

# Northwestern Journal of International Law & Business

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Volume 17

Issue 1 *Winter*

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Winter 1997

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### Recommended Citation

Joel P. Trachtman, The Theory of the Firm and the Theory of the International Economic Organization: Toward Comparative Institutional Analysis, 17 Nw. J. Int'l L. & Bus. 470 (1996-1997)

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# The Theory of the Firm and the Theory of the International Economic Organization: Toward Comparative Institutional Analysis

Joel P. Trachtman\*

Without a theory they had nothing to pass on except a mass of descriptive material waiting for a theory, or a fire.<sup>1</sup>

While the kind of close comparative institutional analysis which Coase called for in *The Nature of the Firm* was once completely outside the universe of mainstream economists, and remains still a foreign, if potentially productive enterprise for many, close comparative analysis of institutions is home turf for law professors.<sup>2</sup>

Hierarchical arrangements are being examined by economic theorists studying the organization of firms, but for less cosmic purposes than would be served by political and economic organization of the production of international public goods.<sup>3</sup>

## I. INTRODUCTION: THE PROBLEM

Debates regarding the competences and governance of international economic organizations such as the World Trade Organization

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<sup>1</sup> Ronald Coase, *The New Institutional Economics*, 140 J. INSTITUTIONAL & THEORETICAL ECON. 229, 230 (1984) (commenting on the "old" institutional economics). See also Kenneth W. Abbott, *Elements of a Joint Discipline*, 1992 PROCEEDINGS OF THE ANNUAL MEETING OF THE AMERICAN SOCIETY OF INTERNATIONAL LAW 167, 169 (1992): "Theory suggests elements to emphasize, relationships to explore, and other ways to bring coherence to a mass of facts. Of necessity, lawyers use such frames of reference, but they often do so unconsciously."

<sup>2</sup> Jason Scott Johnston, *The Influence of 'The Nature of the Firm' on the Theory of Corporate Law*, 18 J. CORP. L. 213, 216 (1993). One is tempted to add the following: "This type of messy mixture of empirical and normative judgments is familiar fare for lawyers, much as it may dissatisfy social scientists." Daniel A. Farber, *Positive Theory as Normative Critique*, 68 S. CAL. L. REV. 1565, 1582 (1995).

<sup>3</sup> Charles P. Kindleberger, *International Public Goods Without International Government*, 76 AM. ECON. REV. 1, 11 (1986)(citations omitted).

(WTO), the European Union (EU) and the North American Free Trade Agreement (NAFTA) seem to grow more polarized. Academic lawyers, political scientists and economists seem to add little light to these heated debates. The purpose of this paper is to examine the theory of the firm and related transaction cost-based literatures of new institutional economics (NIE),<sup>4</sup> law and economics (L&E) and industrial organizations (IO),<sup>5</sup> and the application of their analytical techniques to the linked problems of competence and governance of international economic organizations (IEOs).

I ask the same initial question about the IEO that Ronald Coase asked in 1937 about the business firm: why does it exist, and if its existence is justified, why is there not just one big one? NIE, IO and L&E owe great intellectual debts in the relevant areas to Coase's two seminal papers, *The Theory of the Firm* and *The Problem of Social Cost*.<sup>6</sup> 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.'"<sup>7</sup>

The second question is primarily the province of lawyers, although political scientists and a handful of economists have begun to

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<sup>4</sup> The new institutional economics is best seen as within the paradigm of neoclassical economics, but adds transaction costs analysis to the model used by neoclassical economics. It thus constitutes a more accurate model for use with institutional or organizational analysis. Neoclassical economics is often criticized by NIE adherents as being single institutional: as focusing only on the price system as an institution for economic organization. NIE adds analysis of firms and other organizations, and is thus multi-institutional, and importantly, can engage in comparative institutional analysis. See, e.g., NEIL KOMESAR, *IMPERFECT ALTERNATIVES: CHOOSING INSTITUTIONS IN LAW, ECONOMICS AND PUBLIC POLICY* (1994); THRAINN EGGERTSSON, *ECONOMIC BEHAVIOR AND INSTITUTIONS: PRINCIPLES OF NEO-INSTITUTIONAL ECONOMICS* (1990); Bruno Frey, *The Economic Approach to Institutions: Institutions Matter: The Comparative Analysis of Institutions*, 34 EUR. ECON. REV. 443 (1990); Steven Medema, *Discourse and the Institutional Approach to Law and Economics: Factors that Separate the Institutional Approach to Law and Economics from Alternative Approaches*, 23 J. ECON. ISSUES 417 (1989); Douglass North, *Institutions, Transaction Costs and Economic Growth*, 25 ECON. INQUIRY 419 (1987); Douglass C. North, *The New Institutional Economics*, 142 J. INSTITUTIONAL & THEORETICAL ECON. 230 (1986); Werner W. Pommerehne, *The Empirical Relevance of Comparative Institutional Analysis*, 34 EUR. ECON. R. 458 (1990); Oliver E. Williamson, *Comparative Economic Organization: The Analysis of Discrete Structural Alternatives*, 36 ADMIN. SCI. Q. 269 (1991). The new institutional economics is sometimes referred to as the new economics of organization (NEO).

<sup>5</sup> See, e.g., STEPHEN MARTIN, *ADVANCED INDUSTRIAL ECONOMICS* (1993); JEAN TIROLE, *THE THEORY OF INDUSTRIAL ORGANIZATION* (1988); or PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATION AND MANAGEMENT* (1992).

<sup>6</sup> RONALD COASE, *THE FIRM, THE MARKET AND THE LAW* 95-185 (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). See also Ronald Coase, *The Nature of the Firm: Influence*, 4 *J.L. ECON. & ORGANIZATION* 33, 33 (1988).

<sup>7</sup> COASE, *supra* note at 6.

address it. It concerns the internal governance of IEOs, including voting rules and other rules about how decisions are made. Within U.S. federalism, and within the EU, this question includes that of "horizontal federalism:" how do the different branches of government – including in the United States the executive, the legislature and the judiciary – combine to exercise centralized power? This question is critically related to the question of vertical federalism: what powers should be at the center, and what powers should remain at the periphery? This second question of *governance "inside the box" is inextricably linked to the question of how big the box should be and what functions it should have.*<sup>8</sup> In addition, the mechanism inside the box remains dependent upon, and constantly affected by, the institutional structure outside the box. Together they constitute a system. While, for modelling purposes, we can draw all the boundaries we want, we cannot change the fact that no component of the system operates in isolation from the rest of the system.

Beginning with Coase, NIE has developed analytical tools to answer similar questions to those raised above, within the context of the business firm.<sup>9</sup> These tools have not generally been applied to formal international organizations. This paper proposes that business firms and IEOs have some characteristics in common, and that these commonalities make comparison worthwhile. L&E has drawn on, and is related to, IO and NIE in this field.<sup>10</sup> These three schools of thought have been concerned, primarily in the context of the firm, with the two questions discussed above: why does the firm exist and how should it be governed? These schools of thought are receptive to, and in NIE focus on, transaction cost economizing rather than (or in addition to) the price theory common in neo-classical economics.<sup>11</sup> "The discriminating alignment hypothesis to which transaction cost economics owes much of its predictive content holds that transactions,

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<sup>8</sup> This point is illustrated in the account of the allocation of powers to the European Community in J.H.H. Weiler, *The Transformation of Europe*, 100 *YALE L.J.* 2403 (1991). See also Williamson, *supra* note 4, at 269 ("The paper unifies two hitherto disjunct areas of institutional economics – the institutional environment and the institutions of governance – by treating the institutional environment as a locus of parameters, changes in which parameters bring about shifts in the comparative costs of governance").

<sup>9</sup> For a critical perspective: See Herbert A. Simon, *Organizations and Markets*, *J. ECON. PERSP.*, Spring 1991, at 25.

<sup>10</sup> See Richard Posner, *The New Institutional Economics Meets Law and Economics*, 149 *J. INSTITUTIONAL & THEORETICAL ECON.* 73 (1993). The economics of organization and more particularly the theory of the firm is one area of inquiry for law and economics.

<sup>11</sup> While price theory has potential utility in the study of international organization, this paper will focus on transaction cost economizing.

which differ in their attributes, are aligned with governance structures, which differ in their costs and competencies, in a discriminating (mainly, transaction cost economizing) way.”<sup>12</sup>

Thus, the theoretical perspective of this paper is transaction costs economizing. Transaction costs are interpreted broadly to include all the costs and constraints of organized activity, including information costs, contracting costs, agency costs and enforcement costs. Transaction benefits,<sup>13</sup> including trade in the narrowest commercial sense and trade implicit in the tenderest reciprocities, are the presumed gains from such organized activity. This theoretical perspective has become the dominant approach to analysis of the corporate firm;<sup>14</sup> this paper asks whether it may be a useful approach to the analysis of IEOs. This type of adaptation has been performed in connection with other types of non-firm organizations, including application of “positive political theory”<sup>15</sup> to governmental organizations,<sup>16</sup> but has only been performed in a limited sphere in connection with international organizations.<sup>17</sup>

The main hypothesis of this paper suggests that states use and design international institutions<sup>18</sup> to maximize the members’ net gains

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<sup>12</sup> Williamson, *supra* note 4, at 277.

<sup>13</sup> See OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 22 (1985). See also Todd Sandler & Jon Cauley, *The Design of Supranational Structures: An Economic Perspective*, 21 INT’L STUD. Q. 251 (1977).

<sup>14</sup> Johnston, *supra* note 2.

<sup>15</sup> See, e.g., Farber, *supra* note 2, at 1582; William N. Eskridge, Jr. & Philip P. Frickey, *Foreword: Law As Equilibrium*, 108 HARV. L. REV. 26 (1994).

<sup>16</sup> See, e.g., *Symposium on New Institutional Economics: Bounded Rationality and the Analysis of State and Society*, 150 J. INSTITUTIONAL & THEORETICAL ECON. (1994); JOSEPH E. STIGLITZ, *THE ECONOMIC ROLE OF THE STATE* (1989); Barry R. Weingast & William J. Marshall, *The Industrial Organization of Congress; or, Why Legislatures, Like Firms, Are Not Organized as Markets*, 96 J. POLIT. ECON. 132 (1988) (examining internal organization of legislatures); Terry M. Moe, *The New Economics of Organization*, 28 AM. J. POL. SCI. 739 (1984); Gary J. Miller & Terry M. Moe, *The Positive Theory of Hierarchies*, in *POLITICAL SCIENCE: THE SCIENCE OF POLITICS* (Herbert F. Weisberg ed.) (1986); Jean-Jacques Laffont & Jean Tirole, *The Politics of Government Decision Making: Regulatory Institutions*, 6 J. L. ECON. & ORG. 1 (1990); Jean Tirole, *Hierarchies and Bureaucracies: On the Role of Collusion in Organizations*, 2 J. L. ECON. & ORG. 181 (1986).

<sup>17</sup> See Beth V. Yarbrough & Robert M. Yarbrough, *Dispute Settlement in International Trade: Regionalism and Procedural Coordination*, forthcoming in EDWARD MANSFIELD AND HELEN MILNER, EDs., *THE POLITICAL ECONOMY OF REGIONALISM* (1996); Beth V. Yarbrough & Robert M. Yarbrough, *International Institutions and the New Economics of Organization*, 44 INT’L ORG. 235 (1990); Paul R. Milgrom et al., Douglass C. North & Barry R. Weingast, *The Role of Institutions in the Revival of Trade: The Law Merchant, Private Judges, and the Champagne Fairs*, 2 ECON. & POL. 1 (1990).

<sup>18</sup> It is important to define the term “institution” for our purposes. The term is meant here to include (i) formal organizational institutions such as legislative, executive and judicial bodies and the organizations they comprise, (ii) formal rules from constitutional rules down to normal

(NG), which equals the excess of transaction gains from engaging in intergovernmental transactions (TG), minus the sum of transaction losses from engaging in intergovernmental transactions (TL), and the transaction costs of intergovernmental transactions (including transaction costs of international agreement or of creating and running institutions, TC).<sup>19</sup> Thus, stated mathematically, they maximize the present value of  $NG = TG - (TL + TC)$ . "Intergovernmental transaction" is a kind of transaction in power,<sup>20</sup> including prescriptive jurisdiction,<sup>21</sup> between states.<sup>22</sup> These transactions include, *inter alia*, agreements to reduce protectionist and mercantilist behavior, agreements regarding regulatory jurisdiction and agreements regarding regulatory harmonization. These transactions also include constitutional-type transactions, such as agreements on voting or dispute resolution mechanisms. In fact, it appears that most, if not all, international eco-

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legislation, and (iii) informal (non-legal) institutions comprised of organizations or rules that lack legal effect. A more elegant definition is provided by North: "[i]nstitutions are the humanly devised constraints that structure human interaction." Douglass C. North, *Economic Performance Through Time*, 84 AM. ECON. REV. 359, 360 (1994). Some authors distinguish "institutions" from "organizations." See, e.g., Elias L. Khalil, *Organizations Versus Institutions*, 151 J. INSTITUTIONAL & THEORETICAL ECON. 445 (1995); DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE (1990). North refers to the need to distinguish the rules from the players. However, the rules are the players insofar as a firm, *qua* set of rules, competes with another firm. The distinction is in large part one of point of view: from the point of view of the market, each firm is a player. From the point of view of the employee, the firm is a set of rules.

<sup>19</sup> This maximization formula is congruent with the minimization formula posited by NIE scholars in respect of institutions more generally. "Institutions will be chosen that minimize total costs, the sum of transformation and transaction costs, given the level of output." Douglass C. North & John J. Wallis, *Integrating Institutional Change and Technical Change in Economic History: A Transaction Approach*, 150 J. INSTITUTIONAL & THEORETICAL ECON. 609, 610 (1994). "Economizing takes place with reference to the sum of production and transaction costs, hence tradeoff in this respect must be recognized." Williamson, *supra* note 13, at 22.

<sup>20</sup> "When [states] cooperate, they benefit from the creation of new values, material or non-material. When they are in conflict, they attempt to gain values at each other's expense. In either case, they are interdependent." KLAUS KNORR, *THE POWER OF NATIONS: THE POLITICAL ECONOMY OF INTERNATIONAL RELATIONS* 3 (1975), *quoted by* JAMES E. DOUGHERTY & ROBERT L. PFALTZGRAFF, *CONTENDING THEORIES OF INTERNATIONAL RELATIONS* 67 (1997). This paper focuses on the former kind of interdependence. The latter kind of interdependence can be viewed as transactional also, although it is presumably an involuntary transaction on the part of one party.

<sup>21</sup> For an analysis of prescriptive jurisdiction on the basis of an analogy to domestic property rights: See Joel P. Trachtman, *Externalities and Extraterritoriality: The Law and Economics of Prescriptive Jurisdiction*, forthcoming in *COMPARATIVE DIMENSIONS IN INTERNATIONAL LAW* (Jagdeep Bhandari & Alan O. Sykes, eds.) (1997).

<sup>22</sup> A public choice perspective would consider it also trade between particular components of government of states. See, e.g., DANIEL A. FARBER & PHILIP P. FRICKEY, *LAW AND PUBLIC CHOICE: A CRITICAL INTRODUCTION* (1991); DENNIS C. MUELLER, *PUBLIC CHOICE II* (1989); BERNARD GROFMAN & DONALD WITTMAN, *THE FEDERALIST PAPERS AND THE NEW INSTITUTIONALISM* (1989).

conomic law may involve transactions in jurisdiction, either horizontal or vertical.<sup>23</sup> In turn, much of international law generally is comprised of international economic law.<sup>24</sup>

The maximization of net benefits is by necessity a comparative undertaking. It requires positive evaluation of various forms of organization and indicates normative choice of the form of organization that maximizes the positive sum of these factors.<sup>25</sup> "Hence, both the concept of 'market failure' and of 'government failure' are rejected as they correspond to a 'Nirvana' view. There exists in general no ideal market and no ideal government which could remedy the shortcomings of the other decision-making mechanisms in a perfect way."<sup>26</sup> This analytical and critical theory and its methodology rejects both reflexive world federalism and reflexive autarchy. Less obviously, it rejects blanket calls for "strong" international institutions. Rather, this theory calls for a methodology that requires that each question be answered within its particular context. It is thus a prescription for further theoretical and empirical work.<sup>27</sup>

Given problems of definition and quantification, the maximizing equation described above may be too difficult to operationalize in its full form, except in relatively discrete and limited circumstances. Attempts to create predictive models must seek to simplify this theory, while retaining some predictive capacity. One method of simplification is to consider the transaction costs side of the equation and ignore calculations of transaction benefits. Another method is to seek contexts that are indicative of certain asset specificity or transaction cost profiles, and to try to match governance structures to such contexts. A final method it to seek relatively discrete and limited contexts where transaction costs, transaction benefits and transaction losses are

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<sup>23</sup> See Joel P. Trachtman, *The International Economic Law Revolution*, 17 U. PA. J. INT'L ECON. L. 33 (1996).

<sup>24</sup> See, e.g., John H. Jackson, *International Economic Law: Reflections on the "Boilerroom" of International Relations*, 10 AM. U. J. INT'L L. & POL'Y 595, 596 (1995) (speculating that as much as 90% of public international law is international economic law).

<sup>25</sup> For the leading legal work on comparative institutional analysis: See Komesar, *supra* note 4. See also Edward L. Rubin, *Commentary: The New Legal Process, the Synthesis of Discourse, and the Microanalysis of Institutions*, 109 HARV. L. REV. 1393 (1996).

<sup>26</sup> Frey, *supra* note 4, at 445. See also ERNST-ULRICH PETERSMANN, CONSTITUTIONAL FUNCTIONS AND CONSTITUTIONAL PROBLEMS OF INTERNATIONAL ECONOMIC LAW 6 (1991).

<sup>27</sup> See Johnston's description of Coase's theory of the firm as offering a "progressive research program" in corporation law. Johnston, *supra* note 2, at 218. The progressive research program that this methodology offers in IEOs is similar: it provides both complexity and rationality. Johnston points out that prior scholarship had obscured the complexity of policy issues, and that the prior legal realist tradition failed to provide a theory of behavior. Coase's theory of the firm both embraced complexity and satisfied the scholar's need for rationality.

more amenable to quantification: pick the low-hanging fruit first. It is not clear whether these simplifications have been successful in the theory of the firm, but it is worthwhile to evaluate these attempts and their potential analogs in the theory of the IEO.

## II. THE THEORY

### A. Antecedent Literature

While Coase's ideas stimulated a thick literature seeking to address the theory of the business firm, IEOs have received much less attention in the theoretical literatures of law, politics and economics, especially in recent years. As a background to the explication of the potential applicability of the theory of the firm literature to IEOs, this paper will review selected relevant antecedents from law, economics and political science.

#### 1. Law

Many legal scholars have relinquished any pretensions to autonomy for law as a discipline,<sup>28</sup> and seek theoretical justification in other disciplines: economics, politics, sociology, etc. Much of the legal literature of multilateral international organizations was written before legal scholars accepted the discipline's lack of autonomy. It has continued in a largely descriptive<sup>29</sup> positivist project, or has embraced utopian ideals. Some of the more recent literature is analytical, realistic and informed by the perspective of other disciplines.<sup>30</sup> Modern scholarship of European Union law is more significantly analytical, realistic and interdisciplinary. However, even this body of literature has not yet substantially accessed the NIE, IO or L&E literatures.

#### 2. Economics

From the standpoint of neo-classical international trade economics, the question of whether to form IEOs and how to govern them can be answered from either of two perspectives.<sup>31</sup> The first perspective is that of static analysis, considering trade creation and trade di-

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<sup>28</sup> See Robert Cooter, *Law and Unified Social Theory*, 22 J. L. & Soc. 50 (1995); Richard A. Posner, *The Decline of Law as an Autonomous Discipline: 1962-1987*, 100 HARV. L. REV. 761 (1987).

<sup>29</sup> See, e.g., DEREK W. BOWETT, *THE LAW OF INTERNATIONAL INSTITUTIONS* (1975).

<sup>30</sup> See, e.g., FREDERIC C. KIRGIS, *INTERNATIONAL ORGANIZATIONS IN THEIR LEGAL SETTING* (1993); Abram Chayes & Antonia Handler Chayes, *On Compliance*, 47 INT'L ORG. 175 (1993).

<sup>31</sup> Jagdish Bhagwati, *Regionalism and Multilateralism: An Overview*, in *NEW DIMENSIONS IN REGIONAL INTEGRATION* at 22 (Jaime de Melo & Arvind Panagariya, eds. 1993).



version. The second perspective, according to Bhagwati,<sup>32</sup> is that of the dynamic time path. It asks what the effects of starting down this road will be after a period of time. Implicit in the second perspective is the question of which path will lead soonest to greatest multilateral reduction of trade barriers, with the implicit assumption that this is also the path to the greatest aggregate welfare. This paper adopts the second perspective, but does not accept its implicit assumption. The second, dynamic perspective is capable of examining institutions, while the static perspective can only examine particular international economic relations "transactions" once completed.

By focusing on the static calculation of trade creation and trade diversion, neo-classical economics has addressed the potential benefit side of the integration equation from a static or transactional perspective.<sup>33</sup> Economics has made significant strides toward analyzing data to assess some of the trade benefits of integration,<sup>34</sup> and to compare regional integration to multilateral integration in these terms. It has not addressed the opportunity costs of integration in an organized way. What does a state lose when it gives up a part of its autonomy to regulate, for example, food quality or banking services? These opportunity costs must be analyzed in institutional "trade" terms. How much autonomy is foregone, what is it worth, and how much compensating influence over centralized decisions is obtained, and what is it worth?<sup>35</sup> Assuming that there are circumstances where gains can be derived by exchanging autonomy for integration in particular areas, economics has also spent little time assessing the institutional constraints on the ability to make exchanges in this field. Neo-classical economics has not addressed in a detailed and sustained fashion the institutional context of integration. Public choice theorists and new institutional economics scholars have begun to analyze some of the problems of international economic organization. As their work is described below, I do not describe it here.

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<sup>32</sup> *Id.*

<sup>33</sup> See, e.g., PAOLO CECCHINI, *THE EUROPEAN CHALLENGE 1992: THE BENEFITS OF A SINGLE MARKET* (1988).

<sup>34</sup> See, e.g., C.A. Primo Braga & Alexander J. Yeats, *Minilateral and Managed Trade in the Post-Uruguay Round World*, 3 MINN. J. GLOBAL TRADE 231 (1994).

<sup>35</sup> These costs are not easy to value, and thus do not fit neatly into neo-classical models. However, real options theory in business scholarship has made advances toward analyzing and valuing these types of costs. See note 241, *infra*.

### 3. Politics

The international organizations literature of political science has considered the theory of the firm, IO,<sup>36</sup> NIE<sup>37</sup> and public choice. However, this literature has de-emphasized the role of formal institutions<sup>38</sup> in favor of greater emphasis on power, regimes and informal institutions.<sup>39</sup> "One pattern that can be discerned throughout the maturation of the international organization field in the postwar era has been the steady disengagement of international organization scholars from the study of organizations, to the point that one must question whether such a field even exists any longer except in name . . . ."<sup>40</sup> Indeed, the study of organizations themselves, and the institutional design of organizations, seems to have been attacked in the 1970s and 1980s by both the neo-realist and the regime-based neo-liberal paradigms.

The study of international organizations began in the early part of the 20th century with the kind of technical, institutional and law-oriented perspective that is attractive to lawyers,<sup>41</sup> although it was often motivated by utopianism.<sup>42</sup> It has been diverted from its formal institutional focus by a consensus between the two main competing theoretical perspectives in international relations. These perspectives

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<sup>36</sup> See, e.g., David A. Lake, *Anarchy, Hierarchy, and the Variety of International Relations*, 50 INT'L ORG. 1 (1996) (applying industrial organization concepts to security alliances).

<sup>37</sup> See Duncan Snidal, *Political Economy and International Institutions*, 16 INT'L REV. L. & Econ. 121 (1996); Thomas Bernauer, *International Financing of Environmental Protection: Lessons From Efforts to Protect the River Rhine Against Chloride Pollution*, 3 ENVIRONMENTAL POL. 369 (1995).

<sup>38</sup> On the other hand, the tendency of international lawyers to emphasize the formal has been criticized: "contemporary public international lawyers have developed a highly formalistic and exclusively technical legal positivist approach to international relations," neglecting "the great issues of American foreign policy and world affairs . . . ." FRANCIS BOYLE, *WORLD POLITICS AND INTERNATIONAL LAW* 59 (1985), as quoted by Kenneth W. Abbott, *Modern International Relations Theory: A Prospectus for International Lawyers*, 14 YALE J. INT'L L. 335, 336 (1989).

<sup>39</sup> But see, e.g., MILES KAHLER, *INTERNATIONAL INSTITUTIONS AND THE POLITICAL ECONOMY OF INTEGRATION* (1995).

<sup>40</sup> J. Martin Rochester, *The Rise and Fall of International Organization as a Field of Study*, 40 INT'L ORG. 777, 784 (1986). See also ORAN R. YOUNG, *INTERNATIONAL COOPERATION: BUILDING REGIMES FOR NATURAL RESOURCES AND THE ENVIRONMENT* 207 (1989):

Political scientists steeped in the power-oriented perspectives of realism or trained in the empirical methodologies of behavioralism tend to dismiss any emphasis on the role of institutions as a vestige of the discredited ideas of the formal, legal, institutional school of thought. Yet other students of politics as well as most lawyers (who typically make a living by devising, interpreting, and refining institutional arrangements) cannot imagine treating institutions as anything but central determinants of collective behavior.

<sup>41</sup> Rochester, *supra* note 40, at 780-87. See, e.g., ERNST HAAS, *BEYOND THE NATION-STATE* (1964).

<sup>42</sup> Dougherty & Pfaltzgraff, *supra* note 20, chap. 2.

reject the utopian perspective and apparently neglect its formal institutional concerns. These two main theoretical perspectives are sometimes referred to as neo-realism and neo-liberalism; however, these labels conceal a significant degree of convergence and internal diversity.

The neo-realist perspective tends to ignore formal institutions and law as ineffective and to consider policy as determined by the confluence of power and interest of states.<sup>43</sup> Neo-realism provides a positive account of state behavior based on national interest and national power.

Neo-liberalism, despite its interest in institutions, is only slightly different for our purposes.<sup>44</sup> Neo-liberal institutionalism, led by Robert Keohane,<sup>45</sup> looks to the institutionalization of power through regimes, sometimes led by powerful "hegemons."<sup>46</sup> This body of literature professes acceptance of both formal and informal institutions: however, its research program has focused on informal regimes

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<sup>43</sup> For a full description of the realist perspective, see *id.* "Realism is the antithesis of legalism." Anne-Marie Burley & Walter Mattli, *Europe Before the Court: A Political Theory of Legal Integration*, 47 INT'L ORG. 41, 48 (1993). See also the description of this separation as one between law and political science in Harold Koh, *Transnational Legal Process*, 75 NEB. L. REV. 181 (1996). Koh states that:

[b]y the early 1980s, the schism between the two disciplines was nearly complete. International lawyers tended to find the glass half full, typified by Henkin's famous phrase, 'almost all nations observe almost all principles of international law and almost all of their obligations almost all of the time.' International relations theorists, by contrast (particularly the realists) found such legalism naive and utopian, and tended toward the opposite conclusions: that international law always fails in the big case; that international law cannot be enforced; and that when power and law come into conflict in international affairs, politics is the phenomenon and law is the epiphenomenon.

*Id.* at 191-92 (citations omitted). Of course, many realists see some role for law and institutions. See KENNETH N. WALTZ, *THEORY OF INTERNATIONAL POLITICS* 114 (1979), accepting that "world politics, although not formally organized, is not entirely without institutions and orderly procedures." But see Susan Strange, *Cave! Hic Dragones: A Critique of Regime Analysis*, 36 INT'L ORG. 479, 487 (1982) ("All those international arrangements dignified by the label regime are only too easily upset when either the balance of bargaining power or the perception of national interest (or both together) change among those states who negotiate them").

<sup>44</sup> See STEPHEN D. KRASNER, *INTERNATIONAL REGIMES* (1983). See also the review of this literature in Marc A. Levy, Oran R. Young & Michael Zum, *The Study of International Regimes*, 1 EUR. J. INT'L REL. 267 (1995); BETH V. YARBROUGH & ROBERT M. YARBROUGH, *COOPERATION AND GOVERNANCE IN INTERNATIONAL TRADE: THE STRATEGIC ORGANIZATIONAL APPROACH* 49-67 (1992). See also ROBERT ELLICKSON, *ORDER WITHOUT LAW* (1992) (describing how cattle ranchers in Shasta county devise "regimes" outside of or inconsistent with law).

<sup>45</sup> Keohane's neo-liberal institutionalism has neo-realist assumptions. "Drawing on analogies from economics rather than politics, he offered a neo-realist explanation for the endurance and importance of international institutions that was consistent with neo-realist assumptions." Anne-Marie Burley, *Law and the Liberal Paradigm in International Relations Theory*, 1992 PROC. ANN. MTG. AM. SOC. OF INT'L L. 180 (1992).

<sup>46</sup> KEOHANE, *infra* note 52, at 30-46.

instead of formal legal or institutional mechanisms.<sup>47</sup> “[R]egime theory does not recognize anything distinctively ‘lawlike’ about international rules.”<sup>48</sup> Thus, neo-realism and neo-liberal institutionalism<sup>49</sup> are united by a common focus on national interest and national power, and by a tendency to relegate formal institutions and legal constraints to irrelevance.<sup>50</sup>

The self-interest central to realism and the rationalist body of neo-liberal institutionalism is, of course, one of the basic assumptions of economic theory (and of this paper). Interestingly, the institutional branch of economics has recognized that self-interest can be consistent with the development and empowerment of formal institutions and with integration, while realism-based political science has not. The basic building blocks of modern political theory, “. . . the distribution of preferences (interests) among political actors, the distribution of resources (powers), and the constraints imposed by the rules of the game (constitutions),”<sup>51</sup> are in fact quite comparable to the basic building blocks of institutional economics: preferences, wealth and in-

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<sup>47</sup> See Abbott, *supra* note 38, at 339 (“None of the prevailing definitions [of regimes], moreover, is congruent with the usual descriptive categories of [international law], such as customary rules, conventional rules and international organizations.”) See also Kenneth W. Abbott and Duncan Snidal, *Mesoinstitutions: The Role of Formal Organizations in International Politics*, manuscript dated July 1995 (“But a funny thing happened on the way to regime theory: Formal IOs came to be largely neglected.”) Abbott and Snidal provide a theory of the rationale for development of formal IOs, but do not pursue the applicability of the theory of the firm, or the internal structure of IOs. Their call for a re-emphasis on formal institutions in the study of international institutions stimulated my study of the present topic.

<sup>48</sup> Burley, *supra* note 45, at 182.

<sup>49</sup> See ROBERT O. KEOHANE, *INTERNATIONAL INSTITUTIONS AND STATE POWER: ESSAYS IN INTERNATIONAL RELATIONS THEORY* 1-20, 158-179 (1989).

<sup>50</sup> See, e.g., Yarbrough & Yarbrough, *supra* note 44, at 65 (“The enforcement powers of GATT or any other body against a sovereign state are, in a legal sense, almost nonexistent. Without legal enforcement, a strong arbitrator is necessary for cooperation. The arbitration required for successful multilateral agreements is unlikely without a hegemon to act as a supporter of international institutions such as the GATT.”) From this perspective, the formal institution becomes a mere guise for power; an instrument through which the hegemon acts. See also James E. Alt & Lisa L. Martin, *Contracting and the Possibility of Multilateral Enforcement*, 150 J. INST. & THEO. ECON. 265 (1994):

In a Realist framework, institutions have no power to bind states or even significantly change the constraints in which they operate. . . . Hegemonic stability theory would predict that institutions will only be stable and effective as long as the distribution of power underlying their construction remains stable.

*Id.* at 265-66.

<sup>51</sup> James G. March & Johan P. Olsen, *The New Institutionalism: Organizational Factors in Political Life*, 78 AM. POLIT. SCI. REV. 734, 739 (1984). See also Andrew Moravcsik, *Preferences and Power in the European Community: A Liberal Intergovernmentalist Approach*, 31 J. COMM. MKT. Stud. 473 (1993); Stephen D. Krasner, *Structural Causes and Regime Consequences: Regimes as Intervening Variables*, 36 INT'L ORG. 185, 189 (1982) (power and interest as most prominent causal variables, moderated by regimes).

stitutions. The equation that forms the theoretical basis for this paper can be understood in terms of the central realist variables of power and interest.<sup>52</sup> States transact in power to maximize their ability to achieve their particular interests.<sup>53</sup> The main departures that this paper takes from the realist perspective are in its view of the interests of states and in its view of the role of institutions, which are more fully discussed below.

Regimes and other institutions are best seen "as a set of intermediate factors, or 'intervening variables,' that stand between the landscape of international politics, including especially the distribution of power, on the one hand, and the actual behavior of the basic entities, be they state or nonstate actors, on the other."<sup>54</sup> However, they are not simple tools of power; rather, they are prisms that may modify the direction, color and intensity of power as they carry it from one locus to another, and one time to another. They have a degree of autonomy. The degree of autonomy accorded a particular institution is a design characteristic that serves as a metric of institutionalization. That is, the more autonomy is accorded the institution, the more institutionalized and integrated are the relations (and the less autonomy the states that have formed the institution retain).

Of course, informal institutions are important,<sup>55</sup> both independently and in synergy with formal institutions. The boundary between informal and formal is unclear. Formal law often has its greatest social effect outside of legal fora.<sup>56</sup> However, given the growth of formal institutions in recent years, both in numbers and in competences, it seems appropriate to retrain our eyes on them. In addition, formal institutions are more susceptible to self-conscious design, and are thus a useful focus for considering the design of institutions. Finally, perhaps the problem with the study of informal institutions as constraints on behavior can be summarized by reference to Samuel Goldwyn's

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<sup>52</sup> See ROBERT KEOHANE, *AFTER HEGEMONY* (1984), 30-46.

<sup>53</sup> "Ruthless egoism does the trick by itself." Burley & Mattli, *supra* note 43, at 54. The focus on interests is consistent with neo-functionalism. "... [T]he process of community formation is dominated by nationally constituted groups with specific interests and aims, willing and able to adjust their aspirations by turning to supranational means when this course appears profitable." ERNST HAAS, *THE UNITING OF EUROPE* xiv (1958), *quoted in id.* at 55.

<sup>54</sup> JAMES E. DOUGHERTY & ROBERT L. PFALTZGRAFF, *CONTENDING THEORIES OF INTERNATIONAL RELATIONS* 170 (1990), *citing* Stephen D. Krasner, *Structural Causes and Regime Consequences Regimes as Intervening Variables*, in *INTERNATIONAL REGIMES* (Stephen D. Krasner, ed. 1985).

<sup>55</sup> See Charles Lipson, *Why Are Some International Agreements Informal?*, 45 *INT'L ORG.* 495 (1991).

<sup>56</sup> Robert H. Mnookin & Lewis Kornhauer, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 *YALE L.J.* 950 (1979).

droll comment that unwritten agreements: "aren't worth the paper they're written on."<sup>57</sup> From a lawyer's standpoint, while informal agreements may well affect behavior, they do not do so in a particularly *legal* manner. They lack the quality peculiar to legal agreements. They are not linked to a formal institutional mechanism for enforcement. The enforcement methods for informal agreements may be quite different from those for formal agreements, and the discourse regarding interpretation and compliance may also differ. Informal agreements may incur greater costs of enforcement than do formal agreements. While this may well be a difference of degree rather than of kind, with the degree of difference varying with the institutional support available to the agreement, it is nonetheless a difference with real implications. The point is not that lack of *legal* nature is a defect; rather, it is that legal analysis brings little to the analysis of informal agreements.

This article argues that formal institutions are relevant in the international sphere, as they are in the domestic sphere, although the degree of relevance may differ and change over time. In both spheres, they constrain the naked exercise of power, serve as a conduit for power from an initial time to a later time, and result in states sacrificing later-held interests in order to comply. The assumption of self-interest is retained and accepted as the sole motivating force of individuals and states.<sup>58</sup> These sacrificed later-held interests are presumably smaller than the aggregate of (a) the complying state's general interests in upholding the complying state's reputation, and perhaps more importantly, (b) the complying state's interests in reaping absolute gains (perhaps in a later institutional decision) by upholding this institution or perhaps the "rule of law" generally through compliance. The constraint is not complete in either sphere,<sup>59</sup> nor would we necessarily want it to be. The concept of efficient breach shows that strict compliance is not always the best outcome.<sup>60</sup>

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<sup>57</sup> Lipson, *supra* note 55, at 495.

<sup>58</sup> This harsh assumption can be justified in two ways. First, it can be justified as merely a simplifying assumption, made for purposes of building a model. Second, it can be justified by positing that normative, moral or ethical behavior that seems to rise above self-interest, conventionally defined, is better viewed as the most enlightened self-interest. See Robert Cooter, *Law and Unified Social Theory*, 22 J. L. & Soc. 50 (1995) (developing the concept of "thick self interest," based on socialization to institutional roles). The latter position indicates that what some call "reflectivism" may be better explained as enlightened rationalism.

<sup>59</sup> For an analysis of the incompleteness of the constraint in the domestic sphere see Ellickson, *supra* note 44.

<sup>60</sup> See Arild Underdal, *The Concept of Regime 'Effectiveness,'* 27 *NORD. J. INT'L STUD.* 227 (1992). On efficient breach in international law: See Alan O. Sykes, *Protectionism as a "Safe-*

Note that this model of motivations is at least potentially consistent with a realist or Machiavellian perspective: "a prudent ruler cannot keep his word, nor should he, where such fidelity would damage him, and when the reasons that made him promise are no longer relevant."<sup>61</sup> A sophisticated realist would need to modify this statement to incorporate not only the potential inapplicability of the reasons that induced the promise, which may be neither necessary nor sufficient to induce breach, but also the countervailing effect of interests in keeping the promise, including reputation, potential reciprocal breach in other areas, etc. According to this perspective, the correct question is not "how do we improve compliance,"<sup>62</sup> but "how do we structure our institutions to achieve an optimum level of compliance?" We need not change the psychology of the prince, only his incentive structure.

In the context of this relativistic approach, it is not correct to say that the international sphere is anarchic, while the domestic sphere is ordered.<sup>63</sup> While the international sphere may have "weaker" institutions (in terms of their ability to make decisions and coerce compli-

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guard." *A Positive Analysis of the GATT "Escape Clause" with Normative Speculations*, 58 U. CHI. L. REV. 255 (1991).

<sup>61</sup> NICCOLÒ MACHIAVELLI, *THE PRINCE* 61-62 (Quentin Skinner and Russell Price, eds. 1988), quoted in Abram Chayes & Antonia Handler Chayes, *On Compliance*, 47 INT'L ORG. 175 (1993).

<sup>62</sup> See Chayes & Chayes, *supra* note 61, at 179, for an example of this perspective: "Compliance is the normal organizational presumption." This approach to international law, often found in commentary on the GATT/WTO system, seeks to "harden" it as much as possible. But see William Diebold, *FROM THE ITO TO GATT - AND BACK?* (1994), quoting THOMAS LOVE PEACOCK, *MISFORTUNES OF ELPHIN* 13 (1897): "Seithenyn rejects the criticism that there are weak spots in his seawall, saying: 'That is the beauty of it. Some parts of it are rotten and some parts of it are sound. . . . If it were all sound it would break by its own obstinate stiffness: the soundness is checked by the rottenness, and the stiffness is balanced by the elasticity.'" Chayes & Chayes recognize that compliance should not necessarily be absolute. "'An acceptable level of compliance' is not an invariant standard." *Id.* at 198. "[A] considerable amount of deviance from strict treaty norms may be anticipated from the beginning and accepted, whether in the form of transitional periods, special exemptions, limited substantive obligations, or informal expectations of the parties." *Id.* at 200.

<sup>63</sup> The realist contention that international relations take place in an anarchic setting is based on the relatively horizontal nature of the international legal system: the lack of an "ultimate" source of enforcement authority. See the interesting analysis in Emerson M.S. Niou & Peter C. Ordeshook, "Less Filling, Tastes Great:" *The Realist-Neoliberal Debate*, 46 WORLD POL. 209, 222 (1994). Niou and Ordeshook point out that in the domestic constitutional system, there is no "ultimate" source of enforcement authority: there is no answer to the problem of what happens when the President and Congress disagree in the United States. While the courts could authoritatively answer the question, they often demur on the basis of the political question doctrine or other passive virtues, and even if the courts spoke definitively, the President could ignore their decision for a long time before impeachment proceedings could become effective to force his compliance. Niou and Ordeshook find that "[a]t least at the constitutional level, then, a state is in principle no less anarchic than an international system in the sense that the enforcement of constitutional agreements must be endogenous." *Id.* They conclude that realists "must explain

ance), as compared to an orderly domestic society, the difference is only one of degree. While some portions of international society are extremely orderly (like inter-bank correspondent relations for trade letters of credit), some portions of domestic society seem anarchic. Finally, "weakness" of institutions is a design characteristic and not necessarily a fault. States may be willing to take on greater substantive obligations if there is more procedural "give" in the system. States may be unwilling to take on "strong" obligations that are not supported by democratic legitimation. It may be optimal for other reasons for states to take on only weaker obligations. Again, this is based on a model of states motivated only by self-interest.<sup>64</sup>

This paper accepts but seeks to re-frame the "core insight of neo-functionalism" that "integration is most likely to occur within a domain shielded from the interplay of direct political interests"<sup>65</sup> by focusing on the word "direct." The metaphor of institutions as prisms involves the indirect and constrained interplay of political interests. In fact, integration is the creation of domains shielded from the interplay of direct political interests.

The very creation and development of the Treaty of Rome and the European Court of Justice (ECJ) may be understood as the progressive development of domains shielded from the interplay of direct political interests. For example, the institutional characteristic of fidelity of judges to law is re-framed as fidelity to the goal of maximizing aggregate preferences, viewing law on the books as the definitive available expression of these preferences. At a higher level, fidelity of judges to law is also understood as upholding the underlying interest in enforcing bargains as made, in order to maximize aggregate preferences as expressed in the agreements that result from bargaining; protecting system interests through fidelity to law.<sup>66</sup> The ECJ thus continually justifies "its decisions in light of the common interests of the members as enshrined in both specific and general objectives of the original Rome treaty."<sup>67</sup>

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why they believe that coordination can more readily be achieved at one level of social interaction than at another." *Id.* at 223-24.

<sup>64</sup> Cooter, *supra* note 58.

<sup>65</sup> Burley & Mattli, *supra* note 43, at 57.

<sup>66</sup> Of course, judges may find ways to be "unfaithful" to the letter of the law, perhaps where the costs of fidelity are greater than the costs of exceptionalism.

<sup>67</sup> *Id.* at 68. "Rhetorically, these formulas constantly shift the analysis to a more general level on which it is possible to assert common interests – the same common interests that led member states into the community process in the first place." *Id.* at 69 (referring to references to "foundations of the Community" and other similar formulations noted by Judge Pescatore).



Most recent international organizations literature focuses more on analyzing behavior outside and around the box than inside the box, using "the box" to refer to the formal international organization.<sup>68</sup> This focus is consistent with a neo-realist<sup>69</sup> or neo-liberal<sup>70</sup> theoretical perspective. Each perspective would agree that the products of formal organizations are not determined by the formal mechanics of those organizations. The realist would state that these products are determined by the external power relationships that they mimic,<sup>71</sup> while the regime theorist would say that they were determined by the less formal regime dynamics they mimic.<sup>72</sup>

The focus of recent international organizations literature outside the box and around the box, as opposed to inside the box, is comparable to the pre-1980's focus of neo-classical economists on markets, which avoided examination of corporate governance structures and other economic institutions.<sup>73</sup> These pre-1980's economists saw the corporation as a black box, a production function, and did not analyze how its internal structure might affect the decision to organize produc-

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<sup>68</sup> Beth Yarbrough and Robert Yarbrough, writing together, constitute an important exception. See, e.g., Yarbrough & Yarbrough, *INTERNATIONAL INSTITUTIONS*, *supra* note 17. In this article, the Yarbroughs refer to the questions of firm size and firm content raised by Coase, and note that "such questions have *not* been central to either of the major disciplinary approaches to international organization" (emphasis in original; citations omitted). However, in this article, the Yarbroughs base their work on a premise of an anarchic international system, with little importance for international law. *Id.* at 243.

<sup>69</sup> See, e.g., Waltz, *supra* note 43. See also John J. Mearsheimer, *The False Promise of International Institutions*, 19 *INT'L SEC.* 5 (1994) ("My central conclusion is that institutions have minimal influence on state behavior . . .").

<sup>70</sup> See, e.g., KEOHANE, *supra* note 52. See also Robert Keohane & Lisa Martin, *Delegation to International Organizations*, unpublished manuscript, stating that the new institutionalism "has taken the study of institutions out of a ghetto of international relations research – the study of formal international organizations such as the United Nations – to point out the broad significance of sets of rules, or 'international regimes,' that affect the behavior of states. . . ." In the latter work, Keohane and Martin develop a theory of why states delegate formal authority to formal organizations.

<sup>71</sup> See Krasner, *supra* note 51; see also Waltz, *supra* note 43, chaps 5 and 6. "From the neo-realist perspective, [post-Cold War] clashes . . . cannot be effectively managed within international institutions, unless those institutions somehow reflect the structure of the international system within which they exist." Dougherty & Pfaltzgraff, *supra* note 20, at 63.

<sup>72</sup> "For regime theorists, the most interesting thing about an international regime is not necessarily the presence of a governing treaty. As a consequence, they pay less attention than international lawyers do to the formalities of the treaty process, treaty language, or negotiating history." Abram Chayes & Antonia Handler Chayes, *Compliance Without Enforcement: State Behavior Under Regulatory Treaties*, 7 *NEGOTIATION J.* 311, 312 (1991). But see ORAN R. YOUNG, *INTERNATIONAL COOPERATION: BUILDING REGIMES FOR NATURAL RESOURCES AND THE ENVIRONMENT* 58-80 (1989).

<sup>73</sup> See Ronald H. Coase, *The Institutional Structure of Production*, 82 *AM. ECON. REV.* 713, 714 (1992).

tion within the firm or the relative efficiency of such organization.<sup>74</sup> Similarly, as described above, international organizations literature seems to regard international organizations as either production functions, or as trivial structures that serve as vessels or masks for the real activity based on unconstrained power and interest. Thus, there is a remarkable parallel development between political science and economics. Both have emphasized the market – the world of spontaneous governance (Williamson's terms) – at the expense of attention to the firm – the world of intentional governance (Williamson's term for hierarchical organization).<sup>75</sup>

The perspective of economics in connection with international trade similarly has been innocent of institutions, assuming perfect competition and zero transaction costs.<sup>76</sup> This world of perfect competition has no need for any institutional cooperation; however, this economic perspective ignores the cost of pursuit of the gains from trade. As pointed out by Beth and Robert Yarbrough, neither the realist vision of unmitigated conflict nor the neo-classical vision of a perfect market fits the facts well.<sup>77</sup> The former does not believe institutions could help, the latter does not believe they are needed.

As noted above, international organization scholars have all but abandoned the field of formal structure, or formal governance, of international organizations. None of the industrial organization economists, political economists or lawyers have filled this intellectual niche. New institutional economics, industrial organization and law and economics have paid little attention to international organizations.<sup>78</sup> Although a public choice literature of international organizations has developed, which applies economic theory to activities of international organizations,<sup>79</sup> this literature has not specifically applied the

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<sup>74</sup> For a description of this literature, and of the transition in economic analysis: See Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When do Institutions Matter?*, 74 WASH. U. L. Q. (forthcoming 1996).

<sup>75</sup> See Oliver Williamson, *Economic Institutions: Spontaneous and Intentional Governance*, 7 J. L. ECON. & ORG. 159 (1991).

<sup>76</sup> See Yarbrough & Yarbrough, INTERNATIONAL INSTITUTIONS, *supra* note 17, at 240. Neo-classical economics has more recently emphasized imperfect competition. See ELHANAN HELPMAN & PAUL R. KRUGMAN, MARKET STRUCTURE AND FOREIGN TRADE: INCREASING RETURNS, IMPERFECT COMPETITION, AND THE INTERNATIONAL ECONOMY (1985).

<sup>77</sup> Yarbrough & Yarbrough, INTERNATIONAL INSTITUTIONS, *supra* note 17.

<sup>78</sup> But see Rudolf Richter, *The Louvre Accord From the Viewpoint of the New Institutional Economics*, 145 J. INST. & THEO. ECON. 704 (1989).

<sup>79</sup> See, e.g., THE POLITICAL ECONOMY OF INTERNATIONAL ORGANIZATIONS (Roland Vaubel and Thomas D. Willett, eds. 1991).

theory of the firm to the analysis of formal international organizations.<sup>80</sup>

The theory of the firm has been applied, to a limited extent, to regimes (which may include formal international organizations). Robert Keohane, discussing *The Demand for International Regimes*, asks the same questions about regimes<sup>81</sup> that Coase asks about business firms:<sup>82</sup> "Why should it be worthwhile to construct regimes (themselves requiring agreement) in order to make specific agreements within the regime frameworks? Why is it not more efficient simply to avoid the regime stage and make the agreements on an *ad hoc* basis?"<sup>83</sup> Thus, Keohane makes an analogy between the market for private goods and the "market" of international relations.<sup>84</sup> This analogy is critical to the present paper. It is important to point out that these markets are analogous and linked by their amenability to a common theoretical perspective; however, they are not the same. The market of international relations is a market for exchanges of agreements regarding the allocation of power. Keohane establishes the potential for application of transaction cost economics to this "market."

However, instead of responding to his question of why regimes exist with "transaction costs," as Coase would, Keohane responds with the related, but conclusory and inaccurate, concept of market failure. "In situations of market failure, economic activities uncoordinated by hierarchical authority lead to *inefficient* results, rather than to the efficient outcomes expected under conditions of perfect competition."<sup>85</sup> This perspective is the one Coase sought to debunk in his attack on Pigou.

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<sup>80</sup> But see Yarbrough & Yarbrough, *INTERNATIONAL INSTITUTIONS*, *supra* note 17.

<sup>81</sup> "Regimes have been defined as social institutions around which actor expectations converge in a given area of international relations." John Gerard Ruggie, *International Regimes, Transactions and Change: Embedded Liberalism in the Postwar Economic Order*, 36 *INT'L ORG.* 379, 380 (1982), citing Oran R. Young, *International Regimes: Problems of Concept Formation*, 32 *WORLD POL.* 331, 332 (1980). Regimes are thus different from the types of institutions usually studied by lawyers. However, lawyers are beginning to analyze and recognize the importance of non-legal sources of order. See, e.g., ELLICKSON, *supra* note 44.

<sup>82</sup> See text accompanying notes 141 to 148, *infra*.

<sup>83</sup> Robert O. Keohane, *The Demand for International Regimes*, 36 *INT'L ORG.* 325, 334 (1982). See also ROBERT O. KEOHANE, *AFTER HEGEMONY* (1984) and ROBERT O. KEOHANE, *INTERNATIONAL INSTITUTIONS AND STATE POWER* (1989) (including a revised version of *The Demand for International Regimes* in chap. 5).

<sup>84</sup> See also KRASNER, *supra* note 44, at 191 ("[t]he market is a powerful metaphor for many arguments in the literature of political science, not least international relations"); Abbott, *supra* note 38, at 375 ("Like firms in a market, rational self-interested states interact in an effort to improve their own welfare on political, military and economic issues, more or less impersonally, in a decentralized arena."); KENNETH N. WALTZ, *supra* note 43, at 91.

<sup>85</sup> Keohane, *supra* note 83 at 335.

Keohane argues that the Coase theorem does not justify reliance on the "market" in international relations because the international relations system lacks a clear legal liability framework, has costly information and has positive transaction costs. Keohane is unwilling to give much value to international law: "the lack of a hierarchical structure of world politics does not prevent regimes from developing bits and pieces of law. But the principal significance of international regimes does not lie in their formal legal status, since any patterns of legal liability and property rights established in world politics are subject to being overturned by the actions of sovereign states."<sup>86</sup> While Keohane is no doubt correct that the broad transaction cost profiles of the two markets are quite different, he has stood Coase on his head. Coase would demand to know whether regimes or institutions are affirmatively better than the "market." Coase would particularize this inquiry by examining specific issues and institutions. Keohane concludes that the Coase theorem is useful "because it suggests how international regimes can improve actors' abilities to make mutually beneficial agreements."<sup>87</sup> He does not take the next step, which this

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<sup>86</sup> KEOHANE, *supra* note 52, at 88 (citations omitted).

<sup>87</sup> *Id.* at 338. These agreements, and institutions, have the character of international public goods. Public goods theory has been applied to analyze certain domestic public goods, such as the lighthouse or regulation. Richard Musgrave defined public goods by reference to the characteristics of non-excludibility and non-rivalry. RICHARD MUSGRAVE, *THE THEORY OF PUBLIC FINANCE* 43-44 (1959). "Public management (or as I sometimes put it, the Public Good) is a public good." Stiglitz, *supra* note 16, at 24. Public goods theory has been applied to "international" public goods. See, e.g., Petersmann, *supra* note 26, at 217; Abbott, *supra* note 38, at 380; Charles Kindleberger, *International Public Goods Without International Government*, 76 AM. ECON. REV. 1 (1986); CHARLES KINDLEBERGER, *GOVERNMENT AND INTERNATIONAL TRADE*, Princeton Essays in International Finance no. 129 (1978); Bruno S. Frey, *The Public Choice View of International Political Economy*, 38 INT'L ORG. 199 (1984); John A.C. Conybeare, *International Organization and the Theory of Property Rights*, 34 INT'L ORG. 307 (1980); John G. Ruggie, *Collective Goods and Future International Collaboration*, 66 AM. POL. SCI. REV. 874 (1972); Sandler & Cauley, *supra* note 13; Michele Fratianni & John Pattison, *The Economics of International Organizations*, 35 KYKLOS 244 (1982); Bruce M. Russett and John D. Sullivan, *Collective Goods and International Organization*, 25 INT'L ORG. 845 (1971); Mancur Olson & Richard Zeckhauser, *An Economic Theory of Alliances*, 48 REV. ECON. & STAT. 266 (1966) (public goods as the "characteristic outputs not only of governments but of organizations in general"). But see Robert O. Keohane & Elinor Ostrom, *Introduction to Local Commons and Global Interdependence: Heterogeneity and Cooperation in Two Domains*, 6 J. THEO. POL. 403, 406 (1994): "Few international institutions, however, are perfect public goods: for instance, states can be denied most-favored-nation (MFN) treatment and thus excluded from a liberal trade regime. International institutions also provide private benefit by helping to create gains from exchange . . . ."

paper suggests, to comparative institutional analysis of regimes and “markets.”<sup>88</sup>

## B. The Market of International Relations

It is necessary to engage in comparative institutional analysis because there is no nirvana. Neither market failure nor government failure<sup>89</sup> alone has policy ramifications. Nor is there, in truth, a default option: an institution that should retain power unless it is affirmatively shown that another institution is more efficient. Neither the market nor the state can claim this advantage. Each is on an equal footing with the firm and international organizations as candidates for allocations of authority. Having said this, path dependency, network externalities, economies of scale and economies of scope may argue for concentrating certain types of authority in certain institutions. This is a potential argument for sovereignty as we know it.<sup>90</sup> This section considers the source of gains that may motivate exchange in this market, the motivations of states in seeking such gains, the transaction costs occasioned by exchange and the related theory of the firm. It then further explores the market of international relations by examining the extent to which some of the characteristics of private goods markets and private firms are replicated in the market of international relations.

### 1. Net Gains from Exchange

We assume that states enter the market of international relations in order to obtain gains from exchange. One corollary of this assumption is that, where states find no gains from trade, there should be no trade: no cooperation and no integration. The transaction cost econo-

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<sup>88</sup> In later work, Keohane makes clear that he does not see the “rationalist” perspective as leading to comparative analysis. Rather, he sees a more absolute test for the utility of institutions:

If transaction costs are negligible, it will not be necessary to create new institutions to facilitate mutually beneficial exchange; if transaction costs are extremely high, it will not be feasible to build institutions – which may even be unimaginable. . . . Therefore, according to this theory, one should expect international institutions to appear whenever the costs of communication, monitoring, and enforcement are relatively low compared to the benefits to be derived from political exchange.

KEOHANE, *supra* note 49, at 166-67.

<sup>89</sup> While welfare economics may be viewed as a “theory of market failure,” the field of public choice may be viewed as a “theory of government failure” that offsets the “theory of market failure.” JAMES M. BUCHANAN, *EXPLORATIONS INTO CONSTITUTIONAL ECONOMICS* 24-25 (1989).

<sup>90</sup> See Hendrik Spruyt, *Institutional Selection in International Relations: State Anarchy as Order*, 48 *INT’L ORG.* 527 (1994).

mizing perspective is incomplete without also examining transaction gains.<sup>91</sup> In turn, the transaction gain component is incomplete without considering those gains in net terms by subtracting transaction losses from transaction gains.<sup>92</sup> Any opportunity costs, including "interdependence costs"<sup>93</sup> associated with international organization, must enter the calculation.<sup>94</sup>

I consider below some of the sources of gains from exchange.

## 2. Externalities and Exchange

When considering externalities, the first question to ask is whether the international market for agreements regarding allocation of power is comparable to the domestic market for private goods. To answer the question, we must discriminate among three levels of goods: private goods, domestic public goods (such as regulation or the provision of national security services) and international public goods (such as international law or international organization). Public goods are defined by economists as goods that have two characteristics. First, the costs of preventing use of these goods by persons other than the owner are too great to be worthwhile (non-exclusivity). Second, the consumption of these goods by one person does not diminish their availability to others (non-rivalry).<sup>95</sup> The classic (but not necessarily correct) example is the lighthouse.<sup>96</sup> The classic insight is that public goods will be under-provided by private market mechanisms due to free rider problems; therefore, it may enhance efficiency for government to provide these goods. In a closed system, this model suffices. Public goods generally include infrastructure services, police services,

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<sup>91</sup> KOMESAR, *supra* note 4, at 98-122.

<sup>92</sup> "The more divergent national policies are to begin with, the greater the costs of co-operation. Nonetheless, where these costs are outweighed by the interest in reducing negative policy externalities, international policy co-ordination can help governments reach an optimal balance between increased market access and the maintenance of regulatory standards." Moravcsik, *supra* note 51, at 492-93.

<sup>93</sup> Buchanan and Tullock refer to the sum of costs incurred through the actions of others in the organization and decision-making costs. JAMES M. BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT* 46 (1962). John Ruggie uses this term "to mean a more general loss of control over one's own activities, resulting from the accumulation of collective constraints." Ruggie, *supra* note 87, at 878, n. 24. From an economic perspective, this relates to opportunity costs *ex post*, or the costs of foreclosed options (assuming some valuation of options) *ex ante*.

<sup>94</sup> See RICHARD N. COOPER, *THE ECONOMICS OF INTERDEPENDENCE* (1968).

<sup>95</sup> See note 87, *supra*.

<sup>96</sup> See Ronald H. Coase, *The Lighthouse in Economics*, 17 J. L. & ECON. 357 (1974) (showing that this ubiquitous example of a public good was actually provided privately). Coase was writing in response to economists' general assumption that "the impossibility of securing payment from the owners of ships that benefit from the existence of the lighthouse makes it unprofitable for any private individual or firm to build and maintain a lighthouse." *Id.*

national security services and all manner of law and regulation, including trade regulation.

These domestic public goods, or the lack thereof, can have positive or negative "effects" on other states.<sup>97</sup> For example, the environmental law (or deficiencies therein) in one state may be associated with<sup>98</sup> adverse or beneficial effects (negative or positive externalities) in other states because the first state's law may permit pollution to flow into other states. National environmental laws may also "cause" adverse effects in other states by being too strict with respect to foreign goods or services entering the national market, or too lax with respect to the national production, allowing production at a lower cost in the regulating state (pecuniary externalities). Other examples include national subsidies or national regulation of international trade. Externalization through regulation that fails to protect foreign interests, pecuniary externalization through strict regulation that has protectionist effects, pecuniary externalization through lax regulation that may be viewed as a subsidy and subsidization itself may all be viewed as questions of prescriptive jurisdiction: which state will have power to regulate which actions?

These external effects may cause other states to wish to limit some activities through their own regulation or through changes in the first state's regulation. There are two main ways to do so. The first is through bilateral persuasion. The second is through institutionalization. Bilateral persuasion may involve force, exchange or implicit reciprocities (either specific or diffuse);<sup>99</sup> it occurs in the "spot market." In this context, excluding for a moment the effect of international law, the international community is like the state of nature. Many have compared international society to primitive human society, in which no law and no ruler exists.<sup>100</sup> An historically subsequent comparison has been made between primitive law and international law.<sup>101</sup> While

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<sup>97</sup> For an analysis of spillovers of public goods, and the consequent market for agreement constraining or facilitating spillovers, see Albert Breton, *Public Goods and the Stability of Federalism*, 23 *KYKLOS* 882 (1970). See also Moravcsik *supra* note 51, at 485.

<sup>98</sup> I use the term "associated with" here rather than the more direct "cause" because the causal linkage is constructed, and contingent. See BRUCE A. ACKERMAN, *RECONSTRUCTING AMERICAN LAW* 46-60 (1984). The fact that the causal linkage is contingent means that there is no natural allocation of responsibility for these adverse effects.

<sup>99</sup> See Robert O. Keohane, *Reciprocity in International Relations*, 40 *INT'L ORG.* 1, 8-24 (1986).

<sup>100</sup> See, e.g., Roger D. Masters, *World Politics as a Primitive Political System*, 16 *WORLD POL.* 595 (1964); LUCY MAIR, *PRIMITIVE GOVERNMENT* (1977).

<sup>101</sup> Yoram Dinstein, *International Law as a Primitive Legal System*, 19 *N.Y.U. J. INT'L L. & POL.* 1 (1986).

there are many evident differences, there is a similarity that is salient here. At some point in primitive society, no property rights and no enforcement of contract existed. Goods and land were available for the taking and keeping by force; a promise was not worth much.

Within this state of nature, states may enter into transactions. When they do so, their actions may be viewed as actions in something resembling a market. They have choices to exchange or not, and no institutional constraints on those choices. They may begin to organize this market by establishing the (international) public goods of property rights<sup>102</sup> (rules of jurisdiction) and rules of contract (treaty law).<sup>103</sup> In another study, I have analogized international legal rules of jurisdiction – of regulatory scope – to property rights.<sup>104</sup> It is possible, at least for our purposes, to analogize international treaty law to domestic contract law. Institutionalization of property rights and contract rules facilitates market operations but represents a departure from complete *laissez-faire* and anarchy. The point is that we may begin to consider the creation of international legal rules of jurisdiction, of international treaty law and of more intrusive or organizational kinds of international institutionalization as the creation of international public goods<sup>105</sup> and a constraint on the production of domestic public goods.

Terry Moe argues that “[w]ithout guaranteed property rights, people would approach their exchanges and agreements very differently . . . . [a]nd would create very different organizations. . . .”<sup>106</sup> Moe is discussing domestic politics, not international relations, but the two seem similar in the dimension he considers: less defined “property rights” than those applying to private property in domestic law. However, Moe sees this difference not as one of degree but as one of kind. He argues that public authority, being based on democratic politics, “does not belong to anyone.”<sup>107</sup> “The ‘firms’ in the public and private sectors, therefore, are likely to be structured very differently.”<sup>108</sup> While the premise seems suspect (and is disputed below),

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<sup>102</sup> See MUELLER, *supra* note 22, at 11-17.

<sup>103</sup> See HERSCH LAUTERPACHT, *PRIVATE LAW AND ANALOGIES OF INTERNATIONAL LAW (WITH SPECIAL REFERENCE TO INTERNATIONAL ARBITRATION)* 155-180 (1927).

<sup>104</sup> Trachtman, *supra* note 21.

<sup>105</sup> See Russett & Sullivan, *supra* note 87, at 849-52.

<sup>106</sup> Terry M. Moe, *Political Institutions: The Neglected Side of the Story*, 6 J. L. ECON & ORG. 213, 227 (1990).

<sup>107</sup> *Id.*

<sup>108</sup> *Id.* at 228. Moe recognizes, in a footnote that property rights in the private sector are not completely ironclad either, but seems to maintain that political uncertainty makes for some fundamental difference. *Id.* at n.16.



the conclusion seems almost trivial. Of course we will see quite different structures in organizations with different types of goals, constituencies and historical and institutional settings.<sup>109</sup>

The salient question is whether the same analytical techniques may be applied to these different organizations. The nature of political uncertainty that Moe finds creates a critical difference does not seem to impair the utility of the application of the theory of the firm to political organizations.<sup>110</sup> After all, a corporate manager may be replaced by the board of directors and a director may lose a proxy contest; these corporate uncertainties do not seem different in their ramifications from the fact that a political leader may lose an election. Rights that are more like “property” – that carry residual rights to control and residual rights to economic returns – are granted in both the political and market sphere due to the incentive structures that they carry. In international relations, sovereignty seems parallel to property. At the level of determining the utility of NIE, IO or L&E in connection with political organizations, the nature of “political uncertainty” appears to be a distinction without a difference. Furthermore, even if this distinction is significant in the domestic political sphere, it would probably not hold the same significance in connection with the analysis of international organizations. International organizations today are relatively insulated from the kind of political uncertainty – democratic politics – that Moe describes.

### 3. *Economies of Scale, Scope and Time in International Relations; Frequency and Duration*

Another related, potential source of gains from trade are economies of scale and economies of scope.<sup>111</sup> Given the increasingly global nature of business and of problems such as environmental degradation or trade generally, it seems likely that there would be economies of scale, under some circumstances, in regulation of these matters.

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<sup>109</sup> See, e.g., Stiglitz' evaluation of the state as an economic organization in Stiglitz, *supra* note 16. Stiglitz distinguishes the state from other economic organizations in terms of its universality, and its powers of compulsion. *Id.* at 21. International organizations do not necessarily have either of these features.

<sup>110</sup> See OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* at ix-x (1985): “Striking differences among labor markets, capital markets, intermediate product markets, corporate governance, regulation and family notwithstanding, these are all variations on the very same underlying transaction cost economics theme. Different (sometimes rival, sometimes complementary) explanations for what had hitherto been regarded as settled issues have resulted.”

<sup>111</sup> The dividing line between externalities, on the one hand, and uncaptured economies of scale, on the other hand, is not clear.

[T]he more that the scale of goods and assets produced, exchanged, and/or used in a particular economic sector or activity diverges from the structural scale of the national state – both from above (the global scale) and from below (the local scale) – and the more that those divergences feed back into each other in complex ways, then the more that the authority, legitimacy, policymaking capacity, and policy-implementing effectiveness of states will be challenged from both without and within.<sup>112</sup>

The economies of scale have a number of components.<sup>113</sup> First, there may be economies of scale that arise from global business, which under some circumstances rewards the ability to coordinate rulemaking, surveillance and enforcement activities.<sup>114</sup> Without some global regulatory capabilities, possibilities for evasion, detrimental regulatory competition (which can be driven by externalization) and unnecessary regulatory disharmony may result in inefficiency.<sup>115</sup> Second, there may be technological economies of scale, relating to equipment, acquisition of specialized skills or organization. Economies of scale may provide a motivation for integration, in order to capture these economies.

Economies of scope are reductions in cost that arise from centralized production of a group of products, especially where the products share a common component.<sup>116</sup> For example, in the domestic sphere, banks find it useful to offer both commercial banking and securities services because both activities rely on common firm resources. As a result of these product economies of scope, there are regulatory economies of scope in commercial banking and securities regulation. These domestic regulatory economies of scope may relate to international regulatory economies of scope. Once several areas of international regulation are established, economies of scope may be realized

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<sup>112</sup> Philip G. Cerny, *Globalization and the Changing Logic of Collective Action*, 49 INT'L ORG. 595, 597 (1995).

<sup>113</sup> I use the conventional term "economies of scale" here, although from a transaction costs standpoint, an economy of scale can be viewed as a prescription for overcoming a transaction cost problem. In this sense, the fact that efficient production takes place at a specified volume does not indicate that the efficient sized firm in that line must sell the specified volume itself. From the standpoint of international relations, the fact that it is efficient to regulate activity from a global perspective does not mean that only one regulator should exist. Rather, international regulation of an activity is a problem of contracting and establishing the most efficient institutional structure in response to technical or contextual factors. A similar caveat applies with respect to "economies of scope."

<sup>114</sup> In fact, the problem of jurisdiction and externalities is linked to the question of economies of scale. The scope of external effects alters the availability of economies of scale in government activities.

<sup>115</sup> See Joel P. Trachtman, *International Regulatory Competition, Externalization and Jurisdiction*, 34 HARV. INT'L L.J. 47 (1993).

<sup>116</sup> John C. Panzar & Robert D. Willig, *Economies of Scope*, 71 AM. ECON. REV. 268 (1981).

by regulating other areas. This relates to “spillover” often considered in connection with functional approaches to international integration.<sup>117</sup>

Economies of scale and scope may arise from increased frequency of transactions or from longer duration of transactions. Given greater numbers of transactions in international relations, one would expect greater economies of scale. In addition, given expansion of the subject areas of international relations, for example in intellectual property, environmental regulation and labor standards, one would also expect expanded economies of scope. Finally, learning curve effects may provide economies over time.<sup>118</sup> These may be related, with economies of scope, to the phenomenon of spillover that provided a basis for neo-functional theories of international economic integration.

Thus, increasing international attention to non-tariff barriers, and increasing numbers of transactions in jurisdiction and initiatives toward harmonization, would be expected to increase the gains from this trade to the extent that the economies of scale, scope and time are exhausted. The ability to cover more subject areas permits greater tradeoffs both *ex ante* and *ex post*. The increased scope of coverage of the Uruguay Round is often cited as an example of the utility both *ex ante* and *ex post* of expansion of the subject matter of coverage. *Ex ante* it allowed the grand bargain among interests in liberalization of trade in agriculture, textiles and interests in intellectual property rights and services. *Ex post*, it added the possibility for cross-retaliation among these areas in connection with dispute resolution. *Ex post* tradeoffs can be compared to “relational contracting” where multiple relationships give rise to greater protection against opportunism.<sup>119</sup>

Thus, gains from “trade” in power may arise from economies of scale, scope and time, as well as from allocation of the costs of “externalities” to the cheapest cost avoider.

#### 4. Absolute and Relative Advantage

As indicated above, an initial question relates to the motivations of states: whether they seek absolute advantage, as economic theory would generally predict in most circumstances, or relative or posi-

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<sup>117</sup> HAAS, *supra* note 41, at 48. See also Dougherty & Pfaltzgraff, *supra* note 20, chap. 10, at 11-13.

<sup>118</sup> See Kenneth Arrow, *Economic Welfare and the Allocation of Research for Invention*, in THE RATE AND DIRECTION OF INVENTIVE ACTIVITY (R. Nelson, ed. 1981).

<sup>119</sup> See KEOHANE, *supra* note 52, at 103-104.

tional advantage, as two competitors in a finite single-play game might.<sup>120</sup> States may be more likely to seek "relative gains" where there is a finite, relatively bilateral adversarial game to be won or lost, as in the security context. In such a game, the player in a relatively weaker position might not be willing to accept a transaction that benefits both parties. Such a transaction might accelerate the conclusion of the game, or give the adversary a winning position. In chess, the party with a material advantage will often seek an even exchange of pieces while the weaker party will resist exchange.<sup>121</sup> This debate, an area of contention between realists and institutionalists, may have great practical interest, but in theoretical terms it should be framed differently.<sup>122</sup>

From the standpoint of economic theory, the two positions are reconcilable. The realist adherence to relative gains may be reinterpreted as an adherence to absolute gains, assigning a pre-emptively high value to relative position and eventual victory. Given a high valuation of position and eventual victory, it becomes rational in economic terms to sacrifice lesser absolute gain for greater absolute gain. Similarly, when a rational man is confronted by an armed robber who offers "your money or your life," the rational man gives up the absolute gain associated with keeping his money for the presumably greater absolute gain associated with keeping his life. This perspective transforms the debate to one regarding how states value different goods, including, *inter alia*, gains from trade in goods and services on the one hand, and national security on the other. Thus, the absolute gains school is correct in theory; however, in practice, position and victory may countervail other kinds of gain and the behavioral insights of the relative gains position may be validated.

To the extent that the international system is characterized by "anarchy," including freedom to coerce, the currency of international relations is not necessarily given in exchange, but may consist of threats that may be used without depletion.<sup>123</sup> Perhaps the threat of coercion may be considered a type of expenditure, and therefore a

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<sup>120</sup> See the debate in Joseph M. Grieco, Robert Powell and Duncan Snidal, *The Relative Gains Problem for International Cooperation*, 87 AM. POL. SCI. REV. 729 (1993). See also Duncan Snidal, *Relative Gains and the Pattern of International Cooperation*, 85 AM. POL. SCI. REV. 701 (1991) (showing that the realist case for relative gains blocking cooperation is weak where some absolute gains motivations exist and where more than two actors are involved).

<sup>121</sup> See also Waltz, *supra* note 43, at 105.

<sup>122</sup> See generally Charles L. Glaser, *Realists as Optimists: Cooperation as Self-Help*, 19 INT'L SECURITY 50 (1995).

<sup>123</sup> See Lake, *supra* note 36, at 19-20. "Although it fits awkwardly within the neoclassical economic approach that informs relational contracting theories, coercion is a fact of life in inter-

depletion, of coercive power.<sup>124</sup> If not, this represents a significant departure from our market analogy in which a state may obtain gains without exchange. It may also represent a reversion to a more primitive world, preceding property rights and prohibitions of coercion. In such a world, the transaction costs of exchange are so high that exchange does not occur, and coercion determines allocation. In such a primitive world the first transaction is in security.

In this Hobbesian world, the possessor of a monopoly or dominant position in coercive<sup>125</sup> force may win in a zero- or negative-sum game and may capture all of the surplus, and more, in a positive-sum game. This may be an area where some distinction might be drawn between international political relations and international economic relations: between high politics and low politics. In this conception, low politics is the place safe from physical coercion, where polite diplomats would be embarrassed to coerce physically. It may be the place where the costs of coercion in terms of lives, destruction of trust and unspecified benefits of community or multiplex relations is too great to be worthwhile.<sup>126</sup> High politics, on the other hand, would hold little interest without physical coercion and fear of physical coercion: the great game without any stakes. The ability to engage in coercion seems to decline as the legal nature of a society increases, either in the state of nature or in international law.<sup>127</sup> Testing the hypotheses of this paper may suggest where international society is anar-

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national relations (and elsewhere)." *Id.* at 19. On the other hand, coercion does occur in markets through the use of monopoly positions not unlike virtual monopolies on the use of force.

<sup>124</sup> See *id.* at 20. When a thief points his gun at his victim's head, and has his way by virtue of his threat, he expends no bullet. While coercion may be seen as a type of expenditure, of either munitions or good will, like theft in a domestic market, it can result in great inefficiency. The permission of coercion in international relations may be considered comparable to a state of nature in which coercion by individuals is permitted: property rights, including rights to be free of coercion, emerge because they allow greater creation of wealth, and because this increased wealth is distributed so as to compensate all.

<sup>125</sup> "Coercion" is used here to refer to action that is not rightful, intended to affect another's behavior. Thus Section 301 of the Trade Act of 1974 is sometimes used in a non-coercive fashion (when its use does not violate any international legal rule), and is sometimes used in a coercive fashion (when its use violates international obligation). In addition, a monopoly or truly dominant position in coercive force rarely exists, and is even less likely to exist in connection with economic coercion.

<sup>126</sup> Others distinguish international security affairs from international economic affairs in other ways. See, e.g., Charles Lipson, *International Cooperation in Economic and Security Affairs*, 37 *WORLD POL.* 1 (1984).

<sup>127</sup> The general public international law framework, including the prohibition on the use of force contained in art. 2(7) of the Charter of the United Nations, may be viewed as a rudimentary set of property rights and rules against coercion that are respected to some limited extent. The growth of these types of basic rules may enhance possibilities for "exchange" and broader application of this exchange-based theory.

chic and where it is ordered: the domain of coercion as opposed to the domain of cooperation.

5. *The Basic Unit of Analysis: the Transaction in Power*

“The most fundamental unit of analysis in economic organization theory is the *transaction* – the transfer of goods or services from one individual to another.”<sup>128</sup> As noted above, Keohane and others have analogized international relations to a market in which states meet to make exchanges of things that they have for things that they want. The assets traded in this market are not goods or services *per se*, but are assets peculiar to states: components of power. In a legal context, we refer to this power as jurisdiction, including jurisdiction to prescribe, adjudicate and enforce.<sup>129</sup> In international society, the equivalent of the market is simply the place where states interact to cooperate on particular issues in order to maximize their baskets of preferences.

The theory of the firm and NIE establish a diad between transactions and institutions. Between the spot market transaction and the formal organization lurk many types of formal contracts and informal arrangements. Even the formal organization is a nexus of contracts. Thus, the diad is not a dichotomy but a continuum: the boundary between the transaction and the institution is blurred.<sup>130</sup> The metric of this continuum is the relative scope of retained individual discretion on each side: the extent to which politics is unconstrained and the rules of the game are unspecified.<sup>131</sup> Where the individual retains greater discretion, she is closer to the pole of the market; where the individual retains less discretion – and assigns more discretion through contract or organization – she is closer to the pole of the firm.<sup>132</sup> When we speak of discretion in this context, we mean residual discre-

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<sup>128</sup> MILGROM & ROBERTS, *supra* note 5, at 21.

<sup>129</sup> See RESTATEMENT (THIRD) OF THE LAW OF FOREIGN RELATIONS OF THE UNITED STATES §§ 401-403 (1987).

<sup>130</sup> See Benjamin Klein, *Contracting Costs and Residual Claims: The Separation of Ownership and Control*, 26 J. L. & ECON. 367, 373 (1983) (“Coase mistakenly made a sharp distinction between intrafirm and interfirm transactions, claiming that while the latter represented market contracts the former represented planned direction.”)

<sup>131</sup> See Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POLIT. ECON. 691 (1986).

<sup>132</sup> This formulation leaves a conundrum. Through decentralization within the firm, the amount of individual discretion within the firm may be made to equal the amount of discretion an individual might retain outside the firm. Thus, the continuum has two parameters. The first parameter is the degree of integration *into* the firm (or other integration structure, including contract). The second parameter is the degree of centralization *within* the firm.

tion to be exercised in the future. This diad is translated in international economic relations to a diad between intergovernmentalism and integration, where integration denotes a pooling of authority.

Intergovernmental agreements that can be entered into immediately, such as agreements to cooperate with a request for assistance in gathering evidence in connection with insider trading, are comparable to spot market transactions.<sup>133</sup> "Spot market transactions" fit into a static model of gains, such as the trade-creation, trade-diversion model. There is a spot market for international relations, where states make one-off deals regarding a particular subject, with no future obligations. The "spot" market is a place where exchange is instantaneous. If a contract is formed, its duration is only an instant.

Otherwise, contract amounts to a degree of institutionalization,<sup>134</sup> of binding action in the future and integration. This market becomes less like the private market in goods and more like the firm, to the extent these agreements have: i) longer terms; ii) cover more "transactions," iii) are more complex; or iv) provide for decision making in the future (by adjudication, bureaucratic decision-making or legislation) other than by unanimous consent. Agreements that require continuous monitoring and enforcement, such as for tariff reduction, with: i) little need for further definition; ii) relatively easy identification of defection; iii) the self-enforcing ability to withdraw benefits on a tit-for-tat basis; and therefore iv) less need for institutional support, are hybrids that may be closer to the market than to institutionalization. On the other hand, agreements that require more institutional support, including dispute resolution and further legislative capacity over time, are comparable to organization within an institution or firm, with integration.

Coase's dichotomy of firm and market may be compared to Albert Hirschman's dichotomy of voice and exit.<sup>135</sup> The main differences between the market and the firm are in the duration of relations

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<sup>133</sup> See Paul R. Milgrom, Douglass C. North & Barry R. Weingast, *The Role of Institutions in the Revival of Trade: The Law Merchant, Private Judges, and the Champagne Fairs*, 2 *ECON. & POL.* 1, 6 (1990) ("With the exception of barter transactions, in which physical commodities are exchanged on the spot, virtually all economic transactions leave open the possibility of cheating").

<sup>134</sup> It is worthwhile to clarify here that property and contract themselves constitute a degree of institutionalization. However, they are generally considered as lying in the background, while the establishment of long-term contracts or firms constitute more explicit, and extensive, institutionalization.

<sup>135</sup> ALBERT O. HIRSCHMAN, *EXIT, VOICE AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS AND STATES* (1970). See Joseph Weiler's use of this dichotomy to analyze European constitutionalization in Weiler, *supra* note 8.

and in how decisions are made. In the (spot) market, decisions are digital. You either enter (buy) or exit (sell). In the firm, you have a longer-term relationship and must exercise voice. Voice is heterogeneous, including various mechanisms that may amount to selective or partial exit, such as the ability to vote out a government.

#### 6. *The Costs of Exchange: Transaction Costs*

We know, in theory and in practice, that international society, like any other society, is beset by transaction costs. It is costly for states to identify appropriate counter-parties, negotiate with them, write complete contracts with them and enforce those contracts. Whether these transaction costs are disproportionately great in international society, as compared to any particular domestic society, is not clear. Transaction costs may be viewed narrowly or broadly, but it appears appropriate in the current context to view them quite broadly, as Coase does:

In order to carry out a market transaction, it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on. These operations are often extremely costly, sufficiently costly at any rate to prevent many transactions that would be carried out in a world in which the pricing system worked without cost.<sup>136</sup>

Arrow's definition of transaction costs, as "the costs of running the economic system,"<sup>137</sup> seems, if anything broader. "Transaction costs are the economic equivalent of friction in physical systems."<sup>138</sup> It is worthwhile here to relate transaction costs to agency costs.<sup>139</sup> Agency costs may be viewed as the costs of economic coordination within an organization. Transaction costs are the costs of coordination in the market. Alternatively, agency costs may be viewed as a type of transaction cost that occurs within an organizational setting. Except

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<sup>136</sup> Coase, *supra* note 6, at 114.

<sup>137</sup> Kenneth J. Arrow, *The Organization of Economic Activity: Issues Pertinent to the Choice of Market Versus Non-Market Allocation*, in *THE ANALYSIS AND EVALUATION OF PUBLIC EXPENDITURE: THE PPB SYSTEM*, vol. 1, U.S. Joint Economic Committee, 91st Cong., 1st Sess., 59, at 48.

<sup>138</sup> Williamson, *supra* note 13, at 19. However, there is debate on the content of the term "transaction costs", and there is contention over the boundary between transaction costs and production costs. See Oliver Williamson, *Transaction Cost Economics: The Governance of Contractual Relations*, 22 J. L. & ECON. 233 (1979). See also the commentary listed in Pierre Schlag, *The Problem of Transaction Costs*, 62 S. CAL. L. REV. 1661, at 1662, n.3 (1989).

<sup>139</sup> See generally Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Capital Structure*, 3 J. FINANCIAL ECON. 305 (1976).



where agency costs are referenced specifically this paper uses “transaction costs” to refer to both types of costs. This approach facilitates discussion of comparative transaction costs, comparing costs within an organization to costs outside an organization.<sup>140</sup>

Transaction cost economics is based on Coase’s theoretical advances. The central insight of Coase’s two papers involves the importance of transaction costs in economic organization.<sup>141</sup> In fact, the transaction cost focus of Coase’s two papers explains institutionalization in the form of the firm as well as in the form of government regulation. It frames the problem as one of comparative institutional analysis, considering all alternative institutions. Coase posited that people use the market or the firm to organize their productive activities depending on which is the best mechanism under the circumstances. By “best,” we mean the method that allows people to obtain the maximum amount of what they want at the minimum cost in terms of transaction costs. More precisely, the “best” organization is the one that maximizes the positive sum of transaction gains, transaction losses and transaction costs.

### 7. Comparative Institutional Analysis

Thus, Coase’s theory of the firm is not exclusively about transaction costs. In fact, the lowest transaction cost solution is not always to be preferred.<sup>142</sup> In a zero transaction cost world, infinite exchange would allow perfectly efficient allocation. In a positive transaction cost world – the world as it is<sup>143</sup> – a decision-maker might accept some transaction costs in order to enhance gains from trade, or accept re-

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<sup>140</sup> This wording contains an inaccuracy. I argue below that all transactions are within some institutional system: the market, the state, international society and the firm are all institutions. All these institutions are social constructs. “There was nothing natural about *laissez-faire* . . . .” KARL POLANYI, *THE GREAT TRANSFORMATION* 139 (1944). Cerny, *supra* note 112, at 600. Moreover, these institutions often overlap, without clear borders.

<sup>141</sup> See *supra* note 6. Williamson and North have developed this insight from the standpoint of NIE. See, e.g., Williamson, *supra* note 13; Oliver E. Williamson, *Comparative Economic Organization: The Analysis of Discrete Structural Alternatives*, 36 *ADMIN. SCI. Q.* 269 (1991); Oliver Williamson, *Transaction Cost Economics*, in Richard Schmalensee & Robert Willig, eds., *HANDBOOK OF INDUSTRIAL ORGANIZATION* 136-82 (1989); Douglass North, *Economic Performance Through Time*, 84 *AM. ECON. REV.* 359 (1994); Douglass North, *The New Institutional Economics*, 142 *J. THEO. & INST. ECON.* 230 (1986); Douglass North, *Institutions*, 5 *J. ECON. PERSPECTIVES* 97 (1991).

<sup>142</sup> See North & Wallis, *supra* note 19, at 622 (arguing that “institutions do not exist to minimize transaction costs. Rational economic actors wish to reduce costs at all margins”). The transaction cost minimizing position is not to transact at all, and thus to incur deadweight losses. Wherever the deadweight losses are greater than the transaction costs, this is a mistake.

<sup>143</sup> See Coase, *supra* note 6, at 15. Coase has often been misinterpreted to argue that policy should be formed as though transaction costs are zero. However, transaction costs are never

duced gains from trade in order to reduce transaction costs even more. The actual decision depends on the magnitude of each. Komesar<sup>144</sup> calls for a cost-benefit analysis methodology that compares a number of available institutional alternatives in order to maximize gains from trade net of transaction costs. "Comparative economic organization never examines organization forms separately but always in relation to alternatives."<sup>145</sup> The number of alternatives to be examined will depend on the costs of examination. Given the magnitude of the task of examining all possible alternatives, we are rationally ignorant.

Transaction cost economizing risks tautology. It can be used to argue that what is, is efficient. Thus, just as friction exists in the real world, transaction costs are always with us. Any outcome might be explained as minimizing transaction costs. However, a single institutional analysis is non-testable. Transaction cost economizing is rendered non-tautological and operationalized by a comparative methodology, which requires the comparison of cost and benefit profiles of various institutional alternatives.<sup>146</sup> As a mechanical engineer seeks to engineer machines that do useful things with low friction, so the institutional engineer seeks to engineer institutions that do useful things with low transaction costs. The comparative transaction cost methodology renders institutions contingent and renders us self-conscious regarding the design of institutions. Institutional design has never been, and is recognized not to be, natural. This methodology allows us to produce testable hypotheses, leading us on a journey toward the structural production frontier.<sup>147</sup> Of course, the structural production frontier and the technical production frontier are both constantly subject to change. A change in one always results in a change in the other.<sup>148</sup>

Using Coase's and Williamson's comparative institutional perspective, and combining it with the public choice analysis of government, Komesar develops a legal methodology of comparative

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zero and are rarely insignificant. See KOMESAR, *supra* note 4, at 109-111, citing Robert Ellickson, *The Case for Coase and Against "Coaseanism,"* 99 YALE L.J. 611, 614 (1989).

<sup>144</sup> KOMESAR, *supra* note 4, at 106, 111.

<sup>145</sup> Williamson, *supra* note 4, at 269.

<sup>146</sup> WILLIAMSON, *supra* note 13, at 4.

<sup>147</sup> See Guido Calabresi, *The Pointlessness of Pareto: Carrying Coase Further*, 100 YALE L. J. 1211, 1212 n.5 (1991). See also Douglass C. North, *A Framework for Analyzing the State in Economic History*, 16 EXPLORATIONS IN ECON. HIST. 249, 252 (1979).

<sup>148</sup> North, *supra* note 147, at 257. See North & Wallis, *supra* note 19, at 609, 611; Elinor Ostrom, *Constituting Social Capital and Collective Action*, 6 J. THEO. POL. 527 n.4 (1994) (describing the relationship between physical capital and social capital).

institutional analysis.<sup>149</sup> Komesar expands the domain of comparative institutional analysis to compare market organization to governmental organization. Thus, transaction cost economizing can be used to attack the seemingly impenetrable thicket of arguments between *laissez-faire* and regulation.

Komesar addresses an institutional choice question one step up from that addressed by Coase and Williamson: the market versus the firm. Viewing the market (here inclusive of firms) as a discrete institution, Komesar compares this institution with the institution of domestic government: regulation. This move up the institutional hierarchy provides a platform from which this paper may compare national autonomy with international organization along similar lines. Komesar also compares particular types of governmental activity, including adjudication and regulation, using comparative institutional analysis.

Komesar takes as a given the U.S. institutional context, which has a relatively limited and settled set of formal institutions. While he recognizes that there is potential for deeper scrutiny – the possibility of different types of market, judicial and legislative institutions – he declines to pursue the complex interaction of these institutions.<sup>150</sup> In the international economic law context, the authors of institutional structures often write on a blank slate, with greater contingency of institutional structure. This institutional contingency makes Komesar's project more, not less, applicable to international economic law.

#### 8. *The Coase Theorem, the Prisoner's Dilemma and the Hobbes Theorem*

The Coase theorem, which has been extensively elaborated and critiqued<sup>151</sup> though never explicitly articulated as such by Coase himself, indicates that absent transaction costs, the initial allocation of property rights, including regulation, would not affect efficiency.<sup>152</sup>

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<sup>149</sup> KOMESAR, *supra* note 4, at 3.

<sup>150</sup> "For example, one can productively break out the administrative process from the political process, and I do that at several points in the book. Similarly, consistent with the view of many modern industrial organization economists, one can subdivide the market into firms, relational contracting, and atomistic spot markets." Komesar, *supra* note 4, at 9.

<sup>151</sup> For a summary and reference to further literature: See Robert D. Cooter, *The Coase Theorem*, in 1 THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS 457, 457-60 (1987). See also Elizabeth Hoffman & Matthew Spitzer, *The Coase Theorem: Some Experimental Tests*, 25 J. L. & ECON. 73 n.1 (1982); Robert D. Cooter, *The Cost of Coase*, 11 J. LEG. STUD. 1 n.1 (1982).

<sup>152</sup> Coase, *supra* note 6, at 106.

This initial allocation, assuming zero transaction costs, would not affect efficiency because market participants would engage in costless reallocative transactions that would result in an efficient outcome.<sup>153</sup> All externalities would thus be internalized: no decision-maker would fail to take into account all of the costs of his or her decision.<sup>154</sup> Thus, in a zero transaction costs world, an externality, standing alone, would not justify regulation.

Assume for a moment a potential Pareto efficient<sup>155</sup> set of international law rules: a structure of laws that satisfies the preferences of all countries (or their citizens) better than the alternatives. This set of rules maximizes the value of all social resources, consistent with value relativity. It accepts each actor's preferences as given and seeks to maximize their satisfaction. In a zero transaction costs world (without the problems of holdouts), this set of entitlements would occur regardless of the initial set of international law rules (if any). Actors would costlessly reallocate to the efficient position.<sup>156</sup> Coase's insight is that, given that transaction costs exist and are indeed inescapable, the initial set of international law rules specified has important consequences. It is necessary to compare legal and institutional frameworks, including reliance on market mechanisms, to determine which is best. Transaction costs in the market resulting in externalities are not a sufficient reason for regulation; transaction costs in the international relations "market" are not sufficient reasons for regimes or other institutions.<sup>157</sup> Regulation carries with it transaction costs as well. Both the market and regulation suffer from imperfect allocation. In fact, Coase's insight requires us to compare institutional structures in every case. This insight has dramatic consequences in the real

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<sup>153</sup> Of course, I must define efficiency in this context. By efficiency, I mean the allocation of resources to their highest value uses. The valuation of uses is effected through a price, or shadow price, system.

<sup>154</sup> Another way of stating the Coase Theorem, which formulation has been cited with approval by Coase, is that under conditions of zero transaction costs, "private and social costs will be equal." Coase, *supra* note 6, at 174, citing GEORGE STIGLER, *THEORY OF PRICE* at 113 (1966).

<sup>155</sup> See *infra* text accompanying notes 200-202. The alternative, and more commonly used test of economic efficiency is simple Pareto efficiency: that there is no change that could be made that would make any person better off without making at least one person worse off.

<sup>156</sup> See THRAIN EGGERTSSON, *ECONOMIC BEHAVIOR AND INSTITUTIONS* 13 (1990): "Theoretically, only one set of rules will maximize the wealth of a nation. It can be argued that, in the absence of transaction costs, eventually such a set of rules will evolve. Although a shift from a relatively inefficient structure of rights to a more efficient set will involve losers as well as winners, the gains are greater than the losses. Therefore, the winners will compensate the losers and still be better off than before."

<sup>157</sup> Conybeare, *supra* note 87, at 315-16.

world of policy analysis. It is operational and engenders a progressive research program.

An important critique of the Coase theorem asks whether states will ever be able to agree on the distribution of the gains from trade or will become mired in an endless cycling of negotiation, especially under a zero transaction cost assumption. Coase did not address this issue in *The Problem of Social Cost*. Subsequent literature has raised the possibility that reallocative transactions will be frustrated by strategic behavior: the problem of “holdouts.”<sup>158</sup> Cooter argued in 1982 that the Coase theorem may be countervailed by the “Hobbes theorem,” asserting that strategic behavior – holding out for the last dime of the increase in wealth created by the contemplated transaction – will deter reallocative transactions.<sup>159</sup> The Hobbes theorem has obvious affinities with the realist position in political science. This contention over the distributive consequences of cooperation is also posited by realists, and accepted by Keohane, as a barrier to cooperation.<sup>160</sup>

Coase has addressed this problem in a manner that is not theoretically rigorous, but perhaps is persuasive.<sup>161</sup> Coase recognizes, interestingly, that the holdout problem is *not* simply a transaction costs problem, but a problem of assumptions regarding human motivation and behavior. “[T]here is good reason to suppose that the proportion of cases in which no agreement is reached will be small.” He continues later to state that “[t]hose who find it impossible to conclude agreements will find that they neither buy nor sell and consequently will usually have no income.” “[N]ormally human beings . . . are will-

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<sup>158</sup> See Robert Cooter, *The Cost of Coase*, 11 J. LEGAL STUD. 1, 15-24 n.1 (1982); Varouj A. Aivazian & Jeffrey L. Callen, *The Coase Theorem and the Empty Core*, 24 J.L. & ECON. 175 n.1 (1981).

<sup>159</sup> But see ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* (1984) (demonstrating that under repeated play circumstances, the prisoner’s dilemma may be resolved by “tit for tat” strategies that signal and reward cooperation and punish defection); Robert D. Cooter, *Against Legal Centrism*, 81 CAL. L. REV. 417, 423 n.1 (1993) (reviewing ROBERT C. ELLICKSON, *ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES* (1991) (noting that “one-shot games with noncooperative solutions often have cooperative solutions when they are repeated”), citing DAVID M. KREPS, *A COURSE IN MICROECONOMIC THEORY* 505-15 (1990); Drew Fudenberg & Eric Maskin, *The Folk Theorem in Repeated Games with Discounting and with Incomplete Information*, 54 ECONOMETRICA 533 (1986). See also Herbert Hovenkamp, *Rationality in Law & Economics*, 60 GEO. WASH. L. REV. 293 n.2 (1992). Hovenkamp explains that while the zero transaction costs assumption may produce endless cycling, without resolution, adding transaction costs provides an incentive – the avoidance of transaction costs – to conclude bargaining. *Id.* at 300.

<sup>160</sup> See Robert O. Keohane, *Institutional Theory and the Realist Challenge After the Cold War*, in *NEOREALISM AND NEOLIBERALISM: THE CONTEMPORARY DEBATE* 269, 292 (David A. Baldwin ed., 1993).

<sup>161</sup> See Coase, *supra* note 6, at 161.

ing to 'split the difference.'<sup>162</sup> This response may seem inapplicable to the international system, where states may be more like closed systems, more able to engage in autarkic behavior, than individuals. However, Coase's instinct seems correct, and may be growing in applicability to the international system as interdependence grows. This instinct seems even more valid in a positive transaction costs circumstance, where net gains are reduced as negotiations continue.

The negotiation of a reallocative transaction under the Coase theorem may, under certain circumstances, resemble a prisoner's dilemma. Aggregate welfare may be improved by cooperation, but each party will seek to maximize individual welfare through individual action, resulting in a reduction of aggregate welfare.<sup>163</sup> Game theory predicts that each player's dominant strategy for the prisoner's dilemma will be non-cooperative.<sup>164</sup>

Of course, the prisoner's dilemma, a non-cooperative game, assumes that the parties cannot communicate with or bind one another. However, law and institutions may serve to promote communication and binding agreement that may resolve the prisoner's dilemma, transforming the game into a coordination exercise which allows cooperative solutions.<sup>165</sup> Much of the current political science literature

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<sup>162</sup> *Id.* at 162. See also Duncan Snidal, *International Cooperation Among Relative Gains Maximizers*, 35 INT'L STUD. Q. 387 (1991).

<sup>163</sup> See Snidal, *supra* note 162. (using the prisoner's dilemma model to analyze international cooperation). For an explanation of the prisoner's dilemma, See R. DUNCAN LUCE & HOWARD RAIFFA, *GAMES AND DECISIONS* (1957). See also John A.C. Conybeare, *Public Goods, Prisoners' Dilemmas and the International Political Economy*, 28 INT'L STUD. Q. 5 (1984); Hovenkamp, *supra* note 159, at 311-14. The prisoner's dilemma is thought of as a strategic or non-cooperative game, and therefore would not ordinarily be thought applicable in cases of bilateral monopoly where cooperation is possible. However, the assumption of the ability to cooperate in the Coasean bargaining circumstances may be of limited validity, and therefore the prisoner's dilemma may be instructive. "The prisoners' dilemma is simply a situation [of bilateral monopoly] in which the costs of bargaining or of enforcing the resulting contract are very high. As certain costs of bargaining in a bilateral monopoly become higher, the bilateral monopoly starts to look more like the prisoners' dilemma." *Id.* at 312.

<sup>164</sup> A dominant strategy is a strategy that will provide the best outcome for the player choosing it no matter what the other player chooses. *But see* Axelrod, *supra* note 159, at 27 (1984). Axelrod shows that we may choose strategies other than the dominant strategy, where we can establish some reason to believe that the other player may do likewise, or that we may teach him to do likewise in a repeated play circumstance.

<sup>165</sup> Cooter posits that

[t]here are two alternative ways to solve the problem of cooperation: law and relationships. Law solves the problem by altering the payoff matrix to reduce or eliminate the advantage an individual gains from noncooperation. . . . Relationships solve the problem in a completely different way. When people are tied to each other in an enduring relationship, the game of cooperation is played over and over again.

Cooter, *supra* note 159, at 422-23. One might add to the benefits of relationships, as Ellickson does explicitly, the multiplicity of relationships. See Ellickson, *supra* note 44. That is, cattlemen

is skeptical of the possibility for cooperative solutions.<sup>166</sup> Garrett argues that “[i]n situations in which there are numerous potential solutions to collective action problems that cannot easily be distinguished in terms of their consequences for aggregate welfare – and the [EU] internal market is one – the ‘new economics of organization’ lexicon conceals the fundamental political issue of bargaining over institutional design.”<sup>167</sup> Brennan and Buchanan respond to this criticism along the same lines as Coase by explaining that bargaining over institutional design is cooperative in nature; the aggregate increased value will provide incentives for agreement.<sup>168</sup> They compare such constitutional bargaining with “ordinary politics.” First, they agree with Garrett and Krasner regarding ordinary politics, finding that “the Pareto-optimal set would be exceedingly large.”<sup>169</sup> They continue as follows: “[t]his prospect is dramatically modified, however, when the choice alternatives are not those of ordinary politics but are, instead, rules or institutions within which patterns of outcomes are generated by various nonunanimous decision-making procedures.”<sup>170</sup> The indirectness and broadly reciprocal nature of the distributional consequences of constitutional bargaining erect a limited Rawlsian veil of ignorance that provides incentives for agreement on efficient institutions. This veil of ignorance is limited because those who negotiate constitutions can predict some of the distributive consequences of constitutional-type bargains.

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who must negotiate regarding fencing their cattle might see one another in church, their children might play together, they might need assistance from one another in an emergency, etc., in addition to relationships relating to trespassing cattle. Similarly, European Community legislation takes place in a context of multi-faceted relationships, in which tit-for-tat strategies may become extremely complex and long-sighted. The expansion of the WTO system to include services, intellectual property, etc. may have similar results.

<sup>166</sup> Compare Coase and Snidal, *supra* note 162, with Stephen D. Krasner, *Global Communications and National Power: Life on the Pareto Frontier*, 43 *WORLD POL.* 336, 340 n.3 (1991) (“the problem is not how to get to the Pareto frontier but which point along it will be chosen”); Geoffrey Garrett, *International Cooperation and Institutional Choice: The European Community’s Internal Market*, 46 *INT’L ORG.* 533, 541 n.2 (1992).

<sup>167</sup> Garrett, *supra* note 166. See also Moe, *supra* note 106. (arguing that the neglected side is the distributive side).

<sup>168</sup> BRENNAN & BUCHANAN, *infra* note 184, at 28-32. See also James M. Buchanan, *The Domain of Constitutional Economics*, 1 *CONST. POL. ECON.* 1 n.1 (1990).

<sup>169</sup> BRENNAN & BUCHANAN, *infra* note 184, at 29. “The so-called Folk Theorem of game theory states that for a class of games that includes 2 x 2 repeated Prisoner’s Dilemma, there are many feasible equilibria above the maximin points of both players.” KEOHANE, *supra* note 49, at 168 (citations omitted).

<sup>170</sup> BRENNAN & BUCHANAN, *infra* note 184, at 29.

9. *Rationality, Value, Commensurability and Efficiency*

a. Rationality and Maximization

IO, NIE and L&E share the assumption that individuals are boundedly rational and evaluative maximizers.<sup>171</sup> This paper does not engage in the debate regarding the content of human rationality and its bounds,<sup>172</sup> but briefly examines its applicability to actors in international society: that is, states. "Much contemporary international relations theory is based on the assumption of state rationality."<sup>173</sup>

Bounded rationality involves "[t]he limitations on human mental abilities that prevent people from foreseeing all possible contingencies and calculating their optimal behavior."<sup>174</sup> There are two parts to bounded rationality: limitations on information and limitations on the ability to process information. Assuming rationality, we may view limitations on information as "rational ignorance;" the acquisition of more information is too costly in relation to the anticipated benefits. Bounded rationality also implies limitations on the ability to process information already acquired. Processing, like searching, entails an investment of attention. From the perspective of the decision-maker, such an investment may not be expected to yield a solution that is sufficiently better to make the processing worthwhile. Groups, like individuals, exhibit limitations on information searching and processing; however, these problems may be ameliorated and accentuated in different ways by the conjunction of a number of minds. The literature on social choice and public choice addresses the rationality of group decisions. Arrow's impossibility theorem<sup>175</sup> and Buchanan's methodological individualism<sup>176</sup> indicate that organizations have no rationality of their own, but intermediate imperfectly for individuals. "Even if the collective entity, as such, confronts the alternative, the only genuine choices made are those of the individuals who partici-

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<sup>171</sup> See Michael C. Jensen & William H. Meckling, *The Nature of Man*, 7 J. APPLIED CORP. FIN. 4 (1994).

<sup>172</sup> For a summary of the theories: See PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATION & MANAGEMENT* 126-65 (1992).

<sup>173</sup> Moravcsik, *supra* note 51, at 481. Moravcsik points out that it is necessary to examine domestic politics to understand how state preferences are formed, and in order to examine strategic interaction among states.

<sup>174</sup> *Id.* at 596.

<sup>175</sup> KENNETH ARROW, *SOCIAL CHOICE AND INDIVIDUAL VALUES* (1951).

<sup>176</sup> "Those who prefer to conduct inquiry into the relationships among classes, states, and other organizations as such, and without attempts to reduce analysis to the individuals who participate, do not, in my view, pass muster as social scientists in any useful sense of the term." Buchanan, *supra* note 89, at 47.



pate in the decision process."<sup>177</sup> While this theoretical perspective is no doubt correct, institutions are designed by individuals to achieve their purposes.

Whether it makes pragmatic theoretical sense to impute interests, expectations, and the other paraphernalia of coherent intelligence to an institution is neither more nor less problematic, a priori, than whether it makes sense to impute them to an individual. The pragmatic answer appears to be that the coherence of institutions varies but is sometimes substantial enough to justify viewing a collectivity as acting coherently.<sup>178</sup>

Rationalist international relations theory assumes that states are rational evaluative maximizers of their own preferences.<sup>179</sup>

#### b. States versus People as Constituents

One clear distinction between firms and IEOs is that generally, IEOs do not issue shares and do not have shareholders. In corporations, shareholders hold two kinds of residual rights. First, they have the right to residual value upon liquidation of the firm. Second, and more salient to our inquiry, corporate shareholders have the right to residual control. For corporate shareholders, residual control means, to the extent that rights of control have not been contracted away by either the shareholders (for example to management or to other employees) or the corporation itself (for example in a loan agreement or in a collective bargaining agreement), the shareholders retain authority and power to act as they determine. Even if the shareholders contract away authority, they retain the power (except to the extent that injunctive relief might restrict them) to breach their contracts.<sup>180</sup> In this connection, state sovereignty and shareholder sovereignty seem similar.

Similar to corporate shareholders, the states that are members of currently existing IEOs generally claim the right to residual control over those of their affairs that they have not assigned to the IEO. This residual control takes two forms. First, it is retained domestic sovereignty. Second, it is retention of the right to consent to any new rule that might emanate from the IEO. It might be argued that there are

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<sup>177</sup> *Id.* at 39.

<sup>178</sup> March & Olsen, *supra* note 51, at 739 (citations omitted).

<sup>179</sup> See Kenneth W. Abbott, *Trust but Verify: The Production of Information in Arms Control Agreements and Other International Agreements*, 26 *CORN. INT'L L.J.* 1 (1993).

<sup>180</sup> This is very similar to the position of government of the sovereign state in international law. It retains power and authority except to the extent that it is circumscribed under conventional or customary international law. Here, the definition of sovereignty and the restraints of customary international law may be compared to the rules of corporation law.

important counter-examples to such residual control, including the EU, where the European Commission, the European Parliament and the ECJ purport to share residual control with the inter-governmental Council. (Of course, the German Federal Constitutional Court disagrees on the locus of residual control.)<sup>181</sup> On the other hand, these more transnational bodies might be compared to management of a corporation. In any event, member states have an important kind of residual control similar to the principle of limited liability in a corporation. They have only put at risk, or pooled, the control over their own destinies that they have "invested" in the IEO. This is true so long as final power to determine *competenz-competenz* is retained. There may be significant contention over what has been "invested," as well as where lies the power definitively to determine what has been "invested."

However, the central questions which address whether the theory of the firm may be useful in considering IEOs are twofold. First, are the citizens of the member states the real parties in interest? Second, assuming that the citizens of the member states are the real parties in interest, how does the intermediation of their national governments affect the applicability of the theory of the firm?

With respect to the question of whether the citizens of the member states are the real parties in interest, certainly from a normative contractarian, liberal or cosmopolitan standpoint the answer is an emphatic yes.<sup>182</sup> From a positive or traditional realist standpoint, the citizens might not be the focus. In practice, the answer to this question depends on the responsiveness of the relevant state government. Thus, from a positive theoretical standpoint, the real party in interest

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<sup>181</sup> In its ruling on the Treaty on European Union, and in the prior opinions known as the *Solange* opinions, the German Federal Constitutional Court has asserted control over the application of the Treaty of Rome to Germany, in order to safeguard certain constitutional values. Bundesverfassungsgericht (Federal Constitutional Court) Judgment of Oct. 12, 1993 (Maastricht), 89 Entscheidungen des Bundesverfassungsgerichts 155). See, e.g., Karl M. Meessen, *European Integration: The Maastricht Judgment of the Federal Constitutional Court of Germany*, 17 *FORDHAM INT'L L.J.* 511 (1994); Manfred H. Wiegandt, *Germany's International Integration: The Rulings of the German Federal Constitutional Court on the Maastricht Treaty and the Out-of-Area Deployment of German Troops*, 10 *AM. U. J. INT'L L. & POL'Y* 889, 890-904 (1995).

<sup>182</sup> For a thoughtful exegesis of the contractarian view, and its cosmopolitan, individual-centered perspective, see Buchanan, *supra* note 168. Buchanan defines the research program, in the Lakatosian sense, of constitutional economics as having its foundation in "methodological individualism." "Unless those who would be participants in the scientific dialogue [of constitutional economics] are willing to locate the exercise in the choice calculus of individuals, *qua* individuals, there can be no departure from the starting gate." *Id.* at 13. See Imre Lakatos, *Falsification and the Methodology of Scientific Research Programmes*, in *CRITICISM AND THE GROWTH OF KNOWLEDGE* 91 (Imre Lakatos & Alan Musgrave eds., 1970).

is indeterminate. States are neither billiard balls nor simple conduits. Like other institutions, they are complex mediating prisms that transmit the interests of individuals at varying speeds, with varying intensities and with varying degrees of distortion.<sup>183</sup>

Assuming that the citizens are the real parties in interest, we might compare states to corporations as agents of shareholders, or to mutual funds or investment companies as agents of portfolio companies. From this perspective, states intermediate. From the standpoint of individuals, in addition to the direct functions of states, they serve as agents for entering into international relations. From the standpoint of the IEO, states may be seen as units of decentralized organization. The cosmopolitan individual-centered perspective, based as it is on contractarian individual choice, raises a perplexing theoretical question about the structure of IEOs. Are IEOs dependent on the consent of all individuals who are citizens of the member states? This question is only different in scale, however, from the question of whether the government of a particular member is dependent on the consent of each individual citizen.<sup>184</sup> Our working assumption is that nations do not have personal interests, but simply represent individuals that do.<sup>185</sup>

Accepting the fact that states intermediate, and that state governments generally control the exercise of states' rights in IEOs (subject to successful claims of a democracy deficit), there are important implications for the maximization equation suggested by this paper. *The values maximized through transactions are not directly those of individuals, but are the values of state governments.* This article does not address the extent of congruence between the values of governments and the values of their citizens. This article seeks to address the institutional issues in IEOs; I leave the analysis of institutional issues in states to public choice theorists who address national governments.

While corporations certainly have structures that differ from those of most international organizations, the structures are at least comparable, allocating competences and rights to make decisions in

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<sup>183</sup> To pursue the analogy perhaps too far, one would have to call an institution a reverse prism, taking the component colors and integrating them into a single beam.

<sup>184</sup> GEOFFREY BRENNAN & JAMES M. BUCHANAN, *THE REASON OF RULES: CONSTITUTIONAL POLITICAL ECONOMY* 6 (1985) ("the rules that constrain sociopolitical interactions – the economic and political relationships among persons – must be evaluated ultimately in terms of their capacity to promote the separate purposes of all persons in the polity").

<sup>185</sup> See Bruno S. Frey & Beat Gygi, *International Organizations from the Constitutional Point of View*, in *THE POLITICAL ECONOMY OF INTERNATIONAL ORGANIZATIONS* at 65 (Roland Vaubel and Thomas D. Willett, eds.) (1991); AMARTYA K. SEN, *COLLECTIVE CHOICE AND SOCIAL WELFARE* (1979).

various ways. Indeed, as all of these organizations constitute means of establishing artificial persons to act on behalf of their constituents, it is not surprising that they have common issues. An extensive corporate governance literature concerns the problem of agency costs and conflicts of interest, attempting to ensure the fidelity of corporate managers to shareholder welfare.<sup>186</sup> The public choice perspective on international organizations exhibits similar concerns regarding the pursuit by (i) national governments; and (ii) their delegates to international organizations of their own respective interests rather than citizen interests.

Recall, however, that we are using a comparative institutional analysis. Thus, we would like to reduce these agency-type costs, but we must be mindful of the transaction costs of their reduction and the availability of institutional substitutes. While the corporation carries with it agency costs, Coase posited that corporations exist where they do because the agency costs are smaller than the alternative transaction costs of the same allocation through the market. The same may well be true of the state as intermediary, on the one hand, and of the IEO, on another.

Frey and Gygi cite examples of the types of rules that delegates to international organizations may prefer, which may be inconsistent with the interests of the citizens of their countries. These include rules that require more meetings and travel, allocate quotas of employees to member states, provide the particular international organization with a monopoly in its function, constrain exit from the international organization and provide financial autonomy to the international organization.<sup>187</sup> On the other hand, according to Frey and Gygi, citizens want competition among international organizations with limitations on exclusive jurisdiction – monopoly authority – accorded particular international organizations. Similarly, citizens want to ensure ease of exit from the international organization; exit fortifies and serves as a substitute for voice. In order to avoid “mutual assured destruction,” citizens want to ensure possibilities for partial exit through rules that allow the unbundling of the public goods provided by the international organization. Citizens are interested in obtaining “fiscal equivalence” by virtue of rules allowing voting in proportion to national contribution; this avoids problems of moral hazard. Finally, citizens

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<sup>186</sup> See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991).

<sup>187</sup> Frey & Gygi, *supra* note 185, at 65.

prefer election of the governing body of the international organization by a popular vote, enhancing direct accountability.

c. IEOs versus Firms as Maximizers

Obviously an IEO is not a business firm and does not have profit maximization as a goal.<sup>188</sup> Its purposes and the quality of its relationships with its constituencies are quite different from those of a business firm. Yet the point of this paper is not that IEOs are business firms, but that the method of analyzing the relationships and constituencies comprising business firms can be applied to analyze the relationships and constituencies comprising IEOs. Even more fundamentally, this paper argues that IEOs can be explained in the same currency as business firms, the currency of comparative institutional analysis.

No one would argue that IEOs and business firms exist for the *same* purposes. This paper simply argues that they exist as organizations for the same reasons; they are presumed to be more efficient means of achieving their respective purposes than the alternatives.<sup>189</sup> The purpose of typically organized, publicly-owned, for-profit business firms<sup>190</sup> is maximization of shareholder value; however, although there are attacks on this vision from various quarters, including a stakeholder model<sup>191</sup> that considers value for other constituencies.<sup>192</sup> The stakeholder model, which sees the business firm as a focal point for a number of different "stakeholders," including shareholders, employees, customers, suppliers, communities and others, is an out-

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<sup>188</sup> See Spruyt, *supra* note 90, at 532, citing Terry Moe, *New Economics of Organization*, 28 AM. J. POL. SCI. 761 (1984) ("Most notably, the absence of a clear medium of exchange – that is, the absence of profit making as an evaluative mechanism of the rationale of such association – makes comparisons problematic.")

<sup>189</sup> See Barry R. Weingast, *The Political Institutions of Representative Government*, Working Paper in Political Science P-89-14, The Hoover Institution, Stanford University, at 2. Weingast argues that "[w]hile the specific forms of transaction problems found in legislatures differ from those in markets, the general lessons of the new economics of organizations hold. Institutions are necessary to mitigate these problems in order for the gains from exchange to be captured."

<sup>190</sup> For some other structures, including cooperatives and worker-owned firms: See Henry Hansmann, *Ownership of the Firm*, 4 J. L. ECON. ORG. 267 (1988).

<sup>191</sup> See, e.g., Thomas Donaldson & Lee E. Preston, *The Stakeholder Theory of the Corporation: Concepts, Evidence and Implications*, 20 ACAD. MGT. REV. 65 (1995); R. EDWARD FREEMAN, *STRATEGIC MANAGEMENT: A STAKEHOLDER APPROACH* (1984); Eric W. Orts, *Beyond Shareholders: Interpreting Corporate Constituency Statutes*, 61 GEO. WASH. L. REV. 14 (1992).

<sup>192</sup> Assuming perfect competition, maximization of shareholder value would *require* maximization of value to all other voluntary parties to contracts with the corporation. Thus, those who advance a stakeholder model must show either the transaction costs-based problems in maximizing value to other stakeholders, or the involuntary nature of their relationship.

growth of the model of the firm as a “nexus of contracts.”<sup>193</sup> The stakeholder model is not necessarily inconsistent with the goal of maximization of shareholder value. These concepts may be reconciled if maximization of shareholder value is recognized as the central goal, with subordinate goals of satisfying other stakeholders to the extent necessary to achieve the central goal.

We might consider the purposes of an IEO in similar terms.<sup>194</sup> Each IEO is formed for different purposes; thus, IEOs may be viewed as a more diverse group than business firms. However, if we begin to think of the variety of corporate entities, including incorporated towns, not for profit corporations, cooperative corporations and employee-owned corporations, we begin to see a comparable degree of diversity. Furthermore, if we recall Coase’s *Theory of the Firm*, it becomes clear that at another level the purpose of the business firm is to establish a set of relationships more efficiently – in terms of transaction gains net of transaction costs – than operations in the market could. Here, there seems little to distinguish the IEO. This theoretical perspective predicts that IEOs are formed to establish a set of relationships more efficiently than the equivalent of the market in international society. Each member state government maximizes its basket of preferences.

#### d. Value and Commensurability

The international market for power is different from the market for private goods along many dimensions, some of which are discussed above. While there may well be exchange in the market of international relations, this market is not normally a cash market. Rather, it is most often a barter market, with all the difficulties and transaction costs of barter.<sup>195</sup> For example, agreements within the EU to engage in mutual recognition of regulation are a kind of barter. All trade negotiations are essentially complex, usually multi-party, barter. Trade negotiators try to value the concessions they make and receive, but it is done in an extremely inexact manner. The growing liquidity

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<sup>193</sup> See R.E. Freeman & W.M. Evan, *Corporate Governance: A Stakeholder Interpretation*, 19 J. BEHAVIORAL ECON. 337 (1990).

<sup>194</sup> For an application of the stakeholder approach to the WTO, see G. Richard Shell, *Trade Legalism and International Relations Theory: An Analysis of the World Trade Organization*, 44 DUKE L.J. 829 (1995) (suggesting a “trade stakeholders model” that would include NGO’s, etc.).

<sup>195</sup> Barter requires much greater search costs than money exchange, as it requires what Jevons called the “double coincidence” of wants. The broadening of the scope of coverage of the WTO system may be viewed as a rough method of enhancing the scope for exchange, and thereby reducing this problem.

of this market – increasing frequency and scope of exchange – will facilitate, and will be facilitated by, increasing monetization<sup>196</sup> of various types of exercise of state power, including jurisdiction.

The fact that this market for state power is not extensively monetized does not block its economic analysis. Economists have increasingly turned their attention to the analysis of social phenomena where value is exchanged but not valued in monetary terms. In fact, the public choice school of economic analysis of politics systematically applies economic analysis to exchanges of value outside the normal monetized market for private goods.<sup>197</sup> While such applications make price theory-based economic analysis more difficult, the type of institutional analysis described in this paper is not similarly burdened because it does not rely on monetization and is very similar in its application to the private firm and to the IEO.<sup>198</sup>

Finally, there are significant questions as to whether preferences are commensurable.<sup>199</sup> This paper cannot address the problems of commensurability or interpersonal comparison of utilities. However, two points are worth making. First, the theoretical perspective of this paper would clearly be incomplete if it failed to take all preferences into account, including both those that are easily monetized, and those subject to greater problems of commensurability.<sup>200</sup> The model is

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<sup>196</sup> There is a political science literature that seeks to measure and determine the fungibility of power. See Dougherty & Pfaltzgraff, *supra* note 20, chap. 2, p. 21, and sources cited therein. There is also an economics literature that seeks to value environmental degradation and other values not normally addressed in the market. See, e.g., Note, "Ask a Silly Question . . ." *Contingent Valuation of Natural Resource Damages*, 105 HARV. L. REV. 1981 (1992); ROBERT C. MITCHELL & RICHARD T. CARSON, *USING SURVEYS TO VALUE PUBLIC GOODS: THE CONTINGENT VALUATION METHOD* 65 (1989).

<sup>197</sup> See, e.g., Mueller, *supra* note 22; DANIEL A. FARBER & PHILIP P. FRICKEY, *LAW AND PUBLIC CHOICE – A CRITICAL INTRODUCTION* (1991); Paul B. Stephan III, *Barbarians Inside the Gate: Public Choice Theory and International Economic Law*, 10 AM. U. J. INT'L L. & POL'Y 745 (1995).

<sup>198</sup> See Herbert Simon, *Rationality as Process and as Product of Thought*, AM. ECON. REV., May 1978, at 6-7. Simon argues that

As economics expands beyond its central core of price theory, and its central concern with quantities of commodities and money, we observe in it . . . [a] shift from a highly quantitative analysis, in which equilibration at the margin plays a central role, to a much more qualitative institutional analysis, in which discrete structural alternatives are compared

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[S]uch analyses can often be carried out without elaborate mathematical apparatus or marginal calculation. In general, much cruder and simpler arguments will suffice to demonstrate an inequality between two quantities than are required to show the conditions under which these quantities are equated at the margin.

(quoting Williamson, *supra* note 4, at 270).

<sup>199</sup> See Cass R. Sunstein, *Incommensurability and Valuation in Law*, 92 MICH. L. REV. 779 (1994).

<sup>200</sup> See Buchanan, *supra* note 89, at 31:

drawn between the Scylla of assuming avariciousness for simplicity and the Charybdis of problems of incommensurability. Second, the theoretical perspective of this paper takes each individual's preferences as given, but does not exclude the possibility that one individual's preferences include the modification of another individual's preferences. This raises the need to understand how learning takes place internationally.<sup>201</sup>

e. Efficiency and Path Dependency

If the allocation of resources is such that no person can be made better off without someone being made worse off, such allocation is Pareto efficient. By referring to each person's own decision, in effect giving each person responsibility for implementing his or her own utility function, the concept of Pareto efficiency supports a contractarian approach to allocation and rules. In organizational terms, "an organization is considered to be efficient if the members unanimously accept the general rules under which it operates."<sup>202</sup> Thus, the test for Pareto efficiency of an IEO is whether each state accepts its operating rules. Explicit constitutional rules generally require unanimous consent, while the "constitutionalization" of the Treaty of Rome by the ECJ met only acquiescence.

The Pareto efficiency criterion takes as given an initial allocation of legal rights, such as the pattern of state sovereignty extant in the world today. Economic analysis of law often uses "comparative statics" to compare the equilibria produced by different legal rules.<sup>203</sup> Pareto efficiency is binary and non-unique. An equilibrium is either Pareto efficient or it is not, and there may be multiple Pareto efficient equilibria.

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I suggest that we cease and desist in any attempts to model man, *either* in his market or in his public choice behavior, as seeking exclusively or even predominantly to maximize the value of his net wealth. I suggest that we restrict ourselves methodologically to the more limited model of *Homo economicus*, one that allows the argument for economic value to enter the individual utility function, in market or in public choice behavior, but to enter as only one among several arguments, and not necessarily as the critical influencing factor in many cases.

<sup>201</sup> See North, *supra* note 18, at 362-67; Keohane, *supra* note 49, at 170-74. See also Peter M. Haas, *Introduction: Epistemic Communities and International Policy Coordination*, 46 INT'L ORG. 1 (1992).

<sup>202</sup> Frey & Gygi, *supra* note 185, at 58, 60, citing GEOFFREY BRENNAN & JAMES M. BUCHANAN, *THE REASON OF RULES: CONSTITUTIONAL POLITICAL ECONOMY* (1986).

<sup>203</sup> Robert D. Cooter, *The Best Right Laws: Value Foundations Of the Economic Analysis of Law*, 64 NOTRE DAME L. REV. 817, 821 (1989).



The concept of potential Pareto efficiency (PPE)<sup>204</sup> is different; under PPE, a change that provides enough value to compensate each person otherwise made worse-off is efficient, regardless of whether compensation is actually paid. This paper assumes that the appropriate test is PPE. If the winner's gain is large enough, it may (potentially) compensate the loser so that both the winner and loser derive a net benefit. Where transaction costs are zero, simple Pareto efficiency and PPE converge: compensation is paid and all possible *potential* transactions are realized. The use of PPE becomes more justified as more subject areas are included in international negotiations and governments begin to evaluate concessions in monetary terms. We might align simple Pareto efficiency with realism in international relations theory and PPE with liberalism. PPE assumes away the problem of distribution, but reaches a potentially higher aggregate net benefit; it assumes that trade will occur to reach that higher aggregate net benefit.

A cost-benefit analysis that looks at aggregate net benefits, without concern regarding how the benefits are distributed, is consistent with PPE. An important distinction between simple Pareto efficiency and PPE is that PPE is unique: given the ability to compensate losers, only one structure satisfies the criterion that no one can be made better off without someone being made worse off. Thus, PPE entails cost-benefit analysis searching for a unique maximum net benefit. As a practical matter, assuming that nirvana is out of reach, the appropriate test is potential Pareto superiority. Upon comparison, is one institutional arrangement better than another?

In the context of IEOs, neither simple Pareto efficiency nor PPE can be fixed exogenously by economic research.

Only if individuals' preferences are revealed in markets is the outcome oriented approach consistent with the economic approach because prices and quantities consumed reflect the individuals' voluntary decisions. If the results of voluntary decisions fulfill the commonly accepted Pareto conditions, then the situation is considered to be efficient; Pareto-efficiency thus coincides with efficiency in the constitutional perspective . . . However, international organizations' activities are not valued in markets . . .<sup>205</sup>

Thus, we have what seems like a critical difference between IEOs and firms: the output of IEOs is not monetized, and the utilities sought through IEOs cannot be aggregated. No monetized market

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<sup>204</sup> Sometimes referred to as Kaldor-Hicks efficiency. *Id.* at 828. See also RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 13-14 (1992).

<sup>205</sup> Frey & Gygi, *supra* note 185, at 62.

exists that can reveal valuation of particular goods. As a result, the only available test of the Pareto efficiency or PPE of the rules of an IEO is to determine whether its rules are accepted by its constituents.<sup>206</sup> From a policy perspective, comparative institutional analysis, given an articulated set of preferences and priorities, may indicate the institutional structure that can satisfy those preferences best, as among those institutional structures compared. Thus, the comparative institutional analysis suggested here is designed to inform political discourse, with the ultimate test of efficiency being simply the (tautological) fact of political acceptance of a particular set of rules.

It is important to keep in mind that each institutional solution must fit into a wider institutional structure. "Although the Paretian approach is piecemeal, over time all the laws may be modified or replaced, just as a ship's carpenter may eventually replace all the planks in the hull while it remains afloat."<sup>207</sup> Indeed, each plank must be checked, and it is likely that a change in one will commend change in others. The magnitude and complexity of this project must give rise to considerations of optimal processes and coordination mechanisms. This caveat may be related, in part, to path dependency: what is efficient today depends on what was done in the past. However, bygones are still bygones. What was done in the past is only important for the institutional and technological infrastructure that has survived. Change must be evaluated in context, not in abstract. The costs of changing to a new system must be worthwhile before an otherwise more efficient structure is substituted for an otherwise less efficient structure.<sup>208</sup> However, the larger point is that a static model of efficiency can and must incorporate path dependency and all other context sensitivities. In this sense, history, to the extent that its effects persist, is no more than another part of the wider existing institutional structure that is the essential reference for determining the efficiency of any particular component institutional structure.<sup>209</sup>

On the other hand, a dynamic model is necessary in order to accommodate the need for efficiency measured at various points in time.<sup>210</sup> Thus, a more flexible institutional component may provide

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<sup>206</sup> *Id.* at 64.

<sup>207</sup> Cooter, *supra* note 203, at 822.

<sup>208</sup> See the analysis and citations in Gilson, *supra* note 74, at 329-30. See also Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641 (1996); Keohane, *supra* note 49, at 169.

<sup>209</sup> See Oliver E. Williamson, *The Evolving Science of Organization*, 149 J. INSTITUTIONAL & THEORETICAL ECON. 36, 55-56 (1993).

<sup>210</sup> Gilson, *supra* note 74, at 336-337, 345.

benefits by reducing transition costs when a more efficient replacement component becomes available. It may be perfectly rational to sacrifice maximum efficiency on a static current basis in order to save transition costs, and thereby have greater efficiency later.<sup>211</sup>

The competitive environment of IEOs is certainly different from that of business firms. However, IEOs exist in a competitive environment. On a relatively horizontal axis, they compete against other IEOs, against non-governmental organizations and against transnational entities like multinational corporations. On a more vertical axis, they compete against states themselves. They compete not so much for profits, but for responsibility. Just as a business firm gets more profits when it does well (and, if it does not pay dividends, can expand its business), an IEO may receive more responsibility when it does well. Of course, it may need and demand more funding to fulfill additional responsibilities. Finally, as noted above, the absence of a price system hinders the competitive process and reduces the directness of its discipline.

Interestingly, while IEOs compete with states for responsibility, they are also vehicles of collusion.<sup>212</sup> States engage in a competition in provision of public goods. When they collude, they may make "spot" transactions in power, enter into longer-term agreements to transact in power in the future or form IEOs without knowing *ex ante* exactly what transactions will be made by these institutions. If we could assume that states always represented their citizens' best interests, this collusion would be of little concern. In fact, we could assume that it is intended to provide greater efficiency in terms of economies of scale, enhanced free trade, etc. However, the collusion might be among particular components of the governments, presumably the executives, to the disadvantage of the legislatures and the citizens.<sup>213</sup> This type of potential collusion creates particular concern regarding "democracy deficits." Indeed, IEOs may raise information costs for

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<sup>211</sup> This view is consistent with a so-called "real options" view of firm organization and strategy. By this view, firms are conceived as a bundle of resource commitments generating rents in the current period combined with options for the creation of resources useful in foreseeable scenarios in the next period. For an explanation of this view in greater detail: See, e.g., Nimal Kulatilaka & Alan J. Marcus, *General Formulation of Corporate Real Options*, 7 RES. FIN. 183 (1988); see also note 243, *infra*.

<sup>212</sup> See Roland Vaubel, *A Public Choice View of International Organization*, in THE POLITICAL ECONOMY OF INTERNATIONAL ORGANIZATIONS 27, 33 (Roland Vaubel & Thomas D. Willett eds., 1991).

<sup>213</sup> Abbott and Snidal refer to the possibility of "laundering" of policies through IEOs, as a way that domestic governments, or components thereof, may avoid responsibility for unpopular policies. Abbott & Snidal, *supra* note 47.

taxpayers, allowing politicians to favor interest groups more easily.<sup>214</sup> Some have argued that the control of executives over dispute resolution in the WTO, combined with the relative opacity of the WTO dispute resolution process, permits a degree of unconstrained control by the executive that would not be acceptable in the domestic sphere.

There is also a wide scope for competition with sub-state entities and NGOs, as well as with other IEOs. Among IEOs, there are bilateral, regional, multilateral and functional organizations. In each of these categories there may be multiple organizations competing for responsibility or for gain. Examples of organizations competing for responsibility are the UNCTAD and the GATT in the 1970s and the IMF and World Bank in the 1980s and 1990s. Examples of organizations competing for gain, or for position, are NAFTA and the European Union during the Uruguay Round.

### C. Operationalizing the Transaction Cost Theory: Hierarchy in International Relations

This sub-section seeks to examine attempts to operationalize the transaction costs approach to institutions. Difficulties in the measurement of transaction gains,<sup>215</sup> transaction losses and transaction costs on a comparative basis generally make it difficult to generate testable hypotheses. Analysts have developed two basic kinds of responses. First, they have often decided to ignore transaction gains and losses, concentrating their study on transaction costs.<sup>216</sup> For the reasons set out above, this raises serious questions. Second, they have tried to identify particular transaction profiles identified with particular transaction cost magnitudes, and to associate institutional responses with those transaction cost profiles.<sup>217</sup> For the reasons set forth below, such simplification seems problematic. This article proposes a more particularistic approach, identifying particular institutional components in particular institutional settings, hypothesizing substitute components and evaluating prospective comparative transaction gains, losses and costs.

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<sup>214</sup> Vaubel, *supra* note 212, at 39.

<sup>215</sup> See ALAN O. SYKES, *PRODUCT STANDARDS FOR INTERNATIONALLY INTEGRATED GOODS MARKETS* 10-11 (1995) (arguing that the effects of technical barriers to trade are difficult to measure).

<sup>216</sup> WILLIAMSON, *supra* note 4, at 282: "The analysis here focuses entirely on transaction costs: neither the revenue consequences nor the production-cost savings that result from asset specialization are included."

<sup>217</sup> *Id.* at 277.

1. *Williamsonian Asset Specificity Applied to  
International Relations*

Williamson focuses on asset specificity as a basis for problems of opportunism and, in turn, as a basis for integration within a firm. This type of hold-up problem arises after economic relations are entered and from the fact that one party makes an investment in transaction-specific assets. The classic example of Fisher Body and General Motors illustrates the utility of vertical integration to safeguard the party required to make the asset specific investment from opportunistic behavior on the part of the other party.<sup>218</sup> In this example, an asset specific investment is one that can only realize its full value in the context of continued relations with another party.

Williamson claims that "it is the condition of asset specificity that distinguishes the competitive and governance contracting models. Contract as competition works well where asset specificity is negligible. This being a widespread condition, application of the competitive model is correspondingly broad. Not all investments, however, are highly redeployable."<sup>219</sup>

Asset specificity, as used by Williamson, is too narrowly defined. It is too narrowly defined because it excludes otherwise indistinguishable reasons why parties might decide to contract or enter into firms or other organizations. Williamson uses as an example of asset specificity the worker who obtains special training that is only useful in the employer's business. But what of the worker who declines one job, which will not be available later, to accept another where she is employed at will? Perhaps the opportunity cost is also seen as an asset specific investment. The concept soon becomes broad enough to encompass the giving, or giving up, of anything of value at an earlier stage where corresponding value has not yet been received in return.<sup>220</sup> The concept of asset specificity then becomes precisely congruent with the distinction between market and institutions developed above, with the need to bind another person over time. Whenever this type of asset specificity exists, it will be useful, subject to transac-

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<sup>218</sup> See Benjamin Klein, Robert G. Crawford & Armen A. Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J. L. & ECON. 297, 308-310 (1978). Klein, Crawford and Alchian considered asset specificity only as one explanation of vertical integration.

<sup>219</sup> WILLIAMSON, *supra* note 13, at 42.

<sup>220</sup> Once this is accepted, any transaction that is not completed in the spot market and does not otherwise provide for exact simultaneity of exchange of value is, in this sense, "asset specific."

tion costs, to seek an institutional solution either in contract or in hierarchy.

What makes a particular transaction in international relations "asset specific" in the broader sense used here? Again, any transaction where one state advances consideration at a particular point in time, and must rely on one or more other states to carry out their end of the bargain at a later point in time or experience a significant loss in its expected value, is "asset specific." For example, a state might reduce its trade barriers, including tariff and non-tariff barriers. While this may be the kind of self-enforcing transaction in which the consideration can be withdrawn, it is often difficult to re-establish trade barriers, and doing so involves political and economic costs. Often the domestic political costs of reducing trade barriers are incurred at the time they are reduced, and perhaps cannot be fully recouped later by re-establishment of the barriers. Second, to the extent that the barriers are reduced on a multilateral basis under conditions of MFN,<sup>221</sup> withdrawal may be made more difficult as a matter of both international law and domestic politics, not to mention customs administration. As a matter of international law and politics, the injured state may not be permitted to withdraw concessions on a non-MFN basis, or it may be difficult to calculate and agree on the value of the concession. In addition, the entry into an IEO itself may have high political costs at the outset. It may not be fully possible to be reimbursed for these costs.

Finally, recent attempts to harmonize regulation present a more compelling case of asset specificity. Where a state modifies its domestic regulatory system in pursuit of a plan of harmonization, it is difficult to reverse this course due to defection by another state. On the other hand, it is relatively easy for another state to defect, while it may be difficult to identify and evaluate defection.

Williamson's model does not satisfactorily distinguish among various types of institutionalization, from contract to hierarchy. It becomes important to recognize, as Williamson does, that between market and hierarchy is a broad continuum of "hybrid" structures, including long-term contracts. Williamson does not, however, establish a predictive relationship between degree of asset specificity, on the one hand, and type of institutionalization, on the other.

As Williamson points out, the obligor can be bound by any of three general categories of structure.

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<sup>221</sup> "Most favored nation" treatment, for example, under art. 1 of GATT. General Agreement of Tariffs and Trade, Oct. 30, 1947, art. 1, 61 Stat. A5, A12-13, 55 UNTS 194, 196-200.

- First, there can be a contractual obligation to make a payment upon failure to give value later (“explicit contract”).
- Second, where it may be difficult to write an explicit contract, or where only the writing of an incomplete and unspecific contract can be justified, an alternative “is to create and employ a specialized governance structure to which to refer and resolve disputes” (“incomplete contract and hierarchy”). Incomplete contract and hierarchy may include or incorporate firms, common law rules of property or tort, regulation, state action and international organization.
- “[T]hird is to introduce trading regularities that support and signal continuity intentions”<sup>222</sup> (“informal reciprocity”).<sup>223</sup> Here, one might add complementarity of transactions; regularities may arise even if the specifics of the transaction differ. One might also add the concept that institutions may be used to support informal reciprocity by assisting in the dissemination of information, defining the requirements of reciprocity and acting more directly.

These three types of binding mechanisms may all be referred to as types of governance or institutionalization; these are simply categories of institutions. “Explicit contract” institutionalizes in very discrete ways, with the presumed use of courts as gap-fillers where the contract turns out to be incomplete. “Incomplete contract and hierarchy” resembles a traditional institution or firm, where only broad guidelines are set in advance and a decision-making procedure is established to complete the contract. Finally, “informal reciprocity” may be specific or diffuse; however, it falls outside the rubrics of law or contract. Any of these structures may be used to deal with the need to bind others over time. The first two, and probably often the third, depend upon a framework of law that includes property rights and contract enforcement. The important inquiry is, assuming that surplus arises from a relationship, what mechanism can best establish the relationship or maximize the surplus at the lowest transaction cost? There is a rich diversity of binding mechanisms that have been described, including the use of hostages, collateral, hands-tying, union, self-enforcing agreements and regulation.<sup>224</sup>

In order to develop a predictive theory of economic organization, Williamson identifies and explicates factors responsible for differences among transactions, specifically for different transaction cost profiles and uses of different binding mechanisms.<sup>225</sup> Williamson suggests three main transaction dimensions that may be used to develop a pre-

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<sup>222</sup> WILLIAMSON, *supra* note 13, at 34.

<sup>223</sup> See ELLICKSON, *supra* note 44. See also AXELROD, *supra* note 159.

<sup>224</sup> Richter, *supra* note 78, at 705.

<sup>225</sup> WILLIAMSON, *supra* note 13, at 52-61. See also Milgrom & Roberts, *supra* note 5, at 30-33.

dictive theory of economic organization: asset specificity, uncertainty and frequency.<sup>226</sup> It is worth noting that asset specificity does not directly give rise to transaction costs but to potential opportunism. The potential opportunism, in turn, gives rise to the need for binding mechanisms or institutions, which involve transaction costs. However, the greater the asset specificity, the greater the incentives for and costs of opportunism which require and justify more reliable binding mechanisms. The choice of binding mechanism depends also on the degree of uncertainty involved. The lesser the uncertainty, the greater the ability to write specific or relatively "complete" contracts to address any uncertainty. The complexity of a relationship and the degree of uncertainty about the future – about the relative future value<sup>227</sup> of the various commitments – combine with the "asset specificity" that characterizes the transaction *ex ante* to make it increasingly difficult to write complete contracts. Thus, complexity and uncertainty amplify asset specificity in this sense. In addition, the more frequent the instances of a particular type of transaction, the greater economies of scale there will be in creating governance structures that address its governance needs. Complementary transactions that have different purposes or terms may have similar effects.

Asset specificity indicates the need for institutions but does not alone indicate the kind of institutions needed. However, with higher magnitudes of asset specificity and greater uncertainty and complexity, there are greater incentives and possibilities for opportunism. More complete contracts are required to prevent opportunism. Given positive transaction costs, it is impossible to write explicit complete contracts. Therefore, as asset specificity, uncertainty and complexity increase, the need to define and transfer categories of authority to bureaucratic, legislative or dispute resolution type bodies to establish hierarchy also increases. These institutional mechanisms are needed in order to determine how standards established by the parties should

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<sup>226</sup> WILLIAMSON, *supra* note 13, at 52-61.

<sup>227</sup> We assume that at the time the contract is entered into, the present value of the various commitments is equal. Over time, as events unfold, this state of equivalence is likely to change, and the commitment made by one side will become more valuable than the commitment made by the other side. The party whose commitment is more valuable will have a greater incentive to defect. Thus, asset specificity will vary *ex post*. The position is similar to parties to an interest rate or currency swap agreement, who exchange promises that have equal present values at the time that they contract, but whose promises change in present value over time. While neither party is a creditor of the other at the outset, one will be a creditor of the other, to a fluctuating extent, after the inception of the contract. Moreover, under at least some circumstances, the responsibilities of each party may be theoretically limitless.



be applied in the future when particular issues arise. In other words, greater integration is necessary.

Williamson thus sees transaction costs economizing as the main purpose of vertical integration.<sup>228</sup> Vertical integration is seen as a governance response to a particular set of transaction dimensions, including high asset specificity as the principal factor. Williamson assumes that other sources of transaction costs are insignificant, while transaction gains from economies of scale are significant, making market transaction the obvious choice where asset specificity is low.<sup>229</sup> According to this approach, vertical integration becomes attractive where it represents a net transaction cost savings when compared to more contractual or custom-based integration.

## 2. *Complete Contracts, Constitutive Documents and Dispute Resolution*

Williamson seeks to link the study of the institutional environment (meaning the general legal context external to particular organizations) to the study of the institutions of governance.<sup>230</sup> From a lawyer's perspective, perhaps the most salient difference between firms and IEOs is the general legal context in which they exist. Corporations exist in a thick context of domestic law, including contract law, corporate law and all of the law that gives rights to non-contractual stakeholders, like employees, consumers, tort claimants and statutory claimants under environmental laws. This thick domestic legal context is highly articulated and performs three functions that are critical for our purposes. It prohibits many forms of coercion, supplies a reliable and predictable mechanism to complete contracts and regulates private relations for the purported general good. More generally, it is a source of rules that are, either mandatorily or facultatively, incorporated in any corporation's set of constitutive rules.

This body of law may specify the terms of a relationship where the parties have not done so: it may complete contracts. Take the example of a commercial contract governed by New York or English law. In the event of a dispute, the parties would have an extremely detailed body of statutory and common law that has responded to an enormous history of commercial disputes. This body of law performs the function of a set of terms automatically incorporated by reference in the contract. The likelihood that the dispute is not governed by

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<sup>228</sup> WILLIAMSON, *supra* note 13 at 85-86.

<sup>229</sup> *Id.* at 90.

<sup>230</sup> Williamson, *supra* note 4.

statute or precedent is small. Consequently, the likelihood of proceeding to full litigation is also small. The domestic institutional setting is thick with experience and legislation; it reflects the choices of a complex and relatively comprehensive society. The international institutional setting is thin by comparison.

The role of general law in completing contracts reminds us that no institution is an island; each exists in a broader institutional setting. The broader institutional setting penetrates the institutions at various points to complete contracts and to supply broader institutional rules where appropriate. Thus, each particular institutional setting is really a complex of interacting institutional settings.

Incomplete contracts give rise to strategic action to capture surplus after the contract is entered into: opportunism. Furthermore, "the prospect of *ex post* bargaining invites *ex ante* pre-positioning of a most inefficient kind."<sup>231</sup> Again, potential opportunism gives rise to transaction costs which forestall opportunistic action. Again, the issue of market or hierarchy is linked to the question of what type of hierarchy or institutional design. Greater duration and complexity make incompleteness more likely, while greater asset specificity accentuates the risk of incompleteness and the concomitant transaction costs. The response will be either to complete the contract by greater anticipation, negotiation and specific advance resolution, or to create legislative or judicial institutions to resolve future questions. The same is true of business joint ventures; it is necessary to write the resolution into the contract, to create voting structures or to refer issues to some type of arbitration.

Williamson adds a critical dimension to this model: change. Change in the environment accentuates uncertainty and the incompleteness of contracts. Williamson distinguishes price-based adaptability in the market from coordination-based adaptability in the firm. He links adaptability to asset specificity, finding that in circumstances where there is both frequent need for modification of relationships – especially where prices are not expected to serve as sufficient coordinating statistics – and high levels of asset specificity, hierarchy (firm) may be more responsive than market (contract) forms of relationship.<sup>232</sup>

By comparison to firms in a domestic context, IEOs exist in a comparatively thin context of relatively *laissez faire* international law with two main types of "law." The first is treaty, which corresponds

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<sup>231</sup> *Id.* at 279, citing Grossman & Hart, *supra* note 131.

<sup>232</sup> Williamson, *supra* note 4, at 277-280.

for our purposes to contract in domestic law. For example, we do not even think of it as law emanating from a vertical government in domestic law, but as “private” promises that the law will enforce. The second is customary international law (including the law of treaty), which is quite limited in scope and contains little regarding the rights and duties of parties to IEOs and of IEOs themselves. There is not a significant body of “corporate law” of IEOs.<sup>233</sup> (Of course, within the EU, for example, there is additional law in the form of directives and regulations that constitute neither treaty nor customary law.)

International treaties, unlike domestic contracts, are often subject to the problem of incompleteness. Domestic contract disputes always have an answer: “the common law abhors a vacuum.” Courts interpret, construct or leave the loss where it falls. In international treaties, especially those without compromissory clauses,<sup>234</sup> the loss more often stays where it falls, with auto-interpretation expected to intensify this effect.

An example of an incomplete contract in international relations is the GATT agreement itself. Among other things, this agreement binds tariff levels, prohibits quotas and establishes national treatment and most favored nation rules of non-discrimination. However, it does not specifically exclude from its operation actions that member states may take to protect the global commons. Thus, when the United States banned Mexican tuna because Mexico did not comply with unilaterally-imposed U.S. requirements regarding dolphin-safe fishing, the provisions of GATT that provide exceptions to GATT rules for values like the protection of animal life required interpretation, *inter alia*, as to whether these provisions could extend to animal life outside the regulating state. The unadopted 1991 dispute resolution panel decision<sup>235</sup> held that they did not; the unadopted 1994 decision<sup>236</sup> on the same substantive issues was more equivocal. The point is that there were no international environmental rules available effectively to supplement the GATT contract.<sup>237</sup> Furthermore, if there had been no mandatory dispute resolution process in GATT, this dispute

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<sup>233</sup> See FREDERIC KIRGIS, *INTERNATIONAL ORGANIZATIONS* (1993); D.W. BOWETT, *THE LAW OF INTERNATIONAL INSTITUTIONS* (1982).

<sup>234</sup> John E. Noyes, *The Functions of Compromissory Clauses in U.S. Treaties*, 34 VA. J. INT'L L. 831 (1994).

<sup>235</sup> General Agreement on Tariffs and Trade: Dispute Settlement Panel Report on United States Restrictions on Imports of Tuna, 30 I.L.M. 1594 (1991).

<sup>236</sup> General Agreement on Tariffs and Trade: Dispute Settlement Panel Report on United States Restrictions on Imports of Tuna, 33 I.L.M. 839 (1994).

<sup>237</sup> See, e.g., Jeffrey L. Dunoff, *Institutional Misfits: The GATT, the ICJ and Trade-Environment Disputes*, 15 MICH. J. INT'L L. 1043 (1994).

would have been left entirely to auto-interpretation, and would have been decided in the court of power politics and reputation. Finally, the “weakness” of GATT dispute resolution prior to the establishment of the WTO in 1994 (including Mexico’s reluctance to press these issues during NAFTA negotiations) left these respective panel reports unadopted, and therefore without legal effect.<sup>238</sup>

In a domestic legal system, dispute resolution processes can be relied upon to complete contracts. Parties find that either litigation or arbitration is a cost-effective means to implement the rights they think are theirs. In the international legal system, similar reliability can be constructed but generally is not available. This is not simply another way of referring to the fact that the international legal system is more horizontal than vertical. Rather, this example emphasizes the limited array of institutions available in the international legal system. Milgrom, North and Weingast point out that the medieval law merchant enforcement system “succeeds even though there is no state with police power and authority over a wide geographic realm to enforce contracts. Instead, the system works by making the reputation system of enforcement work better.”<sup>239</sup> The system uses formal institutions to supplement an informal mechanism. Reputation is not simply a non-economic value; rather, it is an important source of transaction cost economizing *ex ante*, where formal institutions are not available cheaply to enforce contracts *ex post*. Appeals to reputation may also assist in enforcement *ex post*. The importance of reputation may be magnified in a context where there are multiple transactions entered into by any one person, as in a village community or an increasingly interdependent international society.

In the international legal system, public international law serves the function that a constitution serves in the domestic legal system; it is a main component, governing the production of the remainder of the institutional environment for international organizations and for states. It provides a limited set of rules regarding the formation of law and its interpretation, application and enforcement. Thus, public international law serves as a set of background norms for treaties<sup>240</sup> and other less “constitutional” varieties of customary international law.

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<sup>238</sup> See text accompanying notes 310 to 318, *infra*.

<sup>239</sup> Milgrom, North & Weingast, *supra* note 17, at 19. The synergistic model that establishes institutions necessary to facilitate private sanctions “appears to have been structured to support trade in a way that minimizes transaction costs, or at least incurs costs only in categories that are indispensable to any system that relies on boycotts and [private] sanctions.” *Id.*

<sup>240</sup> For a new institutional economics perspective on treaty law, see Georg Ress, *Ex Ante Safeguards Against Ex Post Opportunism in International Treaties: Theory and Practice of Inter-*

In international law, there are fewer institutional and legal structures to complete contracts. First, in international law, there is no complete body of law that can be applied to supply missing terms to incomplete treaties. Second, in international law, there is generally no dispute resolution tribunal with mandatory jurisdiction. Thus, it is often difficult to complete contracts through dispute resolution mechanisms. The alternative, of course, is to write comprehensive contracts. Even if this were efficient to do (and presumably it would be more efficient with large international relations issues than with smaller business issues), there is still a problem of enforcement. These problems can be resolved in part through relational contracting, through the multiplication of relationships either in number or over time in order to reduce, through a portfolio technique, the risk of asset specificity in a single relationship. This type of resolution can be expanded by linking transactions with multiple parties through reputation effects.

3. *Grossman and Hart's Focus on Residual Rights Applied to International Relations: Sovereignty and Kompetenz-Kompetenz*

Grossman and Hart consider the literature on transaction costs and incomplete contracts and examine the utility of allocating to one party or another residual rights to determine how an asset is used. Integration, in their terms, amounts to a purchase of residual rights to control. Given the theoretical impossibility, in a positive transaction costs world, of truly complete contracts, every decision to integrate or not to integrate is a decision as to who should purchase the residual rights of control. It may be useful for conceptual purposes to consider the residual rights of control as similar to a "real" option.<sup>241</sup> Its owner has the option to make certain strategic decisions regarding the use of the relevant asset; although, due to the costs of specification, these rights remain unspecified. The failure to specify is consistent with bounded rationality, or more precisely, rational ignorance. As be-

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*national Public Law*, 150 J. INST. & THEO. ECON. 279 (1994). See also John K. Setear, *An Iterative Perspective on Treaties: A Synthesis of International Relations Theory and International Law*, 37 HARV. INT'L L. J. 139 (1996).

<sup>241</sup> See, e.g., AVINASH DIXIT & R.S. PINDYCK, *INVESTMENT UNDER Uncertainty* (1994); S. Majd & R. S. Pindyck, *Time to Build, Option Value, and Investment Decisions*, 18 J. FIN. ECON. 7 (1987); James L. Paddock, D. R. Siegel, & J. L. Smith, *Option Valuation of Claims on Real Assets: the Case of Offshore Petroleum Leases*, 103 Q. J. ECON. 479 (1988); A.J. Triantis & J. E. Hodder, *Valuing Flexibility as a Complex Option*, 45 J. FIN. 549 (1990). See also *Optional Investing*, THE ECONOMIST, January 8, 1994, at 74.

tween any two parties, it can be assumed that while both parties are rationally ignorant regarding the precise value of this option, one party will find the option more valuable than the other party and will purchase it.

How does this apply to IEOs? If we consider the allocation of responsibility for a certain subject matter to be equivalent to the residual rights of control that Hart and Grossman discuss, the question of whether the IEO should be allocated responsibility depends on whether this "option" is more valuable in the hands of the IEO or in the hands of the member state. A reference to "sovereignty" in this context is an assumption that these residual rights are more valuable at the state level. In this context, "value" must be understood as the ability to satisfy state preferences at the lowest cost. The option will be "bought" by the level of government that can make most efficient use of the responsibilities to satisfy the preferences expressed at that level of government. From a transaction costs standpoint, assuming positive transaction costs of reallocation of authority, it may be efficient initially to assign responsibility to the level of government to which it is most valuable.<sup>242</sup>

Of course, the vertical intergovernmental relations context, even more than the horizontal intergovernmental relations context, is not a place where responsibilities are "bought" and "sold." Responsibilities are allocated on the basis of arguments about where they can most effectively be carried out. This is indeed a non-monetized market (perhaps it is not a market at all) which shares some characteristics with a market. To the limited extent that constituent preferences come into play, customers for government as a product seek the quality parameters they desire from the lowest-cost supplier.<sup>243</sup> Just as a corporation acts autonomously to achieve a certain set of shareholder preferences, subject to agency costs, so governments act to achieve constituent preferences as defined by government processes and subject to agency costs. Governments would retain residual rights of control if they are more valuable in the government's hands. They would transfer such control if by doing so they could increase their ability to achieve their preferences, either directly or by way of compensation from other governments.

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<sup>242</sup> For a transaction costs approach to the assignment of jurisdiction horizontally see Trachtman, *supra* note 21.

<sup>243</sup> See DAVID OSBORNE & TED GAEBLER, *REINVENTING GOVERNMENT* (1993); RICHARD D. AUSTER & MORRIS SILVER, *THE STATE AS A FIRM: ECONOMIC FORCES IN POLITICAL DEVELOPMENT* (1979).

#### 4. *Summary: Market and Hierarchy*

How might the work described above yield an approach to operationalization of the maximization formula suggested here? It is not clear that the theory of the firm has been operationalized in its home court, so it would be foolish to pretend that it is operationalizable in its application to IEOs. However, a plausible approach that might be subjected to further analysis and empirical testing might run as follows.

Asset specificity is simply a term for the magnitude of risk involved in a relationship: for the potential loss from opportunism. The higher the asset specificity, the greater the risk of opportunism. Assuming asset specificity, it may be worthwhile, depending on cost, to establish devices to constrain opportunism in order to realize gains from trade. Devices to constrain opportunism are institutions. Institutions entail transaction costs. Institutions may specify discrete rules, but under positive transaction costs they are always incomplete. Such discrete rules are incomplete in their interpretation, application and enforcement. As a result, bureaucratic, legislative or dispute resolution methods must be specified to complete incomplete contracts and avoid opportunism, thereby completing the contemplated transaction as "intended." The higher the magnitude of asset specificity, the greater the incentives for opportunism and the need for institutional integration, the transfer of authority to bureaucratic, legislative or dispute resolution mechanisms. The transfer of authority is a transfer of residual rights to control. Such a transfer would be expected when an IEO can exercise residual rights to greater gain than the original holder: the state.

From the standpoint of the history of international economic integration, it might be theorized that states will engage in integrative transactions in areas characterized by low asset specificity early. Once gains from trade in low asset specificity areas are exhausted (and experience of trust is developed), there are greater incentives (and possibilities) for integration in higher asset specificity areas. From a broad standpoint, this pattern may be discerned in the history of the WTO or EU.

D. Governance in the Market and Governance in Hierarchy:  
Toward a Dynamic Model of the Relationship Between  
Vertical Federalism and Horizontal Federalism  
in International Relations

Does it really make a difference whether human activities are organized within a hierarchical environment? It is important to recognize that the boundary between the inside of the box and the outside of the box is quite porous. The labels "market," "transaction," "firm" and "hierarchy" are gross generalizations. In truth, these labels are inaccurate unidimensional categorizations of relationships that have great potential for complexity, overlap and synergy.<sup>244</sup> Alchian and Demsetz pointed out that the firm "has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting."<sup>245</sup> Indeed, the firm is a nexus of contracts.<sup>246</sup>

Herbert Simon states that "[t]he possibility of using internal division-by-division balance sheets, and internal pricing in negotiation between components of an organization further blurs the boundary between organizations and markets."<sup>247</sup> "The wide range of organizational arrangements observable in the world suggests that the equilibrium between these two alternatives may often be almost neutral, with the level highly contingent on a system's history."<sup>248</sup> On the other hand, Simon recognizes that the existence and effectiveness of large organizations depends on "some adequate set of powerful coordinating mechanisms."<sup>249</sup>

A lawyer can corroborate Simon's perspective by showing that any set of contractual relationships that can be established within a corporation can also be established by various contractual devices, and *vice-versa*. Any market structure can be re-created, with some difficulty, within the firm. The real question is how easily are these structures created. Here, Simon's reference to path dependence is useful. It is clear that corporations are used and have evolved because they have been used in the past and have been hospitable to evolution.

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<sup>244</sup> See Cerny, *supra* note 112, at 599.

<sup>245</sup> Armen Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972).

<sup>246</sup> See note 263, *infra*.

<sup>247</sup> Simon, *supra* note 9, at 29.

<sup>248</sup> *Id.* at 41-42.

<sup>249</sup> *Id.* at 42.



Not only are the labels that we assign to different relationships inaccurate generalizations, but varying relationships coexist and inter-relate in synergy. As an example, the WTO exists in the international legal system while its rules are implemented through national laws. Dispute resolution in the WTO both supports private ordering between states and promotes public order.<sup>250</sup> This is truly a complex system. If one tried to draw a diagram of institutions and relationships, to show how much of industrial organization is in the form of the firm and how much is in the market, there would be several problems.<sup>251</sup> The first and greatest problem is how to model particular relationships. How much generalization is involved in labelling an entity a "firm?" Second, how detailed should the description be? There is an almost infinite degree of detail available to be described. Third, how will overlaps be shown?<sup>252</sup>

While the Coasean theory of the firm does not address the internal governance of the firm, transaction cost economics does. "The coordination problem is not solved by merely putting a nonmarket form of organization in place. . . . Instead, it is transformed into a problem of management."<sup>253</sup>

### 1. *Transaction Costs and Agency Costs*

It makes little sense to consider the market versus hierarchy decision in isolated terms; rather, within this broad and densely overlapping organizational structure, particular points must be evaluated to determine what type of relationship fits best at that point. As noted above, there is a theoretical fungibility between market contract relations and internal relations within a hierarchical structure. In fact, these things are theoretically indistinct. Furthermore, transaction costs outside the firm and "agency costs" within the firm are indistinct and will exist concurrently in many circumstances. The important question is how to minimize these costs of relationship. While no device is the presumptive winner, it is possible for network externalities,

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<sup>250</sup> See Kenneth W. Abbott, *GATT as a Public Institution: The Uruguay Round and Beyond*, 18 *BROOK. J. INT'L L.* 31 (1992).

<sup>251</sup> See Simon, *supra* note 9, at 27, describing the perspective of a spaceman viewing the earth in a way that would show organization in firms and in market relationships. Simon argues that most relationships would appear to be within firms: in hierarchy.

<sup>252</sup> In ITALO CALVINO, *INVISIBLE CITIES* 76 (1972), Ersilia is described as the city where "the inhabitants stretch strings from the corners of the houses, white or black or gray or black-and-white according to whether they mark a relationship of blood, of trade, authority, agency. When the strings become so numerous that you can no longer pass among them, the inhabitants leave: the houses are dismantled; only the strings and their supports remain."

<sup>253</sup> Milgrom & Roberts, *supra* note 5, at 113.

path dependence and economies of scope to support some degree of uniformity of outcome.

## 2. *Subsidiarity: Intra-Firm Centralization and Decentralization*

Thus far, this paper has been concerned largely with the delegation of responsibilities to IEOs from the perspective of a sovereign state that, until such delegation, retains plenary power. There appears to be little difference in theory between this question and the question of subsidiarity.<sup>254</sup> Once an IEO exists and has plenary power (albeit cabined within limited authorizations), what powers should it exercise at the center? What powers should it devolve to decentralized units? All other things being equal, the question remains, where should responsibility be lodged?

Thus, the transaction costs approach described above is applicable to the question of centralization or decentralization within an IEO. The IO perspective on decentralization is similar to the perspective associated with the principle of subsidiarity: "Adapting well to changing local circumstances, using local information well, saving on the costs of information transfer, and making effective use of scarce central management time and attention all argue for pushing decision-making power and responsibility as far down in the organization as possible."<sup>255</sup> The ability of an international organization to decentralize appropriately will be a factor in its ability to compete for responsibility.<sup>256</sup>

Of course, we know that all other things are not often equal. The question of where plenary authority is initially lodged and how it is transferred will often make important design differences. There is a subtle difference between top-down design and bottom-up design. The less subtle distinction, however, relates to the location of residual authority. In both the U.S. federal system and the European Union, this is somewhat blurred. In the U.S. federal system, the blur is generated by the tension between Article 10 of the Constitution and other notions of state sovereignty on the one hand, and the Commerce Clause and Supremacy Clause on the other.<sup>257</sup> In the European Union, the blur is generated by the tension between the limited pur-

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<sup>254</sup> See, e.g., George A. Bermann, *Taking Subsidiarity Seriously: Federalism in the European Community and the United States*, 94 COLUM. L. REV. 331 (1994).

<sup>255</sup> Milgrom & Roberts, *supra* note 5, at 548.

<sup>256</sup> See GARY MILLER, *MANAGERIAL DILEMMAS: THE POLITICAL ECONOMY OF HIERARCHY* (1992) (in complex environments, delegation is necessary to compete).

<sup>257</sup> See, e.g., *Seminole Tribe of Florida v. Florida*, 166 S. Ct. 1114 (1996); *United States v. Lopez*, 115 S. Ct. 1624 (1995); *New York v. United States*, 505 U.S. 144 (1992); *Garcia v. San*

poses of the European Union and the rather unlimited legislative authority needed to achieve those purposes. Textually, we can look to the provisions of the Treaty on European Union requiring subsidiarity analysis<sup>258</sup> and at the *Solange* opinions of the German Constitutional Court.<sup>259</sup>

Indeed, the question of centralization versus decentralization must be answered in synergy with the question of intergovernmentalism versus integration. That is, as a state delegates responsibility to an IEO, it must consider how the IEO will carry out that responsibility in terms of centralization or decentralization. "In a system with both centralized and decentralized decisions, the centralized decisions serve to define the parameters of the decentralized ones and to put constraints on the local decision makers."<sup>260</sup>

### 3. *Horizontal Federalism and Vertical Federalism; Integration and Intergovernmentalism*

Similarly, when authority is delegated to an IEO, it is necessary to ask how that authority will be exercised. What is the decision-making process within the IEO? IEOs may be delegated authority; however, the internal decision-making process, by requiring such things as unanimity prior to action, may recreate the "market" of international relations. Thus, there are two types of intergovernmentalism: intergovernmentalism outside the walls of an institution and intergovernmentalism within an institution. Why bring intergovernmentalism within an institution? The institutional context may bring various benefits in terms of facilitation, commitment and legitimation.

In a more complex way, the possibility for various internal decision processes makes the choice between integration and intergovernmentalism a choice along a continuum instead of a stark binary choice. Thus, an IEO may be accorded responsibility for a particular issue area as a whole, while the decision-making structure preserves intergovernmentalism in some respects<sup>261</sup> and allows greater integration in other respects. In this sense, the structure of horizontal federalism – relations between legislatures, executives and judiciaries – may

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Antonio Metropolitan Transit Authority, 469 U.S. 528 (1985); National League of Cities v. Usery, 426 U.S. 833 (1976).

<sup>258</sup> Treaty on European Union, February 7, 1992, art. 3b, O.J. C 224/1 (1992) 31 I.L.M. 247 (1992).

<sup>259</sup> See Wiegandt, *supra* note 181.

<sup>260</sup> Milgrom & Roberts, *supra* note 5, at 114.

<sup>261</sup> At present, foreign and security policy for the European Union are subject to a rule of unanimity. Most internal market issues, on the other hand, are subject to majority voting.

replicate or complement vertical federalism – relations between the center and the components.<sup>262</sup>

#### 4. *Voting and Dispute Resolution in Organization Theory*

As mentioned above, the “firm” is a gross way of referring to a number of specific characteristics of organization. This perspective describes the corporation as a “nexus of contracts.”<sup>263</sup> At any given point in time, each of these contracts is an incomplete contract. To the extent that they are incomplete, they may be completed with respect to particular issues as they arise by four possible means: (i) exercise of residual control (to the extent residual control has been assigned); (ii) renegotiation by consensus; (iii) decision by majority voting; and (iv) dispute resolution. It is worthwhile here briefly to distinguish these different means.

Exercise of residual control is the means emphasized by Hart and Grossman for “completing” incomplete contracts. Yet in some cases and to specified extents, residual control is shared. To the extent of retained state sovereignty, each state holds residual control. To the extent of delegated responsibility to an organization without current legislation, residual control is assigned to the legislative organs of the organization. In the event of ambiguity or lack of specification, residual control is either (a) back in the hands of the states, subject to text-based arguments by other states under a rule of auto-interpretation, or (b) in the hands of such dispute resolution tribunal as may be created and assigned jurisdiction.<sup>264</sup>

Re-negotiation by consensus is equivalent to voting under a rule of unanimity. Assuming two parties, they are in a position of bilateral monopoly.<sup>265</sup> A rule of unanimity requires Pareto optimal action<sup>266</sup>

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<sup>262</sup> Horizontal federalism may also be motivated by a desire to provide “checks and balances.” There are various game theoretic and public choice reasons why checks and balances may be appropriate.

<sup>263</sup> See, e.g., Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); Alchian & Demsetz, *supra* note 245; Eugene Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980).

<sup>264</sup> A good set of examples of assignment to dispute resolution as a response to ambiguity involve the application of the U.S. Commerce Clause, articles 30 and 36 of the Treaty of Rome, and art. XX of GATT to regulatory restraints on trade. In the context of the European Union see Geoffrey Garrett, *The Politics of Integration in the European Union*, 49 INT'L ORG. 171, 178 (1995).

<sup>265</sup> See Richard Epstein, *Holdouts, Externalities and the Single Owner: One More Salute to Ronald Coase*, 36 J. L. & ECON. 553 (1993).

<sup>266</sup> See Lisa L. Martin, *Heterogeneity, Linkage and Commons Problems*, 6 J. THEO. POL. 473, 488 (1994).

and makes it more difficult to move to potential Pareto improvements, unless actual compensation arrangements are made to convert them into actual Pareto improvements. Rules of unanimity may still allow potential Pareto improvements under circumstances where multiple issues are covered, providing room for creation of "basket deals."<sup>267</sup> This requires multiple issues and issue linkage, which involves transaction costs. The question before us is how do these transaction costs compare with those raised by majority voting, and how do the respective deadweight losses compare?

Majority voting, including qualified majority voting,<sup>268</sup> is associated with a derogation of sovereignty because it entails a willingness to accept a resolution of a future issue without consent of each state.<sup>269</sup> Thus, majority voting is associated with integration, while rules of unanimity are associated with intergovernmentalism. From this perspective, a transfer of responsibility to an IEO that may only act by unanimous consent is of little formal legal substance. It is little different from declining to transfer responsibility to the IEO.<sup>270</sup>

Easterbrook and Fischel analyze voting rights as generally flowing to the constituencies that comprise the main residual claimants. The residual claimants are generally shareholders, but at times of financial distress may be bondholders or preferred stockholders.<sup>271</sup> This rule aligns residual control with residual financial responsibility.<sup>272</sup> In the IEO context, this is an argument for maintaining residual control in the member states or in their citizens. It suggests assigning residual control to the member states because the member state gov-

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<sup>267</sup> See *Id.* at 489.

<sup>268</sup> "Qualified" majority voting is a type of weighted majority voting used for certain types of decisions in the European Union. It is defined in art. 148(2) of the Treaty of Rome, by allocation of specified numbers of votes to particular member states, and by specification of the size of majority required. At present, a qualified majority equals 62 votes out of 87, with 26 votes comprising a "blocking minority."

<sup>269</sup> See Stephen Zamora, *Voting in International Economic Organizations*, 74 AM. J. INT'L L. 566, 571-75 (1980). Zamora notes that "[u]nder traditional international law, as exemplified by early diplomatic conferences, two basic truths controlled the question of voting: every state had an equal voice in international proceedings (the doctrine of sovereign equality of states), and no state could be bound without its consent (the rule of unanimity)." *Id.* at 571.

<sup>270</sup> Of course, such an assignment of responsibility may have a number of collateral effects. It may provide the basis for political pressure. It may provide the legal basis for pre-emption of national action. The point, however, is that there is no legal obligation to accept positive action without future consent.

<sup>271</sup> Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J. L. & ECON. 395, 405 (1983).

<sup>272</sup> See Robert D. Tollison & Thomas D. Willett, *Institutional Mechanisms for Dealing with International Externalities: A Public Choice Perspective*, in *THE LAW OF THE SEA: U.S. INTERESTS AND ALTERNATIVES*, 77, 82 (Ryan C. Amacher and Richard J. Sweeney eds., 1976).

ernments are generally viewed as having full responsibility for the welfare of their constituents and therefore experience residual responsibility.

Finally, dispute resolution entails derogation of sovereignty of a different type. It assumes that the contract has specified some principles, explicitly or implicitly, for reference in determining particular issues that arise. As discussed above, dispute resolution is a central means for completing incomplete contracts on an *ex post* basis. Williamson points out that while integration may result in the ability to resolve disputes by fiat, the ability to resolve disputes by fiat gives rise to uncertainty regarding the possibilities for intervention, diminishing "high-powered incentives."<sup>273</sup> Dispute resolution may also serve as a neutral interpreter of obligations that can feed the process of reputation-based relations.<sup>274</sup>

### III. METHODOLOGY

It is necessary to begin to describe a methodology that will operationalize the theoretical perspective described in this paper by generating testable hypotheses.

Given the difficulties described above in operationalizing the theory of the firm, this article must be modest in its approach to methodology. From a positive standpoint, the theory suggested here would indicate a full methodology that calculates, on a comparative basis, the sum of the following factors for particular institutional structures. From a normative standpoint, it would seek to maximize the present value of net gains from trade:  $NG = TG - (TL + TC)$ , where

- a. NG = net gains
- b. TG = transaction gains
- c. TL = transaction losses
- d. TC = transaction costs

NG must be positive for trade – for international agreement – to be worthwhile.

The most direct methodology would choose a particular institutional context, establish a comparative foil and calculate each of the four factors listed above (putting aside for the moment problems with quantification). If substituting the comparative foil would increase net gains from trade by an amount greater than the costs of transition, positive theory would indicate that the original institutional context would be unstable and normative theory would prescribe substitution.

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<sup>273</sup> Williamson, *supra* note 13, at 133-35.

<sup>274</sup> See Milgrom, North & Weingast, *supra* note 17.

This analysis and result would itself be an expansion of the structural production frontier; it would indicate a more efficient institutional context.

This methodology requires the quantification, or at least the estimation of magnitudes, of these difficult factors that – especially in the international inter-governmental sector – would generally not be monetized. Further theoretical and empirical work will be required in order to determine whether a simplified or truncated analysis, perhaps focusing only on transaction costs, would yield useful results. Empirical work might be used to determine whether there are general categories of high asset specificity or high transaction cost transactions, and whether it is possible empirically to associate particular institutional solutions with those transactions. A pattern of such association might be instructive. In particular, it would be useful to test whether transactions characterized by a high degree of asset specificity are associated with higher degrees of transfer of authority to international economic organizations. “The basic strategy for deriving refutable implications . . . is this: Transactions, which differ in their attributes, are assigned to governance structures, which differ in their organizational costs and competencies, so as to effect a discriminating (mainly transaction cost economizing) match.”<sup>275</sup>

Perhaps the problem of operationalization may be resolved through narrow definition of the institutions evaluated. Given a sufficiently narrow definition, a full transaction costs and benefits analysis and comparison may be performed. The next question, of course, is how will a narrow perspective be used to make policy? How will a series of narrow perspectives be combined to form a policy regarding a broader institution?

#### A. Comparative Institutional Analysis

The method indicated by the above theory is comparative institutional analysis.<sup>276</sup> In most social science, and in law in particular, there is no laboratory, no place in which all other factors can be held constant and a particular regulatory device evaluated. Rather, the laboratory most available to law is the comparative or historical

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<sup>275</sup> WILLIAMSON, *supra* note 13, at 387-88.

<sup>276</sup> For a law and economics approach to comparative institutional analysis: See Nicholas Mercuro, *Toward a Comparative Institutional Approach to the Study of Law and Economics*, in *LAW AND ECONOMICS* 1 (Nicholas Mercuro ed., 1989). See also Edward L. Rubin, *Institutional Analysis and the New Legal Process*, 1995 *Wis. L. Rev.* 463 (1995) (reviewing KOMESAR, *supra* note 4).

method.<sup>277</sup> This laboratory provides historical or comparative settings for evaluation of law or regulation. Cappelletti, Seccombe and Weiler describe the utility of the comparative method as follows.

Comparative legal analysis will then be brought to "evaluate" laws, institutions and techniques in relation to that particular problem and need. This approach represents, in a real way, a "Third School" of legal thinking, different both from mere positivism, for which law is a pure *datum* not subject to evaluation, and from evaluation of such *datum* based on abstract, airy, inevitably subjective criteria such as "natural law" principles.<sup>278</sup>

Thus, the methodology is necessarily inductive, rather than deductive. Of course, this does not mean that every possible institutional matrix must be subjected to evaluation. Rather, the social scientist's art is deductively to choose institutional structures for evaluation that are likely to yield useful results and to engage in a type of triage of evaluation. Such selective evaluation is a type of rational ignorance based on the presumption that it economizes on search and evaluation costs.

#### B. Comparative Strategies: Cross-Jurisdictional, Historical and Hypothetical Comparative Foils

As we engage in selective evaluation, we must recognize that the range of possible comparative foils is infinite. There are three types of comparative foil. The first is cross-jurisdictional, as in horizontal comparative law.<sup>279</sup> This type of comparison would include evaluation of EU institutions for use in NAFTA. The cross-jurisdictional category might also include domestic law foils for international law evaluation.

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<sup>277</sup> See, e.g., Bruno S. Frey, *Institutions Matter: The Comparative Analysis of Institutions*, 34 EUR. ECON. REV. 443 (1990); Eric Stein, *Uses, Misuses - and Nonuses of Comparative Law*, 72 NW. U.L. REV. 198, 213-216 (1977). See generally FRANKLIN E. ZIMRING & GORDON J. HAWKINS, *DETERRENCE: THE LEGAL THREAT IN CRIME CONTROL* 253-70 (1973) (discussing controls for comparative research); Arend Lijphart, *Comparative Politics and the Comparative Method*, 65 AM. POL. SCI. REV. 682 (1971) (discussing the comparative method and the case study method).

<sup>278</sup> MAURO CAPPELLETTI ET AL., *INTEGRATION THROUGH LAW: EUROPE AND THE AMERICAN FEDERAL EXPERIENCE - A GENERAL INTRODUCTION*, in 1 *INTEGRATION THROUGH LAW: EUROPE AND THE AMERICAN FEDERAL EXPERIENCE - METHODS, TOOLS AND INSTITUTIONS* bk. 1, at 5 (Mauro Cappelletti et al. eds., 1986) (citation omitted). See also Alberta M. Sbragia, *Thinking About the European Future: The Uses of Comparison*, in *EURO-POLITICS: INSTITUTIONS AND POLICYMAKING IN THE "NEW" EUROPEAN COMMUNITY* 257 (Alberta M. Sbragia ed., 1992).

<sup>279</sup> See, e.g., Ugo Mattei, *Efficiency in Legal Transplants: An Essay in Comparative Law and Economics*, 14 INT'L REV. L. & ECON. 3 (1994) (examining comparative law and economics as a positive discipline, but recognizing the possibility of a normative comparative law and economics).



For example, is the U.S. Commerce Clause a good model for application to regulatory non-tariff barriers in the international setting?<sup>280</sup>

A second category of comparative foil is historical, or diachronic.<sup>281</sup> For example, does the organization of the Roman Empire hold lessons for current efforts toward European economic integration?<sup>282</sup> The historical and cross-jurisdictional may be combined: should NAFTA use some of the institutional devices that have been successful within the European Union? Finally, and most flexibly, the comparative foil may be constructed. While there is little that is new under the sun, a particular device may, and often should, be a hybrid, custom designed for a particular use.

### C. Assessment of Transaction Gains and Losses

The first and perhaps most difficult problem of measurement relates to the assessment of transaction gains. Some types of gains will be more amenable to measurement than others. Any cost-benefit methodology would obviously be incomplete without considering all costs as well as all benefits. In connection with analysis of institutions for international economic integration, it is necessary to consider both the benefits of greater control over the domestic regulation imposed by trade partners, and the costs of greater control by those partners of domestic regulation. If we simply couch the cost-benefit analysis in private trade terms, we would not take full account of losses arising from reduced local autonomy to structure regulation specifically for local conditions.

### D. The Matrix of Choice

In the context of international relations, we might begin to categorize the available choices of institutions as depicted in the following table.

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<sup>280</sup> See Daniel A. Farber & Robert E. Hudec, *Free Trade and the Regulatory State: A GATT's-Eye View of the Dormant Commerce Clause*, 47 VAND. L. REV. 1401 (1994).

<sup>281</sup> See Lijphart, *supra* note 277, at 689.

<sup>282</sup> See, e.g., the symposium on "megaorganizations," considering *inter alia* ancient Rome, Tokugawa Japan and multinational corporations in comparative perspective, in 151 J. INST. & THEO. ECON. 703 (1995).

	Private Sector	Domestic Government	International Government
Competition (absence of cooperation)	Competition	Regulatory competition and externalization; failure to produce public goods	Regulatory competition and externalization; failure to produce public goods
Spontaneous Cooperation	Spot Market	Uninstitutionalized transactions in power among decentralized units of government	Uninstitutionalized transactions in power among states
Contractual (including firms and organizations as nexus of contracts)	Contract	Regulatory agreements or federal action	International agreements or centralized action
Judicial (assumes contractual relations)	Arbitration—private interest litigation	Judicial—public interest litigation <sup>283</sup>	Dispute resolution
Legislative (assumes contractual relations)	Firm governance	Legislative	Majority voting

Of course, each of the categories listed above contains great diversity; the true matrix for institutional choice is infinite. All sorts of combinations and hybrids are possible, as well as adaptation from other institutional settings. "Because comparison necessarily involves a common metric, it suggests the interchangeability of techniques that are now associated with a specific institution."<sup>284</sup>

There are multiple types of international action. Unilateralism amounts to operations in the "market" which may grow to development of customary rules or comity, based on reciprocity. Bilateralism allows for development of contract-type rules but not third party type legitimation or supervision, except where dispute resolution or other institutions are created in order to fulfill this function. However, such constructs will lack an independent source of power. Regionalism allows greater commitment and may engender the development of institutions, like those of the EU, with independent power. Regionalism also includes the ability to exclude as a potential sanction. Multilateralism also allows greater commitment through multilateral responses; however, here the ability to exclude may be too great a deterrent for actual use.

Within each of these branches, the choice of the more integrationist approach entails additional choices of (i) the degree of centralization or de-centralization; and (ii) rules versus institutions.

<sup>283</sup> See Abbott, *supra* note 250.

<sup>284</sup> Rubin, *supra* note 276, at 470.

Finally,

... Williamson's demonstration that the firm/transaction choice is highly complex impacts the institutional choice between market and regulation by raising the cost of regulation. ... The relevance of any of these insights, however, can only be determined by integrating them into an institutional choice different than the intra-market institutional choice upon which Williamson focused.<sup>285</sup>

This is an argument for functionalism and against idealism. It argues that the choice of integration is a difficult one; integration from above, without the full political process endorsing integration from below (analogous to regulation in this context), will require a costly analysis.

#### IV. CONSTITUTIONAL BARGAINS I: LEGISLATIVE JURISDICTION AND VOTING RULES IN THE SINGLE EUROPEAN ACT

One of the two most significant constitutional changes in European Union history is the Single European Act, which facilitated the "completion" of the single market project.<sup>286</sup> The major constitutional change made by the 1987 Single European Act<sup>287</sup> (SEA) permitted qualified majority voting in cases that – despite language in the original Treaty of Rome to the contrary – had been addressed by a voting method which amounted to a requirement for unanimity.<sup>288</sup> I consider here only voting in the Council, not the important collateral effects of the cooperation procedure established in the SEA, the co-decision procedure enacted under the 1992 Treaty on European Union or of judicial review.<sup>289</sup>

How does the SEA fit into this paper's theory? In this case, at least one goal was to reduce deadweight losses due to barriers to trade

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<sup>285</sup> KOMESAR, *supra* note 4, at 109.

<sup>286</sup> See Robert O. Keohane & Stanley Hoffmann, *Institutional Change in Europe in the 1980's*, in THE NEW EUROPEAN COMMUNITY: DECISION MAKING AND INSTITUTIONAL CHANGE 1, 1-8 (Robert O. Keohane & Stanley Hoffmann eds., 1991); J.H.H. Weiler, *The Transformation of Europe*, 100 YALE L. J. 2403, 2453-74 (1991). See generally Bernard Steunenberg, *Decision Making under Different Institutional Arrangements: Legislation by the European Community*, 150 J. INSTITUTIONAL & THEORETICAL ECON. 642 (1994); Geoffrey Garrett, *International Cooperation and Institutional Choice: The European Community's Internal Market*, 46 INT'L ORG. 533 (1992).

<sup>287</sup> Treaty Establishing the European Economic Community, Mar. 25, 1957, 1973 Gr. Brit. T.S. No. 1 (Cmd.5179-II) 298 U.N.T.S. 3 (1958), as amended by Single European Act, O.J. L 169/1 (1987), [1987] 2 C.M.L.R. 741 [hereinafter SEA].

<sup>288</sup> See George A. Bermann, *The Single European Act: A New Constitution for the Community?*, 27 COLUM. J. TRANSNAT'L L. 529 (1989). See also Fritz W. Scharpf, *The Joint-Decision Trap: Lessons from German Federalism and European Integration*, 66 PUB. ADMIN. 239 (1988).

<sup>289</sup> For a game theoretic analysis of these modifications: See Robert Cooter & Josef Drexler, *The Logic of Power in the Emerging European Constitution: Game Theory and the Division of Powers*, 14 INT'L REV. L. & ECON. 307 (1994).

at the private level, which were viewed as deadweight losses at the public level. The Cecchini Report attests to the potential reduction of private deadweight losses that creating the internal market was expected to achieve.<sup>290</sup> Of course, the Cecchini Report only considered one dimension of deadweight losses, those from failure of trade in goods and services which occur because of regulatory and other barriers to trade and investment ("private sector deadweight losses"). However, private sector deadweight losses flow only indirectly into the equation suggested in this paper, which considers gain and loss to the state. Losses in terms of national income affect the state indirectly by virtue of their effects on citizens. The degree to which citizens make their voices heard in formulating the state's policies serves as a limit on the degree to which these losses flow through to the state.

The Cecchini Report did not consider a potential countervailing source of deadweight losses: deadweight losses in the domestic public sector arising from restrictions on the ability of member states to regulate so as to maximize local preferences ("regulatory deadweight losses"). Member states were certainly wary that the move to majority voting necessary to achieve the single market would bring about these regulatory deadweight losses.

Thus, one formulation of a testable hypothesis would be the following. The voting provisions of the SEA were designed to reduce transaction costs associated with voting for single market measures, in order to facilitate transactions in governmental authority in Europe, and thereby diminish public sector deadweight losses, in an amount greater than the concomitant regulatory deadweight losses. This hypothesis raises difficult issues of quantification, especially in connection with regulatory deadweight losses. However, I will not seek to quantify these values. In order to test this hypothesis in an indicative sense, I will examine the history of the SEA to determine if it was motivated by reduction of transaction costs in order to diminish public sector deadweight losses.

It is worth noting that the modification we are considering – the move to majority voting – occurred within a complex context. A kind reading of the Luxembourg Compromise, which the SEA was thought to "reverse," would read it simply as an informal waiver of a treaty

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<sup>290</sup> Cecchini, *supra* note 33. See COMMISSION OF THE EUROPEAN COMMUNITIES, RESEARCH ON THE COST OF NON-EUROPE (1988). See also Jean Waelbroeck, 1992: *Are the Figures Right? Reflections of a thirty Per Cent Policy Maker*, in THE COMPLETION OF THE INTERNAL MARKET (Horst Siebert ed., 1990); Anton Bakhoven, *An Alternative Assessment of the Macro-Economic Effects of "Europe 1992,"* in THE COMPLETION OF THE INTERNAL MARKET (Horst Siebert ed., 1990).

provision at a time when states were unlikely to comply in any event. It sometimes makes sense to change agreements. A less kind reading regards the Luxembourg Compromise as an example of the fundamental resiliency of state power and unrestrained defection. The kind view seems more accurate, and more consistent with this paper's theory. It shows the resilience of the problem of allocation of power and the use of multiple temporizing and adjusting devices to manage the problem. The Luxembourg Compromise is part of a package of tools which includes article 100A(4) of the Treaty of Rome added by the SEA, the principle of subsidiarity added in article 3b by the Treaty on European Union (TEU), the German *Solange* opinions<sup>291</sup> and other legal and political devices. Some commentators have pointed out that when the SEA was implemented, facilitating legislative action, the European Court of Justice backed away from its previously powerful integrationist tilt.<sup>292</sup>

These tools, together or in series as the case may be, show an exceedingly complex vertical allocation of power. They also illustrate how "residual control" may be divided in subtle and ambiguous terms. A picture of institutional flow and autonomous adaptation begins to emerge. This adaptability makes static formal institutional analysis suspect and requires a subtle evaluation of the actual use of institutions in context, as well as the process of institutional change.

#### A. Historical Background

The original 1957 Treaty of Rome is, given its monumental function, a brief document, a *traité cadre*. It is an intentionally and in some cases unintentionally incomplete contract, with several potential completion devices. First, the European Court of Justice is assigned various types of limited jurisdiction to interpret and apply the treaty.<sup>293</sup> Second, various kinds of amendments and substantive legislation are authorized.<sup>294</sup> In this article, I will concentrate on legislation. The Treaty of Rome permits legislation by "directives," which have emerged as the principal legislative tool of the builders of the single market. Not only was the original Treaty of Rome intended to grow by interpretation and legislation, but it had provisions for phased integration. The example relevant here is the several provisions that pro-

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<sup>291</sup> See note 181, *supra*.

<sup>292</sup> Burley & Mattli, *supra* note 43, at 48 (citing Koen Lenaerts, *The Role of the Court of Justice of the European Community: Some Thoughts About the Interaction Between Judges and Politicians*, 1992 U. CHIC. LEG. FORUM. 93 (1992)).

<sup>293</sup> See, e.g., Treaty of Rome arts. 169, 170, 173, 175 and 177.

<sup>294</sup> See, e.g., Treaty of Rome arts. 189, 235 and 236.

vided for majority voting to commence on January 1, 1966, on certain issues.

This is not the place to write the history of the 1966 Luxembourg Compromise.<sup>295</sup> President de Gaulle of France refused to accept the agreed transition at January 1, 1966, to majority voting under several provisions, including art. 101, of the Treaty of Rome, arguing that France's power and interests had changed.<sup>296</sup> The crisis over this refusal abated on January 29, 1966, when the Luxembourg Compromise was adopted.<sup>297</sup> As a result, majority voting was not adopted as planned and was not in effect until the passage of the SEA.

The Luxembourg Compromise recorded the French view that a member state could invoke "vital national interests" as a basis for declining to proceed to a vote (by majority). Of course, what was accepted as available to the French had to be available to all. Until 1982, it also was accepted that the term "vital national interests" was to be defined by the dissenting state. *Competenz-competenz*, in this legislative sense, was in the hands of the member states individually.<sup>298</sup>

Under a rule of unanimous voting, it is still possible to make compromises, to persuade another not to exercise its veto. In order to do so, of course, it is necessary to provide a bribe of some valuable concession. Often in this context, the bribe would consist of a countervailing agreement not to veto in a vote of similar importance or possibly in some combination of matters. Cobbling together such barter transactions entails significant transaction costs: (i) the cost of searching for a partner; (ii) the cost of identifying appropriate "bribe" issues; (iii) the cost of negotiating the transaction; and (iv) the cost of enforcing the transaction.<sup>299</sup>

In addition, under a rule of unanimous voting, a national government gets no political cover for European Union decisions and in Ab-

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<sup>295</sup> See Anthony L. Teasdale, *The Life and Death of the Luxembourg Compromise*, 31 J. COMMON MKT. STUD. 567 (1993).

<sup>296</sup> *Id.* at 568. See the quote from Machiavelli at text accompanying note 61, *supra*.

<sup>297</sup> See W. Nicoll, *The Luxembourg Compromise*, 23 J. COMMON MKT. STUD. 35, 35-36 (1984) (reprinting the French text of the Luxembourg Compromise).

<sup>298</sup> Teasdale, *supra* note 295, at 571.

<sup>299</sup> See Weingast & Marshall, *supra* note 16, at 138-139. Weingast and Marshall argue that the committee system in the U.S. Congress exists due to the problem of enforcing political bargains in a legislature that votes issue by issue: the problem of noncontemporaneous benefit flows. See also Bruno S. Frey, *The Public Choice View of International Political Economy*, in *THE POLITICAL ECONOMY OF INTERNATIONAL ORGANIZATIONS: A PUBLIC CHOICE APPROACH* 7, 17 (Ronald Vaubel & Thomas D. Willett eds., 1991).

bott and Snidal's terms, no ability to "launder"<sup>300</sup> national policy through European Union decisions. The national government cannot claim to have been outvoted. Where the national government might like to barter away an issue, a rule of unanimity requires it to do so explicitly; it must tell its domestic constituents that it "sold them out." Under a rule of majority voting on the other hand, the national government can report credibly that the issue was beyond its control and blame its partners and the Brussels bureaucrats. "Laundering" entails the ability to effect at the international political level what is otherwise too costly in political terms at the national level.<sup>301</sup>

Finally, unanimous voting restricts the subject areas that may be addressed. The fact that a particular state would veto action in that subject area is a complete bar to action.

### B. The SEA as a New Constitutional Bargain

The voting reforms of the SEA were seen as an "improvement" in the European Community's capacity to legislate. "One way to view 1992 is as a move to reduce costs associated with self-enforcing agreements based on linkages and hostages by replacing bilateralism with an alternate governance structure: minilateralism."<sup>302</sup> Certainly history has shown a great acceleration of legislation after the implementation of the SEA, although this acceleration could have been caused by political factors that would have existed without the SEA. In other words, it is at least possible to view the SEA as simply mimicking "underlying" political realities: the need to complete the internal market. This article does not show the causal link between the voting reforms and the legislation, but will seek to show that the causal link was expected by those who negotiated the SEA.<sup>303</sup>

Of course, the development of the SEA itself was largely inter-governmental, with the power and interests of states as the determinants of its shape and success. Moravcsik refers to the SEA as "intergovernmental institutionalism."<sup>304</sup> The institutionalism referred to here is the role of the centralized institutions, including the Commission and its President, Jacques Delors. After "France moved into

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<sup>300</sup> Abbott & Snidal, *supra* note 47.

<sup>301</sup> The other name for "laundering" is the "democracy deficit."

<sup>302</sup> Yarbrough & Yarbrough, *supra* note 44, at 96.

<sup>303</sup> See JEAN DE RUYT, L'ACTE UNIQUE EUROPEEN 112-19; 255-58 (1989).

<sup>304</sup> Andrew Moravcsik, *Negotiating the Single European Act: National Interests and Conventional Statecraft in the European Community*, 45 INT'L ORG. 19, 25 (1991). See also David R. Cameron, *The 1992 Initiative: Causes and Consequences*, in ALBERTA M. SBRAGIA, EURO-POLITICS: INSTITUTIONS AND POLICYMAKING IN THE "NEW" EUROPEAN COMMUNITY ch. 2 (1991).

the German and Benelux camp in arguing for more majority voting to allow the completion of the Single Market," Delors jumped on this bandwagon.<sup>305</sup> Thus, states and the existing transnational mechanism militated toward majority voting, recognizing that this would facilitate further substantive agreement. In part as a response to economic and political "eurosclerosis," the member states developed a consensus toward majority voting. "At their Milan session in mid-1985, the EC heads of government agreed to a negotiating conference to amend the Treaty for this and other purposes."<sup>306</sup> "The revival of a supranational style of decision making and the strengthening of European institutions in the Single Act resulted most immediately from decisions by governments to press, in their own interests, for a removal of internal economic barriers and for institutional changes that would permit such a policy to be carried out."<sup>307</sup>

As noted above, the change made by the SEA is intricate, especially in light of art. 100A(4), which takes away at least some of the increased integration otherwise provided by the SEA, but in a different institutional dynamic that constrains state discretion procedurally.<sup>308</sup>

The story of the Luxembourg Compromise has not ended; rather, there seems something durable about the tension that it represents. Not only did its use as a threat survive the SEA, but a more limited version has been developed more recently, in a slightly different context. The so-called Ioannina Compromise relates to the size of a blocking minority in qualified majority voting, in connection with the enlargement of the European Union.<sup>309</sup> While it does not preserve a veto *per se*, the Ioannina Compromise informally reduces the size of a blocking minority in terms reminiscent of the Luxembourg Compromise.

Thus, the agreement to article 100A(4) in the SEA, and the persistence of the Luxembourg Compromise, might be viewed as capping the cost to states of regulatory deadweight losses. These institutional

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<sup>305</sup> Teasdale, *supra* note 295, at 573.

<sup>306</sup> MICHAEL CALINGAERT, *THE 1992 CHALLENGE FROM EUROPE: DEVELOPMENT OF THE EUROPEAN COMMUNITY'S INTERNAL MARKET* 11 (1988).

<sup>307</sup> Robert O. Keohane & Stanley Hoffmann, *Institutional Change in Europe in the 1980s*, in ROBERT O. KEOHANE & STANLEY HOFFMANN, *THE NEW EUROPEAN COMMUNITY: DECISION MAKING AND INSTITUTIONAL CHANGE* 17 (1991).

<sup>308</sup> See Joseph H.H. Weiler, *The Future of the European Community in the Light of the American Federal Experience*, in *TWO HUNDRED YEARS OF U.S CONSTITUTION AND THIRTY YEARS OF EEC TREATY* 49, 56 (Koen Lenaerts, ed. 1988).

<sup>309</sup> See David O'Keefe, *Current Issues in European Integration*, 7 *PACE INT'L L. REV.* 1, 36-37 (1995).



features were designed to provide an escape clause in case the cost of regulatory deadweight losses became too high. The Treaty on European Union provisions on subsidiarity and the post-Maastricht revulsion from centralized control also may be viewed as reactions to the centralizing impetus of the SEA.

### C. The Maximizing Calculus

We might begin to summarize, in a very rough and tentative way, the comparative gains from the SEA as follows.

	Pre-SEA	Post-SEA
TG: Gains from trade (from international agreement)	Public sector deadweight losses due to inability to trade by virtue of transaction costs: failure to achieve gains from trade	Significant: Cecchini Report
TL: Losses from trade (production costs or opportunity costs)	n/a	Regulatory deadweight losses capped by art. 100A(4) and by the persistent Luxembourg Compromise
TC: Transaction costs (intra-organization)	High transaction costs of barter and problems of enforcement of political agreements	Reduced on a per-transaction basis due to ability to bind dissenters; reduced <i>holdout</i> problems and increased ability to make exchange
NG: Net gains from trade	Zero	Positive

This section suggests that states roughly appear to have made this type of calculus in their decision to move to majority voting in the SEA.

## V. CONSTITUTIONAL BARGAINS II: DEFECTION, DISPUTE RESOLUTION AND NEW ISSUES IN THE WORLD TRADE ORGANIZATION

A persistent problem in the GATT/WTO system has been the fear of defection.<sup>310</sup> Fear of defection may provide disincentives for agreement *ex ante* and incentives for pre-emptive defection *ex post*. The inability to bind one's trade partner leaves trade partners in the prisoner's dilemma, unable to resolve the dilemma through cooperation. Often the result has been unilateralism, especially as exercised by the United States through section 301 of the Trade Act of 1974. Unilateralism is combined with auto-interpretation, allowing "might

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<sup>310</sup> See William Diebold, Jr., *The End of the ITO*, in *ESSAYS IN INTERNATIONAL FINANCE* 18-20 (International Finance Section of the Department of Economics and Social Institutions in Princeton University ed., 1952) (arguing that fear of defection was one of the critical factors in the U.S. rejection of the ITO).

to make right" in international economic relations. In this sense, law resolves the prisoner's dilemma in international economic relations by allowing parties to communicate with one another and enter into binding agreements.

Enhanced dispute resolution, which reduces the costs of enforcement due to problems like defection, may increase the willingness of states to accept rules as concessions. The extension of dispute resolution also can result in greater completion of contracts. Contracts that benefit from effective dispute resolution mechanisms implicitly leave less room for opportunism or holdout strategies. Furthermore, as seen in the recent Uruguay Round, enhanced dispute resolution provides incentives for states to renounce, at least in part, unilateralism and auto-interpretation.

How might this example of change be explained by the theoretical perspective adopted in this article? As with the SEA, at least one goal of the Uruguay Round was to reduce deadweight losses due to barriers to trade at the private level which were viewed as deadweight losses at the public level.<sup>311</sup> To do so, the Uruguay round would need to bring "new" areas into the jurisdiction of world trade law, including agriculture, textiles, services, intellectual property and other more functional areas, such as voluntary export restraints. It would also need to strengthen enforcement of law applicable to existing areas.

Here, the theory would predict that states would design institutions that they expect to facilitate the entry into and enforcement of agreements. The pre-WTO dispute settlement arrangement might have been expected to deter further agreements because states that would unilaterally comply with their commitments would be concerned that the commitments of others were not equally reliable. This is a problem of high asset specificity without congruent institutions to enforce agreements. It is also a problem of incomplete contracts, especially in regard to "new" issues such as trade and intellectual property rights and trade and environment. It is a problem of transaction costs insofar as the cost of designing unilateral or bilateral arrangements for enforcement may be more costly than the potential gains from trade. Thus, "stronger" dispute resolution arrangements can address asset specificity, complete contracts and reduce the transaction costs of entry into and enforcement of commitments. On the other

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<sup>311</sup> Again, with the possibility of countervailing "regulatory deadweight losses" due to international constraints on national regulatory decisions, in the areas of subsidies, environment, intellectual property, etc.

hand, stronger dispute resolution might make states more cautious about the commitments they undertake.

### A. Historical Background

As is now well-understood and the subject of much commentary, the Uruguay Round brought a dramatic shift in the structure of dispute resolution in international trade.<sup>312</sup> Prior to the establishment of the WTO, and its Understanding on Rules and Procedures Governing the Settlement of Disputes (the DSU), GATT dispute settlement suffered from many significant weaknesses. Chief among the perceived weaknesses was the fact that consensus among the members of the GATT Council (the full membership) was required in order for the report of a dispute resolution panel to acquire legal effect.<sup>313</sup> Thus, the loser had the ability to block consensus adoption of a panel report, and often did so or temporized sufficiently to undermine the effectiveness of the process. This problem, combined with others, made GATT dispute resolution less attractive and less reliable as a method of interpreting or completing the incomplete contract of GATT, or simply of enforcing relatively clear obligations. It encouraged members like the United States to “go unilateral” using section 301 and other authorization of unilateral action under domestic law to “take the law into their own hands.” After a comprehensive study of GATT dispute resolution from 1948 to 1989, Prof. Hudec concludes as follows:

The record of positive results in almost nine out of ten cases has obviously been high enough to induce governments to use the dispute settlement system extensively, and to invest considerable political capital in trying to strengthen it further. At the same time, however, the failure rate of 12 percent has served as a vivid warning that it is a new and

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<sup>312</sup> See, e.g., Andreas F. Lowenfeld, *Remedies along with Rights: Institutional Reform in the New GATT*, 88 AM. J. INT'L L. 477 (1994); Richard Shell, *Trade Legalism and International Relations Theory: An Analysis of the World Trade Organization*, 44 DUKE L. J. 829 (1995); Michael K. Young, *Dispute Resolution in the Uruguay Round: Lawyers Triumph over Diplomats*, 29 INT'L LAW. 389 (1995); Miguel Montaña i Mora, *A GATT with Teeth: Law Wins over Politics in the Resolution of International Trade Disputes*, 31 COLUM. J. TRANSNAT'L L. 103 (1993).

<sup>313</sup> In the Omnibus Trade and Competitiveness Act of 1988, the United States expressed as its first trade negotiating objective “to provide for more effective and expeditious dispute settlement.” Omnibus Trade and Competitiveness Act of 1988, Pub. L. No. 100-418, § 1101(b)(1), 102 Stat. 1107 (codified at 19 U.S.C. § 2901(b)(1) (1988)). *But see* Ernst-Ulrich Petersmann, *Uruguay Round Negotiations 1986-1991*, in ERNST-ULRICH PETERSMANN & MEINHARD HILF, *THE NEW GATT ROUND OF MULTILATERAL TRADE NEGOTIATIONS: LEGAL AND ECONOMIC PROBLEMS* 555 (1991) (arguing that this was not a significant problem).

primitive legal order, one that is still some distance away from being able to impose its order on all major problems.<sup>314</sup>

The change made in the DSU was to reverse the consensus rule: panel decisions are to be adopted automatically unless *rejected* by consensus.<sup>315</sup> On the other hand, article 23 of the DSU seems to forbid unilateral action in dispute resolution under a WTO agreement, at least where the complaint is for violation, nullification or impairment of benefits.

During the earlier stages of the Uruguay Round negotiations, the United States and Canada staked out a position that panel reports should be adopted automatically.<sup>316</sup> The European Community and Japan favored the status quo.<sup>317</sup> On the other hand, the United States resisted a commitment to forego unilateral action, while the European Community, Canada and Japan sought such a commitment. "The issue would boil down to whether a greatly strengthened and broadened GATT dispute settlement procedure would be sufficient to induce the United States to back off or at least greatly restrain its unilateral approach for dealing with unfair trade practices."<sup>318</sup> The cost of auto-interpretation and unilateralism, of course, is the possibility that unilateral action is used or seen as a vehicle for defection. On the other hand, the United States and other countries were concerned regarding the possible threat to sovereignty that effective dispute resolution might pose. As with the SEA, the strengthened WTO dispute resolution system required some substitute safeguards in order to be acceptable, including a new appellate review process.<sup>319</sup>

## B. The Maximizing Calculus

We might begin to summarize, in a very rough and tentative way, the comparative gains from the WTO DSU as follows.

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<sup>314</sup> ROBERT E. HUDEC, ENFORCING INTERNATIONAL TRADE LAW: THE EVOLUTION OF THE MODERN GATT LEGAL SYSTEM 286 (1993). See also William J. Davey, *Dispute Settlement in GATT*, 11 FORDHAM INT'L L.J. 51 (1987).

<sup>315</sup> DSU, art. 16(4). Automatic adoption can be blocked either by consensus, or by an appeal.

<sup>316</sup> TERENCE P. STEWART, THE GATT URUGUAY ROUND: A NEGOTIATING HISTORY (1986-1992) 58-61 (1993). See also JOHN CROOME, RESHAPING THE WORLD TRADING SYSTEM: A HISTORY OF THE URUGUAY ROUND 149 (1995).

<sup>317</sup> STEWART, *supra* note 316.

<sup>318</sup> ERNEST H. PREEG, TRADERS IN A BRAVE NEW WORLD: THE URUGUAY ROUND AND THE FUTURE OF THE INTERNATIONAL TRADING SYSTEM 78 (1995).

<sup>319</sup> See Ernst-Ulrich Petersmann, *The Dispute Settlement System of the World Trade Organization and the Evolution of the GATT Dispute Settlement System Since 1948*, 31 COMM. MKT. L. REV. 1157, 1216 (1994).

	Pre-DSU	Post-DSU
TG: Gains from trade (from international agreement)	Deadweight losses due to problems with binding commitments; diminished willingness to comply and to enter into new commitments; unilateralism provides possibilities for defection or perceptions of defection	Positive: permitted acceptance of Uruguay Round package, with significant coverage of new areas, and reduction of possibilities for defection
TL: Losses from trade (production costs or opportunity costs)	n/a	Opportunity costs arising from more enforceable restrictions on national action, capped by lack of direct effect of WTO law, and ability to pay compensation; diminished by establishment of procedure for appellate review
TC: Transaction costs (intra-organization)	High transaction costs of creating structures for enforcement of, or of enforcing, agreements	Reduced transaction costs due to use of multilateral interpretation and legitimation of enforcement
NG: Net gains from trade	Zero	Positive

Again, this section suggests that states appear to have made this calculus in connection with the move to enhanced dispute resolution in the WTO. This paper lacks a substantial empirical foundation and the examples provided above are mere sketches of plausible stories.

## VI. TOWARD A PROGRESSIVE RESEARCH PROGRAM IN INSTITUTIONS FOR INTERNATIONAL ECONOMIC INTEGRATION

The foregoing analysis incorporates the following hypotheses regarding transactions between states and institutional choice:

- (i) Cooperation (trade in power) will occur when the gains from trade exceed the sum of the losses from trade plus transaction costs: when NG is positive, with  $NG = TG - (TL + TC)$ . Alternatively,  $TG > TL + TC$ .
- (ii) States design international institutions to maximize NG, but will only engage in institutionalization when the transaction costs are less than the present value of the NG.
- (iii) High magnitudes of asset specificity indicate high levels of integration.

Maximization of NG is by necessity a comparative institutional analytic process. A progressive research program would operationalize these hypotheses in specific factual settings, developing falsifiable hypotheses and then testing them. There are significant theoretical issues to be addressed, as well as an infinite number of institutions to

be evaluated. Particular institutions can be evaluated in game theoretic terms to analyze their actual effects. Game theory is a powerful source of further insights for application to the structure of international economic organizations.<sup>320</sup>

The transaction costs methodology has a number of limitations.<sup>321</sup> First, it is often by necessity crude and indeterminate. Its analytical approach requires that pieces of intricately interconnected structures be hived off for separate comparative analysis. Cooter's image of a ship's carpenter, fixing each plank separately and eventually replacing the entire ship's hull, is evocative.<sup>322</sup> After the carpenter finishes her first pass through the hull, she begins again. This raises questions of evolution of institutions.<sup>323</sup> The legislature has the problem of choosing which planks to fix first, and then isolating them for analysis. Not only must institutional components be separated from one another, but they must be separated for analytical purposes from the non-institutional components of the phenomenon, the preferences and production costs structure. "[O]bserved situations represent a combination of underlying circumstances and institutional responses."<sup>324</sup>

Finally, there is the difficulty of measurement of transaction costs and benefits. It may be possible to use (and to measure) transaction dimension proxies, such as asset specificity, uncertainty, frequency, etc.; however, only further empirical research will tell us whether these types of proxies can be reliable. Is monetization useful and should it be pursued as a policy objective? Tradeable permits in pollution or other international public goods might begin to develop greater monetization. Greater monetization might also reduce transaction costs by reducing the need for barter or complex barter, and by allowing value to be stored and transported from one time to another. Similarly, it might be useful to develop measures of integration, as in

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<sup>320</sup> See generally Cooter & Drexler, *supra* note 289 (using game theory to show effects of decisions on the structure of the European Community); Harrison Wagner, *The Theory of Games and the Problem of International Cooperation*, 77 AM. POL. SCI. REV. 330, 331 (1983) (arguing game models can "help" us understand better why international cooperation is more easily achieved in some areas than others).

<sup>321</sup> See WILLIAMSON, *supra* note 13, at 390-93.

<sup>322</sup> See note 207, *supra*.

<sup>323</sup> See Ken Binmore & Larry Samuelson, *An Economist's Perspective on the Evolution of Norms*, 150 J. INSTITUTIONAL & THEORETICAL ECON. 45 (1994) (discussing evolution of social norms).

<sup>324</sup> Yarbrough & Yarbrough, *supra* note 44, at 115 (construing OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING* 204-205 (1985)).

corporate analysis.<sup>325</sup> Once measures of integration are in place, it may be possible to evaluate the relationship between different levels of integration and particular governance structures.

## VII. CONCLUSION

The maximization formula described in this article – maximizing gains from trade, net of losses from trade and transaction costs – encounters significant problems of operationalization. Additional theoretical and empirical research will be required to operationalize this theory further. However, two routes appear promising. First, the selection of institutional features for analysis should seek relatively discrete and limited institutional features amenable to calculation of gains from trade, losses from trade and transaction costs. Second, it seems appropriate to analyze further, and test empirically, the relationship between high asset specificity and depth of integration.

This paper has argued that IEOs and less articulated institutions may, under appropriate transaction costs circumstances, provide the means to capture greater gains from intergovernmental “trade:” transactions in power. From a positive standpoint, it has argued that states design institutions to maximize the results of these transactions. From a normative standpoint, it has argued that this is indeed the measure of an institution’s effectiveness and the metric for designing efficient institutions. Here efficiency is defined in terms of maximization of state government preferences without direct regard to the preferences of individual constituents. This separation, arising from the need to analyze discrete institutions, must be recognized to be artificial. Once discrete institutions are analyzed, perhaps analyses may be stitched together. In this regard, the design of IEOs apparently would have significant effects on the design of states, and vice versa. A staged programmatic research program must be structured to perform this work in the optimal order.

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<sup>325</sup> See, e.g., Kirk Monteverde & David J. Teece, *Supplier Switching Costs and Vertical Integration in the Automobile Industry*, 13 BELL J. ECON. 206 (1982).