. "Subsidiarity" raises the question of vertical conflict of laws. Finally, we may view sovereignty as the power and responsibility left to the state when horizontal and vertical claims of extraterritoriality and subsidiarity have been collated and integrated. The goal of this essay is to indicate some possible paths toward defining, analyzing and relating these three epithets.

I. The Rhetoric of Sovereignty

Those who are concerned about the formal imposition of constraints on national action under the proposed World Trade Organization or NAFTA, or about the formal legislation of centralized regulation, preempting national action, in the European Union, use the

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[1] This essay is a revised version of a presentation made to the Canada/U.S. Law Institute's Conference on "Sovereignty in the North American Context and in an Changing World," held from April 22-24, 1994. I wish to thank the other participants in the conference for their helpful comments, and especially Professor Henry King for his encouragement and stimulation of my thinking in this area.

epithet "sovereignty."[2] Mexicans who reject U.S. efforts to tell them how they should fish for tuna,[3] and Europeans who reject U.S. efforts to apply its antitrust or securities laws to European conduct or persons under the "effects" doctrine also use this epithet. They mean by this that the state should not give up too much authority, or should not give up more authority, or should not give up authority in a particular area.

The rhetoric of sovereignty tends to view the problem, incorrectly, as a quantitative, rather than qualitative, one. In order to understand sovereignty, we must first recognize a "law of conservation of sovereignty." Sovereignty, viewed as an allocation of power and responsibility,[4] is never lost, but only reallocated. The attractiveness of a reallocation of sovereignty should be measured by reference to whether it allows social goals to be achieved more effectively. Thus the question raised regarding the reallocation is whether the recipient of enhanced power and responsibility will exercise power and recognize its responsibility more effectively.

When a state's sovereignty is reduced, the important question raised is where the sovereignty goes, and how the citizens of the state may exercise power, and call on responsibility. That is, it may be viewed as a question of what is received, and by whom, in exchange for a reduction in the state's sovereignty, rather than simply a question of whether sovereignty is reduced. The question of what is received refers to the concept of "pooling of sovereignty"[5] that has been compelling in the context of the European Union: by giving up national sovereignty, member states may increase the scope of their influence, both within the European Union and in external relations. One part of this calculus relates to the cost-benefit analysis between the degree of local autonomy given up and the measure of influence over other sovereigns obtained. Thus, if the U.K. had been able to bind Austria, Norway, Sweden and Finland to the European Union, without giving up the measure of ability to block European Union legislation that it had prior to their

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[2] Many have noted the strange bedfellows that have rushed to the defense of "sovereignty" in connection with the proposed World Trade Organization. *See, e.g., Nader, Buchanan, Others Urge Clinton to Delay Consideration of GATT Accord*, Daily Report for Executives (BNA) at 151 (Aug. 9, 1994); "Sovereignty is so emotive a term that it very naturally finds an important place in international rhetoric. Any proposed diminution of a state's political freedom or legal jurisdiction is likely to evoke a response which will be expressed, in part at least, as a defence of its sovereignty." ALAN JAMES, SOVEREIGN STATEHOOD: THE BASIS OF INTERNATIONAL SOCIETY 1 (1986).

[3] *See United States—Restrictions on Imports of Tuna, No. DS21/R*, 30 I.L.M. 1594 (1991). This panel report was not adopted by the GATT Council, and the European Community subsequently brought another action on similar grounds. *See United States—Restrictions on Imports of Tuna, No. DS29R*, 33 I.L.M. 839 (1994).

[4] By juxtaposing "power" and "responsibility" I mean to signal that I am using "responsibility" to include a sense of responsiveness and a bilateral relationship between the person responsible and the persons to whom the responsibility is owed.

[5] JAMES, *supra* note 2, at 1 and notes 1-2.

entry, it would have obtained greater foreign influence without a net additional expenditure of local autonomy.[6]

The question of what is received, and by whom, in exchange for a reduction of state sovereignty refers, in effect, to the "democratic deficit." The democratic deficit arises when the most directly democratic element of member state government — the parliament — gives up power to the European Union, which power is dependent upon the vote in the Council of the less directly democratic element of member state government — the executive. In this light, the democratic deficit is really a deficit of directness of democracy. It can be reduced by allocating more power in the European Union to the branch that is directly responsive to the people: the European Parliament. This is important to concerns about sovereignty, because it denies the mediating role of the member state government: the member state transfers sovereignty to the European Union, which is no longer simply a creature of member states, but is directly responsible to the people of Europe. This is not a simple pooling of sovereignty among executives, but a restructuring of relationships in which the fount of authority is recognized as the people.

II. AN INSTITUTIONAL PERSPECTIVE

Each man's experience starts again from the beginning. Only institutions grow wiser: they accumulate collective experience, and owing to this experience and this wisdom, men subject to the same rules will not see their own nature changing, but their behaviour gradually transformed.[7]

This essay proceeds from the premise that "history . . . is largely a story of institutional evolution . . . ."[8] Institutions freeze the operation of the market or freeze politics temporarily to reduce transaction costs. Institutions also change over time, as old institutional structures fail to reflect social needs, and new or revised institutional structures are devised and negotiated to meet social needs more accurately. We find that the ontogeny of our generation's society recapitulates its phylogeny: that the history of our institutions is still visible in varied and sometimes embedded forms, despite the continuation of institutional evolution. Thus, this essay examines sovereignty as a socially contingent phenomenon, as an institution. It is an institution insofar as it is a

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[6] *See, e.g., No Breakthrough on Blocking Minority Issue; Ministers Adjourn Talks*, EUROPEAN REPORT, March 23, 1994. In Spring, 1994, the U.K. and Spain for a time blocked accession of these four countries to the European Union, hoping to maintain their voting rights undiluted.

[7] Jean Monnet, quoting Swiss philosopher Henri-Frederic Amiel (1821-81), in the course of a speech to the Common Assembly of the European Coal and Steel Community in 1955, *quoted by* D.G. GOYDER, EEC COMPETITION LAW 69 (1988).

[8] *Id.*

ready-made template or constraint for social relations.[9] While this institution is subject to evolution, evolution rarely entails revolution.

The definitional convention adopted in this essay is that "sovereignty" is the set of powers of any particular state, recognizing that this set of powers has evolved significantly since 1648, and that this set of powers differs among states.[10] Thus sovereignty is contingent, both inter-temporally and intra-temporally.[11] Furthermore, in this sense, "sovereignty" and the "state" are congruent. Indeed, those who separate the "state" from its "sovereignty" assume some artificial life for the state, as though the state is more than a bundle of powers and responsibilities. Just as a corporation, in analytical terms, is no more than a bundle of powers and responsibilities—a bundle of legal relationships—[12] so too is a state no more than a bundle of powers and responsibilities. To say otherwise is artificially to deify or humanize this institution.

Bodin deified sovereignty, defining it as supreme power over citizens and subjugated peoples, bound by no other law.[13] This vision of a sovereignty of unilateral domination and dominion appears increasingly alien, not to mention bleak, to us today. Most kings or queens reigning today are figureheads, and we know that neither our executives nor our legislatures are divine. Consequently, we increasingly think of the state in bilateral terms, subjecting it to the requirement that it provide benefits at least equal to its costs.[14] We are no longer so willing to "ask not what your country can do for you; ask what you can do for your country," at least when we think of the state in economic terms. While political loyalty as an emotive force may still have power, and may still be desirable,[15] especially when it results in solidarity, benevolence and altruism, it is no longer blind; it increasingly asks, "what's in it for me or my family, or my co-religionists or my municipality, at least in the

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[9] "Institutions are the humanly devised constraints that structure political, economic and social interaction." Douglass C. North, *Institutions*, 5 J. ECON. PERSP. 97 (1991).

[10] For a general history of sovereignty, *see* CHARLES E. MERRIAM, HISTORY OF THE THEORY OF SOVEREIGNTY SINCE ROUSSEAU (1900). *See also* Leo Gross, *The Peace of Westphalia, 1648-1948*, 42 AM. J. INT'L L. 20 (1948).

[11] For a history of sovereignty designed to show that the definition of sovereignty is not fixed, *see* J. Samuel Barkin and Bruce Cronin, *The State and the Nation: Changing Norms and the Rules of Sovereignty in International Relations*, 48 INT'L ORG. 107 (1994).

[12] *See* Felix Cohen, Letter to the editor, 5 FORDHAM L. REV. 548, 549 (1936) (explaining that "in actual practice I have never found it necessary or useful to assume that a corporation is anything more than a bundle of legal relationships between actual human beings. The bundle of relationships exists, but it is not a human being.").

[13] *See* JEAN BODIN, THE SIX BOOKES OF A COMMONWEALE A75 (Eng. trans. 1606, corrected by Kenneth D. McRae 1962).

[14] *See, e.g.*, DAVID OSBORNE & TED GAEBLER, REINVENTING GOVERNMENT: HOW THE ENTREPRENEURIAL SPIRIT IS TRANSFORMING THE PUBLIC SECTOR (1992).

[15] Such loyalty may be desirable insofar as it concentrates and enables benevolent attitudes that would be lost by dispersion if sought to be applied to a larger group.

long run?"

Another discomfort we have with Bodin's notion of sovereignty is its exclusivity: the subjects are bound by no other law. This exclusivity rejects the idea of international law or institutions that can bind sovereigns, and also rejects the problem of conflicts of law. Instead, it posits a sovereign that may choose to comply with international law, or to apply foreign law, but is not bound to do either. It is clearly dualist in its vision, and moreover demands the supremacy, even in international law, of domestic law.

Along with the domestic sovereignty of unilateral domination came a concept of international law as a means of subordination of states. This essay articulates a different, less Hobbesian, view of both domestic and international law. Domestic law is not simply a unilateral emanation from the ruler, the sovereign. While it never has been so, it is now recognized that domestic law involves issues of legitimacy and implementation that require a bilateral process of communication and negotiation, between the governed and the governor. Indeed, in a democracy, the governor is at least in part a tool or conduit for the governed, and the term "the governed," connoting unilateral rule, becomes inappropriate. The extent to which the governor is not a tool or conduit for the governed, described by the literature of public choice, is a measure of the defectiveness of a particular system of democratic politics, unless the distortion is intended to constrain democratic politics. Indeed, we never were limited to a choice between voice and exit,[16] just as we never have been limited to a choice between the firm and the market.[17] Rather, the menu of modes of social relationship is infinite, with many subtle variations.[18]

In international law — in the world of external, as opposed to internal, sovereignty—as well, the better view is not of a state subordinate to international law, but of a state participating in international society, both forming and complying with law. This vision of law, less Hobbesian and more Rousseauvian or Lockean, is much more subtle and nuanced, and reflects the complexity of both domestic and in-

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[16] ALBERT O. HIRSCHMAN, EXIT, VOICE AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS AND STATES (1970).

[17] *See* RONALD COASE, THE FIRM, THE MARKET AND THE LAW (1988), incorporating and commenting upon earlier work, including Coase's seminal articles: *The Nature of the Firm*, 4 ECONOMICA 386 (1937) and *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960). Coase explains that these articles are related. "In order to explain why firms exist and what activities they undertake, I found it necessary to introduce . . . " the concept that has come to be known as 'transaction costs'." *Id.* at 6.

[18] Thus, real law has little to do with Bodin's sovereignty, which involves simply the emanation of orders and the clarification or application of orders. Real law is a social contractarian transaction in which rules are established interactively, and are interpreted and applied in accordance with an objective system. The very objectivity of the process by which law is made diminishes the exclusive power of the legislator.

ternational society. It also enables us to solve the conundrum posed by sovereignty: if states are indeed absolutely sovereign, how can international law exist? It appears that states are indeed sovereign, but that sovereignty itself is a malleable and limited concept. People are the source of authority; to the extent that the state represents the aspirations of people, it should carry their authority. The converse is also true.

Many have criticized the concept of sovereignty. Indeed, it is facile to argue, as many have done, that sovereignty, and the sovereign state with it, should simply be discarded.[19] However, while it is necessary to critique our institutions and relentlessly to inquire as to whether they are serving our needs, and perhaps also to demystify them, there also may be legitimate reasons for conservatism. Law and economics scholars have evaluated the efficiency of the common law, finding that certain legal rules developed by the common law meet their definitions of "efficient."[20] It appears worthwhile to evaluate the possible efficiency of sovereignty, to examine how the authority allocated to the state might be justified or unjustified, resulting in the retention or reduction of sovereignty. This essay examines this authority in the context of international business regulation, and more specifically in the context of two international business regulation problems: extraterritoriality and subsidiarity.

Extraterritoriality and subsidiarity are, respectively, horizontal and vertical challenges to, or affirmations of, sovereignty. Extraterritoriality refers to the fact that no state is autarkic or autarchic, but each exists in a world filled with persons that penetrate the state at many points. Two broad categories of response are available to contend with these chaotic circumstances. First, the state may unilaterally, bilaterally or plurilaterally set rules for jurisdiction: these conflict of laws rules may be based on territoriality, nationality or other parameters. Second, the state may unilaterally, bilaterally or plurilaterally establish common substantive rules. Either of these techniques, like the establishment of any international legal rule or institution, is a form of integration. Subsidiarity responds to the question of how far the state should proceed in this integration.[21]

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[19] Both the word and the concept of sovereignty have been amply criticized. Louis Henkin argues that in addition to some validity, "sovereignty has also grown a mythology of state grandeur and aggrandizement that misconceives the concept and clouds what is authentic and worthy in it, a mythology that is often empty and sometimes destructive of human values." He goes on to write "[a]way with the 'S' word!" *See, e.g.*, Louis Henkin, *The Mythology of Sovereignty*, Newsletter of the American Society of International Law, March-May 1993, at 1, 6-7.

[20] There is voluminous literature arguing the issue of the relative efficiency of the common law, and its implications. *See, e.g.*, WILLIAM M. LANDES & RICHARD A. POSNER, THE ECONOMIC STRUCTURE OF TORT LAW (1987); Richard A. Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487 (1980).

[21] *See* George A. Bermann, *Taking Subsidiarity Seriously: Federalism in the European*

This essay adopts the perspective of law and economics, developed in the context of the analysis of business firms, to examine the state and its authority, with particular reference to extraterritoriality and integration. The modern work on the theory of the firm began with Ronald Coase's seminal work, *The Nature of the Firm.*[22] In *The Nature of the Firm*, Coase asked two analytical questions: first, why does the firm exist, and second, if the firm should exist, why is not all production organized in a single large firm? We may ask the same two questions about the state: first, history aside, why does it exist, and second, to what extent should international organization or integration take its place? In *The Nature of the Firm*, Coase posits that the firm exists in order to reduce transaction costs. This essay argues that the state also exists to reduce transaction costs, calculated both internally and externally. This proposition provides a guiding principle in determining what to do about extraterritoriality and what degree of international integration is appropriate.

However, an absolute formula for state sovereignty is not likely to make sense, and different circumstances — different social goals, different types of communities, different technologies — demand different formulae. Different formulae are obviously needed from an internal standpoint, although they make inter-national social life more difficult. A degree of homogeneity among states facilitates inter-national social life, and may be justified internally as a means to achieve community goals that require inter-national coordination.

III. SOVEREIGNTY AND EXTRATERRITORIALITY

Sovereignty is threatened in two ways in connection with extraterritoriality problems.[23] First, when State A seeks to apply its laws to conduct that occurs in State B, State B may feel its sovereignty threatened. Its sovereignty is threatened by the projection of State A's

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Community and the United States, 94 COLUM. L. REV. 332 (1994).

[22] Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937), *reprinted in* Coase, *supra* note 17.

[23] "Extraterritoriality" is a highly inaccurate word to describe the topic at hand. First, "extraterritoriality" has no generally agreed meaning. The reason is that we lack a clear definition of "territoriality". Territoriality refers to a relationship with territory. However, any particular legal or physical person, or any particular transaction, may have multiple relationships with one, two or several separate territories. One way to regard extraterritoriality is to view it broadly, as Professor Brilmayer and Mr. Norchi have done: "As used here, a case involves extraterritoriality when at least one relevant event occurs in another nation." Lea Brilmayer & Charles Norchi, *Federal Extraterritoriality and Fifth Amendment Due Process*, 105 HARV. L. REV. 1217, 1218 n.3 (1992). While this definition is quite broad, it recognizes the problem that many "relevant" events may occur in another jurisdiction, giving rise to a degree of doubt with respect to any exercise of jurisdiction. The real question is to assess the magnitude of the degree of doubt, and to determine what to do in light of doubt.

sovereignty into its territory.[24] Second, State A may feel its sovereignty threatened by virtue of rules of State B law or of international law that purport to restrain its regulation of foreign conduct that affects State A.

Before proceeding further, we must recognize that "extraterritoriality" is an unsatisfactory term.[25] First, "extraterritoriality" has no generally agreed meaning. The reason is that we lack a clear definition of "territoriality." Territoriality refers to a relationship with territory. However, any particular legal or physical person, or any particular transaction, may have multiple relationships with one, two or several separate territories. Second, territoriality itself is not a coherent concept. There is no assurance that a relationship to territory should be the touchstone of prescriptive jurisdiction. Prescriptive jurisdiction[26] exercised on the basis of nationality (as opposed to residence) of the subject or the object of a given action or condition may have an attenuated or negligible relationship to the regulating state's territory, although nationality is generally unchallenged as a basis for jurisdiction. Thus, it is not territory that we should be concerned with, but people and societies, and territory is an increasingly inaccurate proxy for a community. In fact, society is increasingly varied and plural, existing at many vertical levels and in many functional sectors, and with increasing disregard for national boundaries.[27]

Thus, "extraterritoriality" is an unsatisfactory reference, often used to connote dissatisfaction with the scope of prescriptive jurisdiction being exercised. It should be replaced with a more refined concept of over-extended jurisdiction or "excess of jurisdiction": there are certainly circumstances where one community takes excessive control over matters that have implications for other communities. The difficulty is that of allocating jurisdiction: it is necessary to seek greater accuracy

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[24] *See, e.g.*, Kurt M. Hoechner, *A Swiss Perspective on Conflicts of Jurisdiction*, 50 L. & CONTEMP. PROBS. 271 (1987).

[25] In fact, one argument of this chapter is that very few assertions of jurisdiction should be considered extraterritorial in an absolute sense, although many assertions of jurisdiction may be excessive in light of their relative connections with the society exercising jurisdiction.

[26] Prescriptive jurisdiction, also sometimes referred to as legislative jurisdiction or subject matter jurisdiction (although these latter two concepts are different) is defined and distinguished in RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW, § 401 (1987). Generally, it is the power to make national law applicable to particular persons or circumstances. U.S. assertion of prescriptive jurisdiction on the basis of territorial effects is often criticized by other governments or by commentators as "extraterritorial" or excessive. *See, e.g.*, HOMER MOYER, JR. & LINDA MABRY, EXPORT CONTROLS AS INSTRUMENTS OF FOREIGN POLICY, App. 8-11 (1985) (explaining diplomatic objections to U.S. extraterritorial export controls). For a thoughtful overview of this topic, *see* Gary B. Born, *A Reappraisal of the Extraterritorial Reach of U.S. Law*, 24 L. & POL'Y INT'L BUS. 1 (1992).

[27] *See* Joel P. Trachtman, *L'Etat, C'Est Nous: Sovereignty, Economic Integration and Subsidiarity*, 33 HARV. INT'L L. J. 459 (1992).

in allocating jurisdiction.[28]

Despite its indeterminacy, "extraterritoriality", as generally used, refers to at least a sector of the most serious question in social studies. This is the question of the scope of a state's jurisdiction: how far does the state's power extend? This durable question is often addressed in the domestic sector by law and economics when law and economics considers the relationship between the individual and her domestic government: what activity should be regulated and what rules should be left to private ordering by market forces? We see this question arise in the area of economic law, such as antitrust law, securities law or environmental regulation. It is necessary to consider the same question — the scope of the state's power — from the standpoint of international society.[29] This question is most often raised in connection with the application of U.S. law to conduct that takes place largely abroad, although there are indications that, as their regulatory structures grow, other countries or jurisdictions will increasingly grapple with similar questions.[30]

This essay suggests a single articulated effects test[31] as such a rule. However, this effects test ultimately merges with the balancing tests that have been developed to compete with or to qualify the effects test, as it incorporates the components of the balancing tests that have sub-

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[28] *See* Joel P. Trachtman, *Conflict of Laws and Accuracy in the Allocation of Government Responsibility*, 26 VAND. J. TRANSNAT'L L. 975 (1994).

[29] I have argued elsewhere that there is a continuity, but not an equivalence, between the question of whether an activity should be regulated and the question of at what level—the state or some transnational level—the activity should be regulated. Joel P. Trachtman, *International Regulatory Competition, Externalization and Jurisdiction*, 34 HARV. INT'L L. J. 47 (1993).

[30] One might argue that the U.S. has not been an assertive hegemon, but has simply been a pioneer in business regulation. In order to play this pioneering role domestically, the U.S. has had to pioneer extraterritoriality. "You can tell the pioneers because they are the ones with the arrows in their chests."

Other jurisdictions are increasingly addressing problems of extraterritoriality and dividing up regulatory jurisdiction. *See, e.g.*, Joined Cases 89, 104, 114, 116, 117 & 125-29/85, A. Åhlström Osakeyhtio v. Commission (The "Wood Pulp" Cases), 1988 E.C.R. 5193, 4 Comm. Mkt. Rep. (CCH) ¶14,491 (1988) (without actually using these words, applying an effects-type test, to determine jurisdiction under European Community competition laws). In addition, the harmonization efforts of the European Community would not be possible without an approach to dividing up regulatory jurisdiction. Often, regulatory jurisdiction is allocated to the home state of the good or of the person providing the relevant service, with other member states accepting the exclusive nature of this allocation of regulatory jurisdiction under the principle of "mutual recognition." Essentially harmonization and mutual recognition are the cornerstones of the integrative thrust under the Single European Act of 1986 leading to the culmination of the "1992" program. Single European Act, 30 O.J. EUR. COMM. (NO. L 169) 1, 3 Common Mkt. Rep. (CCH) ¶ 21,000 (1987). *See* Jacques Pelkmans, *The New Approach to Technical Harmonization and Standardization*, 25 J. COMM. MKT. STUD. 251 (1987).

[31] For a recent analysis of the effects test, *see* Russell J. Weintraub, *The Extraterritorial Application of Antitrust & Security Laws: An Inquiry Into the Utility of a "Choice-of-Law" Approach*, 70 TEX. L. REV. 1799 (1992).

stantive validity, and at the same time adds a quantitative, comparative element to balancing tests. The rule advanced here seeks to establish a full set of categories of real effects, and calls for the valuation of each type of effect. Once effects are identified and valued, they can be compared. The rule advanced here would allow jurisdiction in proportion to effects. It can be stated as follows: Prescriptive jurisdiction over a transaction should be allocated to the government(s) whose constituents are affected by the transaction, *pro rata* in proportion to the relative magnitude of such effects, as accurately as is merited given transaction costs in allocation of prescriptive jurisdiction.[32]

This rule is less a test than a measure, to determine not whether jurisdiction exists, but how much jurisdiction exists. Of course, in some cases, a relatively small amount of jurisdiction may not be worthwhile to be exercised, given transaction costs. This rule is advanced based on law and economics principles.[33] This rule could be incorporated in international law, multilaterally, regionally or bilaterally, or could be applied unilaterally by individual countries as part of their domestic law.[34] This rule could even be said to have social contractarian or even constitutional-type underpinnings, as it relates the powers of a society to the purposes of that society.

Viewing law as a public good — as the product of or even as a factor of production owned by governments — provides an important analogy to the private sector. In the private sector, the law of property rights determines the initial distribution of goods and rights.[35] In the intergovernmental sector, the allocation of prescriptive jurisdiction determines the initial distribution of power.[36] In both cases, the Coase

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[32] This statement is similar to, but distinct from, Professor Baxter's comparative impairment approach, William F. Baxter, *Choice of Law and the Federal System*, 16 STAN. L. REV. 1 (1963), and the approach suggested by Prof. Alexander. Gregory S. Alexander, *The Concept of Function and the Basis of Regulatory Interests Under Functional Choice-of-Law Theory: The Significance of Benefit and the Insignificance of Intention*, 65 VA. L. REV. 1063, 1080 (1979) (stating that "Choice-of-law theory therefore must recognize a basis for allocating regulatory authority to a state whenever that allocation would further the state's goals or achieve some beneficial social effect that is consistent with the state's conception of public welfare"). The author has articulated this approach in greater detail as a general conflict of laws rule, and compared it with other conflict of laws rules, in Trachtman, *supra* note 28.

[33] While the rule advanced addresses the question of efficiency in jurisdiction, it leaves open the question of efficiency in administration. The question of efficiency in administration can be addressed by analysis of appropriate institutions.

[34] We do not analyze in this chapter the question of whether unilateralism, or an approach of reciprocity, or multilateralism, would be the best approach for an individual state to take. The answer to this question would depend on game theory, and the relative value of unilateral action versus reciprocation. *See* LEA BRILMAYER, CONFLICT OF LAWS: FOUNDATIONS AND FUTURE DIRECTIONS (1991).

[35] *See* Thomas W. Merrill, *Trespass, Nuisance, and the Costs of Determining Property Rights*, 14 J. LEG. STUD. 13 (1985).

[36] We may consider here familiar governmental powers, such as the power to tax, the power to regulate and the power to enforce these prescriptive powers. The RESTATEMENT (THIRD) OF

Theorem would indicate that, absent transaction costs, this initial allocation of property rights would not have efficiency ramifications.[37] The reason that this initial allocation would, in theory, not affect efficiency, is that market participants would engage in reallocative transactions that would result in an efficient outcome. Thus, in the intergovernmental sector, if it is clear that the laws of State B govern a particular transaction that imposes costs on State A, State A may pay State B to prohibit the transaction.

Coase further argues (perhaps somewhat inconsistently) that, "if market transactions were costless, all that matters (questions of equity apart) is that the rights of the various parties should be well defined and the results of legal actions easy to forecast."[38] In the intergovernmental sector, this is an argument that the specifics of the rules allocating prescriptive jurisdiction are irrelevant, so long as their results are predictable and their application is administrable. However, as Coase noted with respect to the private sector, transaction costs exist. In fact, they may be greater in the intergovernmental sector. In connection with the private sector, Coase notes that legal decisions should be made with a view to "reduce the need for market transactions and thus reduce the employment of resources in carrying them out."[39] "The same approach which, with zero transaction costs, demonstrates that the allocation of resources remains the same whatever the legal position, also shows that, with positive transaction costs, the law plays a crucial role in determining how resources are used."[40]

Thus, rules allocating prescriptive jurisdiction in the intergovernmental sector may be equated with property rights in the private sector: each determines which decision-maker initially controls the use of factors of production. The goal of rules allocating prescriptive jurisdiction in this context is to minimize transaction costs, in order to maximize the extent to which transactions that may result in optimal allocation of the factors of production of public goods occur. Rules allocating prescriptive jurisdiction may achieve this goal in two ways.

FOREIGN RELATIONS LAW §§ 401-403 (1987) divides jurisdiction into three components: jurisdiction to prescribe, jurisdiction to adjudicate and jurisdiction to enforce.

[37] COASE, *supra* note 17, at 95-185 (reprinting and commenting on *The Problem of Social Cost*, 3 J. L. &. ECON. 1 (1960)).

[38] *Id.* at 119. Indeed, even this may be too conservative a position. In the absence of transaction costs, even property rights may be unnecessary to be specified. Steven N.S. Cheung, *Will China Go "Capitalist"?* 37, Hobart Paper No. 94 (1986). Thus, in a world without transaction costs, not only is the firm unnecessary, but law, the state and international law are also unnecessary. As Coase says, "[i]t would not seem worthwhile to spend much time investigating the properties of such a world." Coase, *supra* note 17, at 15.

[39] Coase, *supra* note 17, at 119.

[40] *Id.* at 178. Coase argues that with positive transaction costs, the "market transactions" by which private action would reallocate resources may become too costly to effect.

- First, rules allocating prescriptive jurisdiction may, by their predictability, administrability and transparency, facilitate "market" transactions that reallocate authority. In the intergovernmental sector, "market" transactions are agreements allocating authority: treaties, constitutions, uniform laws, practices (such as comity[41]) or other means of circumscribing claims of authority. The extent to which rules allocating prescriptive jurisdiction satisfy this condition is referred to herein as "predictability". Administrability and transparency may be considered as incorporated in predictability.
- Second, rules allocating prescriptive jurisdiction may provide starting positions — allocations of authority — that reduce transaction costs by obviating the need to transact. The extent to which rules allocating prescriptive jurisdiction provide such allocations amounts to "accuracy" in this context.

We may relate the first method — predictability — to the prisoner's dilemma used by game theory.[42] If each prisoner is able to know what her comrade intends to do, and to bind her comrade to cooperative action through a binding contract, the negotiation of an optimal solution will be facilitated and the prisoner's dilemma will be resolved. Thus, rules allocating prescriptive jurisdiction that are predictable, administrable and transparent will allow State B to negotiate an exchange with State A, whereby State A changes its rule of substantive law for application to a particular class of transactions, and State B confers something of value on State A.[43] On the other hand, rules allocating prescriptive jurisdiction that are unpredictable or opaque because they are result-oriented ("substantive", using Prof. Juenger's terminology[44]), or that depend on an analysis of forum policy that has not yet been undertaken (as in balancing tests or reasonableness tests absent the role of binding precedent), reduce the ability of states to negotiate such exchanges.

The second method — accuracy — seeks to establish in advance an allocation of authority that market participants — governments — would come to themselves in the absence of transaction costs. It is thus a theoretical exercise that might, if it were not for transaction costs, be

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[41] Here, we may consider comity as a method of communication, perhaps but not necessarily including an element of reciprocity.

[42] For an explanation of the prisoner's dilemma, *See* R. LUCE AND H. RAIFFA, GAMES AND DECISIONS (1957); *see also* R. AXELROD, THE EVOLUTION OF COOPERATION 27 (1984). Essentially, the prisoner's dilemma is a game theoretic illustration of a circumstance in which each player's individual choices are less attractive in an aggregate sense than cooperation, if the players fail to cooperate, their aggregate welfare is diminished.

[43] For example, if the United States and Brazil could agree that Brazil owes no *obligation* to the U.S. to protect its rain forest, or its biodiversity, negotiations could proceed with greater clarity, albeit to the greater cost of the U.S.

[44] *See* FRIEDRICH K. JUENGER, CHOICE OF LAW AND MULTISTATE JUSTICE 191-237 (1993); Friedrich Juenger, *What Now?*, 46 OHIO ST. L. REV. 509 (1985).

subject to empirical testing on the basis of whether the initial allocation of authority is revised through subsequent negotiation. In fact, predictability is subsumed within accuracy. One component of accuracy — of determining the most stable allocation of jurisdictional competences — is determining how to make these allocations predictable. These factors — they are all components of accuracy — should be traded off against one another in order to minimize transaction costs and achieve efficient allocation of authority. The optimum tradeoff between these factors may be defined as accuracy. By definition, "accurate" allocations would be relatively stable — there would be nothing to be gained by renegotiating them. What theoretical allocation of authority is most likely to be relatively stable? We might begin by seeking to assess what allocations would be unstable.[45]

First, an allocation of authority is likely to be unstable if it fails to accord an appropriate measure of authority to a government whose constituents are affected by the circumstance in question. This is nothing less than the principle that each community should have control over its own destiny, and be able to negotiate with other communities, or foreign individuals, when their destinies collide. The term "affected" must be interpreted very broadly, to include not just the frustration of a positive governmental policy, but any harmful effects that a constituent would pay to abate, including frustration of a decision, or of a laissez faire "policy." We normally think of these effects as "externalities." Conversely, (and illustrating that this is, in Coase's terms, a "problem of a reciprocal nature"), an allocation of authority is likely to be unstable if it accords authority to a government whose constituents are not affected, in derogation from the authority of a government whose constituents are affected.[46] Thus, for example, a rule that allocated all jurisdiction to a government on the basis of territorial conduct, where the territorial effects occurred in another state's territory, would be unstable.[47]

It is important to note that a stable system would not, like Professor Baxter's comparative impairment approach,[48] measure the effects on each state and simply award plenary authority to the state most affected.[49] Greater complexity must be embraced in order to avoid

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[45] Baxter's methodology of hypothetical negotiations seems to be an appropriate tool. Baxter, *supra* note 32.

[46] This is Currie's disinterested third state problem. *See* Brainerd Currie, *The Disinterested Third State*, 28 L. & CONTEMP. PROBS. 754 (1963).

[47] Of course, the affected state might resort to diplomacy or to retaliation, and thereby indirectly exercise jurisdiction. Thus, the instability is not necessarily absolute, but relative, depending on the transaction costs incurred to resort to diplomacy or retaliation, as the case may be.

[48] Baxter, *supra* note 32.

[49] Of course, each of the conflict of laws systems discussed here, or otherwise known to the author, would assign full authority to one or more jurisdictions, but would not Solomonically divide authority among jurisdictions.

moral hazard, illegitimacy, and consequently, instability. Accuracy will be enhanced by a kind of *depeçage*[50] (let us call it "*nouveau depeçage*") that spreads authority, *pro rata*, to all governments whose constituents are affected.[51] Shared effects indicate a need for shared authority.[52]

Second, an allocation might be unstable to the extent that it allocates authority to a government other than the government that holds a "comparative advantage" in regulating the subject matter. These may be first mover advantages,[53] advantages due to greater experience with the type of business or type of regulatory problem or other advantages in regulating.

Thus, accuracy in allocation of authority horizontally calls for analysis of effects on different societies horizontally. We find below that accuracy in allocation of authority vertically — subsidiarity — similarly calls for analysis of effects vertically. Of course, one type of effect on the vertical scale is the effect of horizontally coordinated activity: horizontal coordination amounts to an ascent along the vertical scale.

IV. Sovereignty and Subsidiarity

In the context discussed here, the principle of subsidiarity is a basis for retaining the state as a social institution, as well as a guide for determining what functions should be allocated to the state. It is a methodological guide to reconciling the continued existence of the state with the rise of transnational society. Jacques Delors, President of the European Commission during the formulation and implementation of the single market project, as well as the Maastricht Treaty on European Union, has indicated that subsidiarity is a basis for reconciling the state and lower levels of organization with transnational society:

> I often have the occasion to return to federalism as method, including the principle of subsidiarity. I see there the inspiration to reconcile that which appears very much irreconcilable: the emergence of a

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[50] *Depeçage* is normally associated with the application of laws of different states to resolve *different* issues in the same case. *See, e.g.*, Willis Reese, *Depeçage: A Common Phenomenon in choice of Law*, 73 Colum. L. Rev. 58 (1973). Here, I use the term to refer to the application of laws of different states to resolve the *same* issue in the same case.

[51] Of course, this is the way shareholders vote in corporations and banks vote in syndicates: each has control in proportion to the extent to which it is affected. Share ownership and loan commitments measure both voting rights and economic interests, ensuring that these are congruent.

[52] *See, e.g.*, Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. Pol. Econ. 416, 423 (1956) (indicating that where externalities are of sufficient importance, "some form of integration may be indicated."). *See also*, Trachtman, *supra* note 29, at 71.

[53] *See* Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. Econ. & Org. 225 (1985).

> united Europe and loyalty to our nation, to our fatherland; the necessity of a European power to be applied to the problems of our times, and the imperative to keep our nations and our regions.[54]

It would not be necessary to establish a general formula for determining at what level particular issues should be governed, if it were possible to negotiate in advance and list the areas to be governed at each level. If subsidiarity is viewed as establishing a rule that issues should be addressed at the level where they can be addressed most effectively, this principle establishes a competition for governmental effectiveness among levels of government. In order to understand the basis for and effects of this competition, it is important to consider how effectiveness is to be measured.

Of course, effectiveness cannot be measured simply in terms of economic efficiency, without assessing a broader range of values that may be described as effectiveness in implementing social policy. Here, we encounter the same types of problems as those referred to above in assessing "effects" in order to allocate jurisdiction horizontally. In both the horizontal and vertical scale, we are seeking to assess the relative magnitude of effects on different societies, and to allocate jurisdiction in a manner designed to maximize their achievement of social policy.

Defining social policy for these purposes is the difficult task. Clearly, different social groups — families, villages, cities, sub-national regions, states and supra-national regions — will have varying preference sets or utility functions. However, to some extent, these preference sets will intersect, indicating agreed social policy. Given subsidiarity measured in terms of effectiveness in satisfying a given common preference set, there will always be some benefit in regulating at varying levels, to take advantage of varying combinations of preference sets. While there might be unacceptable transaction costs and excessive complexity associated with a great multiplicity of levels of social organization, it would appear useful to have at least several levels of social organization, to capture the benefits of varying combinations of preference sets. This indicates a need for flexibility and experimentation in allocating functions to varying levels of sub-state units, as well as varying levels of supra-state units, such as regional and functional organizations.

V. Vertical and Horizontal Institutional Competition

Can we write the theory of the firm large, as the theory of the state, or as the theory of institutions, including global ones?[55] In this

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[54] Speech by President Jacques Delors at the opening of the 40th academic year of the College of Europe, Bruges, Belgium (Oct. 17, 1989) (translation by author).

[55] *See* Douglass C. North, Structure and Change in Economic History (1981) for a discussion of the state as an economic institution. North has stated that "[a] satisfactory theory of

sense, we can consider the theory of the state, along the lines described by Ronald Coase, as informed by the social contractarian problem of determining whether the state or some other type of organization — sub-state, supra-state or trans-state — entails the lowest social costs. Surely the state expresses a much broader range of human needs and aspirations than most firms. However, the role of the state is increasingly viewed as economic, and even to the significant extent that it is not, the transaction costs basis for the theory of the firm is not restricted to transaction costs relating to economic transactions.

If we assume that each type of institution — the firm and the state — exists to reduce transaction costs, then the best firms and the best states are those that reduce transaction costs the most. Thus, the states that provide the most efficient institutional economic structures are the best. While this may appear a call for unmitigated competition among states to provide the most efficient structures, the competition need not be unmitigated. Consider three qualifications. First, the competition is not merely horizontal among states. According to the principal of subsidiarity, it is also vertical among states and sub- and supra-national units. Second, different groups of people populating states will have varying preferences.[56] Third, the best states (those that best transmit their citizens' aspirations) will recognize that the first qualification means that they cannot provide the most efficient structures without transferring sovereignty to sub- and supra-national units in some fields.[57] Selective cooperation among states is necessary to provide the most efficient product: the most efficient regulation.[58]

If, as Coase indicates, the firm and the market are simply two alternate ways to organize production in such a way as to minimize transaction costs, perhaps we may add another alternative: the state. Indeed, there are many alternatives that involve complex interactions of firm, market, state and other social units: within an economic system, none of these methods of allocation operates in isolation. The

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the firm would be a long step toward the development of a theory of the state." Douglass C. North, *A Framework for Analyzing the State in Economic History*, 16 EXPLORATIONS IN ECON. HIST. 249 (1979) (citations omitted).

[56] "The study of transaction cost economizing is thus a comparative institutional undertaking which recognizes that there are a variety of distinguishably different transactions on the one hand, and a variety of alternative governance structures on the other. The object is to match governance structures to the attributes of transactions in a discriminating way." OLIVER WILLIAMSON, ECONOMIC ORGANIZATION 140 (1986).

[57] This process indeed appears to be occurring through the European Community, GATT and other less global (geographically and functionally) structures.

[58] A remaining question is what incentives the state has to maximize citizen welfare at the expense of the state's autonomy? Perfect democracy would make this question unnecessary. However, even without perfect democracy, the incentives include the discipline of imperfect democracy, fortified by greater dissemination of information regarding the relative success of other states, as well as greater international trade.

state's power and responsibility depends on its ability to bring people together to get what they want: to maximize social preferences on the horizontal (extraterritoriality) and vertical (subsidiarity) axes simultaneously. No single formula, no single definition of "sovereignty" can possibly achieve this goal. Thus, sovereignty must be dynamic and variable.