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Letter from the Chair

In theory, perhaps, theory knows no borders. In practice, disciplinary borders impose transaction costs on scholars who venture afield to build theory. Professor Trachtman's contribution to this issue of ILT reaches across the boundaries of law and economics to enhance our understanding of international organization. The cost to many of us, as readers, is the hard work of picking our way through an alien conceptual landscape. The reward is an exemplary demonstration of what good scholars can do with powerful theoretical materials, wherever found.

Professor Sellers' response eloquently identifies a hidden cost of forays across frontiers: we tend to forget what is important and distinctive about our home disciplines. Professor Keohane's response points to another cost. Scholars in one discipline may not realize that scholars from other disciplines may have made the trip already and paid the costs. In this instance, political scientists have learned a great deal about international institutions by crossing over to economics. If legal scholars followed a well-marked path through one neighboring discipline to another, they might be able to lower the costs of building theory for themselves. For any such undertaking, the current issue of ILT functions as a border post. Reduced transaction costs are good reasons for you to read, and write for, ILT.

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The annual business meeting of the International Legal Theory Interest Group is scheduled, as usual, in conjunction with the annual meeting of the American Society of International Law (April 1-4, at the ANA Hotel in Washington). We are on the program from 8:00 to 9:00 on Saturday morning, April 4 - coffee and pastries provided. Please make a point of attending.

ASIL sessions promise a good deal of interest to Group members. One highlight is a panel on "Separatism and the Democratic Entitlement," which Tim Sellers, *ILT* co-editor, will chair.

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The Theory of the Firm Applied to International Organization

This essay is based on the author's The Theory of the Firm and the Theory of the International Economic Organization: Toward Comparative Institutional Analysis, 17 Northw. J. INT'L L. & Bus. 470 (1997). The reader is referred to that work for citations to sources of ideas and information, as well as supporting materials. At the request of the editors, footnotes have not been included here except to indicate the source of quotations. That paper was originally presented at the Conference on Institutions for International Economic Integration convened by the International Economic Law Interest Group of the American Society of International Law in May 1996. Special thanks for comments and suggestions are due to Rick Mancke, Andrew Moravcsik, George Norman, Jean Schere, Anne-Marie Slaughter, Paul Stephan and Paul Vaaler.

All students of international law are familiar with the debate regarding the formation of, and allocation of competences to, international organizations ("IOs"). Why are these organizations created, and how should they be designed? The response to this question has implications for sovereignty, for in asking what competences shall be accorded to 10s, we implicitly ask what competences shall be left to states, and in asking how decisions shall be made in 10s, we ask how states may retain power despite the relegation of competences. This essay seeks to identify a theoretical basis for responding to these questions, by an act of academic arbitrage. This essay transports, only partially intact, the carefully expounded (although still deficient) theory of the firm from the realm of business organizations to the realm of IOs. In doing so, this essay takes one step in a project to apply some of the insights of the new institutional economics, law and economics and industrial organization to international law. Finally, this essay suffers from a deficiency familiar both in law and in economics: it is heavy on theory and light on empiricism.

This essay asks in 1997 the same fundamental question about the 10 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? (In an extraordinarily theoretical, and perhaps unproductive, sense, there is just one big one: the world is organized vertically in a single institution, for which the general public international law system is the constitution.) Coase developed the theory of the firm to answer his, own question. The theory of the firm relies, implicitly, on the so-called Coase theorem, which focuses attention on transaction costs as the central determinant of the organization of production: the choice between organizing production within the firm or organizing production through purchases in the market, or contract, depends on the relative transaction costs of these alternate structures.

Of course, lawyers know well that the market is heterogeneous, as is the firm, and that the firm is no more than a bundle of contracts. Internal organization of firms may be structured to resemble the market, as where one division sells to another at a "market" price. On the other hand, contractual joint ventures, intellectual property licenses or long-term contracts may be structured to resemble the internal organization of a single firm. Thus, we must follow justice Holmes' dictum to "think things not words," and examine how decisions are actually made, and how distributive consequences are actually allocated.

The main hypothesis of this essay is that states use and design international institutions to maximize the members' net gains, including in an expansive definition of "institution" both rules themselves and organizations that make or apply rules, both formally and informally. Net gains equal the excess of gains from engaging in the transaction in power, minus transaction losses, including loss of freedom or opportunity costs, minus transaction costs. Each of these terms will be addressed in more detail below. The reader may wonder what is meant by a "transaction in power." Consider for a moment any international treaty where a state constrains its power in discrete ways in exchange perhaps for reciprocal constraints by other states. On another level, consider the process of legislation of directives to approximate laws in the European Community. On yet a third level, consider "constitutional bargains" such as those that are made when states within the European Union agree to address an issue by majority voting, or when states party to the World Trade Organization agree to more binding dispute resolution. Each of these is a transaction in power, although it is worth noting that none is a transaction in the state of nature. Rather, each takes place within a particular institutional context. The broadest and most diffuse institutional context, as noted above, is the international law system itself.

The maximization of net gains is by necessity a comparative undertaking. As pointed out by Buchanan, Frey, Komesar and others, neither "market failure" nor "government failure" by itself has public policy implications. This is where both the Pigouvian regulators and the public choice anti-regulators commit sins of excess. Assertions of market failure and government failure simply beg the question of which fails less, or succeeds more, and how might a different institutional structure provide greater net benefits. 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. In fact, it opens for discussion the question of what it means for an international institution to be strong. Like the economist who, when asked how her husband was, responded "compared to what?" this theory requires particular institutions to be evaluated on a comparative basis: it calls for comparative institutional analysis.

This essay is structured as follows. I first develop the analogy between the private market for goods and services on the one hand, and the "market" for international power on the other hand. I establish as the basic unit of analysis the transaction in power. Second, I examine how the Coase theorem and the theory of the firm apply to the market for international power. In this section, I examine the transportability of some of the assumptions underlying the Coase theorem and the theory of the firm to this international power market, including the assumption of rationality and maximization. I also examine the problem of valuation, commensurability and interpersonal comparison of utility in this non-monetized market. Third, I examine attempts by Oliver Williamson to operationalize the theory of the firm in the private market context, and suggest the extent to which the theory of the firm can be operationalized in the international

power market context. Finally, I describe a comparative institutional analysis methodology derived from the theoretical perspective presented.

1. The Analogy Between the Private Market and the Market for International Power

The analogy between the private market and the market for international power is not new, having been drawn by Abbott, Keohane, Krasner and Waltz. Why do states enter this market? The assumption that rationalism requires is that states do so in order to obtain gains from exchange. An obvious corollary of this assumption is that where states find no gains from trade, they would not trade: they would not enter into cooperative or integrative transactions. As noted above, gains are defined as the net of transaction gains, transaction losses and transaction costs.

Transaction gains would arise from several potential sources. First, where one state imposes a harmful effect (an externality) on another, the second might be willing to compensate the first to stop -For example, the environmental law in one state may be associated with adverse or beneficial environmental effects in other states. More troublesome, lax or strict regulation may have intended or unintended trade effects. These trade effects may be more costly in adjustment terms or in other terms than the benefits that flow to the regulating state. Under these circumstances, there would be gains from trade: from a transaction in power whereby the second state cedes to the first state, or to an 10, some control over issues that would otherwise be within national jurisdiction. Of course, it is still possible that the affected state would simply engage in unilateral action. It might engage in unilateral action designed to persuade the second state to cease its offensive action, by coercion, exchange, implicit reciprocity (tit-for-tat) or otherwise. This type of unilateral action (it might also be considered bilateral informal action) occurs in a setting analogous to the "spot market" in private market structures. States may begin to organize this market by establishing international legal rules analogous to property rights (jurisdictional rules) and contract (treaty). Institutionalization of this type may facilitate "market" transactions, but represents a constraint on states. Another type of institutionalization would involve entering into longer-term or broader commitments regarding particular exercises of state power, perhaps establishing organizations to determine the circumstances under which state power is circumscribed.

A second gain from exchange would involve the exploitation of economies of scale, scope and time. These economies may be assimilated to externalities, but for clarity of exposition, I treat them separately. Economies of scale may arise from the often-noted fact that business is more global today, presenting opportunities for regulatory arbitrage and regulatory evasion. Without some global regulatory capabilities, possibilities for evasion, detrimental regulatory competition (which may be driven by externalization. also) and unnecessary regulatory disharmony may result in inefficiencies. There may also be technological economies of scale relating to the acquisition of equipment or regulatory skills. These economies of scale may provide a motivation for integration, or in other words, a source of gains from transactions in power.

A question of interest in international security relations is whether states seek absolute or relative advantage. Some argue that states seek relative advantage in this sphere; that is, that for example, during the Cold War, the U.S. would not have entered into an arms control agreement with the Soviet Union that benefitted both states in absolute terms, if it were to enhance the relative position of the Soviet Union. However, this seems more a dispute over the definition of states' preferences than over whether states seek to maximize those preferences. If in our example, the preference of the U.S. in 1980 is defined as a certain level of military superiority over the Soviet Union, the U.S. refusal to enter into this hypothetical bargain may be viewed simply as maximization of this preference. In the economic area, the concept that states seek to maximize their absolute gains seems even more clear.

Another, more serious, challenge to the market analogy comes from the fact that in international relations, coercion seems more prevalent than in domestic life. The sphere where coercion is possible may be viewed as the state of nature. Each individual in domestic life lives in part in this state of nature: law and suppression of coercion are in-complete. We might say that in the international sphere, law and suppression of coercion are simply more incomplete. Furthermore, the frontier of law may be viewed as a market itself. The property rights literature postulates the development of property rights in more primitive society based on the relative benefits and costs of establishing property rights. In international relations, states may agree to be bound not to use their coercive power. A recent example in the international economic relations sector, perhaps, is article 23 of the World Trade Organization's Dispute Settlement Understanding, purporting (at least in the minds of Japan and the European Union) to restrain the U.S. use of unilateral coercive power in international trade disputes under WTO agreements. The United Nations Charter, and the United Nations operation against Iraq, may also be seen as restraints on state coercive power. To those who respond that these examples may be viewed merely as exercises of coercive power through these 10s, I agree, but point out that these organizations are not simple conduits, but are complex prisms of power, that may modify the direction, color and intensity of power as they carry it from one locus to another, and one time to another.

Thus, 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 utility functions. 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. This perspective is consistent with the modem conception of property as a bundle of rights in relation to assets. It is important to say what is meant by the "firm" in this context, as opposed to the "market." Here, it is important to recognize, with many proponents of the theory of the firm, that there is no sharp demarcation between the two. Rather, relations are more market-like or more firm-like. The metric of this continuum is the relative scope of individual discretion on each side: the extent to which politics is unconstrained and the rules of the game are unspecified. Where the individual retains greater discretion, she is closer to the pole of the market; where she retains less discretion, she is closer to the pole of the firm. This diad is translated in international 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. Contract, or treaty, or other binding commitment, amounts to a degree of institutionalization, binding action in the future. These kinds of relations become less like the market and more like the firm, to the extent that they have longer terms, cover more "transactions," are more complex, or 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 little need for further definition, relatively easy identification of defection and the self-enforcing ability to withdraw benefits on a tit-for-tat basis, and therefore 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 compared to organization within an institution or firm: with integration.

2. The Applicability of the Theory of the Firm and the Coase Theorem to the Market for International Power

The theory of the firm is based on Coase's insight that the choice between methods of relating-of exchanging- is based on transaction costs. General Motors can buy auto bodies from Fisher Body, or it can acquire Fisher Body (or build its own auto body plant). The gains from assigning this work to Fisher Body do not depend on whether General Motors owns Fisher or not, but on the transaction costs involved in the two alternative modes of organization. I follow Coase and Arrow in using a broad definition of transaction costs, including the costs of identification of a counter-party, the costs of communication with that counter-party, the cost of negotiations (including the costs arising from holdout or bilateral monopoly problems), the costs of establishing legal relations, by contract or otherwise, the costs of monitoring performance and the costs of enforcement. More simply, they are the costs of coordination of production. It is important to recognize that there is a set of transactions that would otherwise provide net gain for the parties, but that are not entered into, due to the presumed fact that the transaction costs exceed the net gains otherwise available.

In fact, Coase's transaction costs focus explains institutionalization in the form of the firm, as well as in the form of government regulation at local, national and international levels. 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" in this context, 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.* Further, if the sum of these items cannot be made positive, no transaction or institutionalization is appropriate.

Implicit in the above, but often forgotten, is the fact that neither the Coase Theorem nor the theory of the firm is exclusively about transaction costs: in fact, the lowest transaction cost solution is not always to be preferred. Rather, the point is that in a zero transaction cost world, infinite exchange would allow perfectly efficient allocation. In a positive transaction cost world-the world as it is-a decision-maker might accept some transaction costs in order to enhance gains from trade, or accept reduced gains from trade in order to reduce transaction costs even more. The actual decision depends on the magnitude of each. Williamson and Komesar call for a cost-benefit analysis methodology that compares a number of available institutional alternatives to seek the maximum gains from trade net of transaction costs. 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, as 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, and any outcome might be explained as minimizing

transaction costs. However, a single institutional analysis is non-testable. Transaction cost economizing is potentially rendered non-tautological, and may in limited circumstances be operationalized, by a comparative methodology, which requires the comparison of transaction cost and benefit profiles of various institutional alternatives. 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, and thus leads us on a journey toward what Calabresi terms the "structural production frontier." Of course, the structural productionfrontier and the technical production frontier are both constantly subject to change, and a change in one always results in a change in the other.

The Coase theorem, which has been extensively elaborated and critiqued, 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. The reason that this initial allocation would, assuming zero transaction costs, not affect efficiency, is that market participants would engage in costless reallocative transactions that would result in an efficient outcome, and all inefficient externalities would thus be internalized: no decision-maker would fail to take into account all of the costs of his or her decision. Thus, in a zero transaction costs world, an externality, standing alone, would not justify regulation.

Assume for a moment a potential Pareto efficient set of international law rules; that is, 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; that is, it accepts each actor's preferences as given, and seeks to maximize their satisfaction. In a zero transaction costs world (without problems of holdouts), this perfect set of entitlements would occur regardless of the initial set of international law rules (if any): actors would costlessly reallocate to the efficient position. 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" is not a sufficient reason for regimes or other institutions. Regulation carries with it transaction costs as well, and both the market and regulation suffer from imperfect allocation. In fact, Coase's insight requires us to compare institutional structures in every case.

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 whether they will become mired in endless cycling of negotiation, especially under a zero transaction cost assumption. Coase did not address this problem 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". 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. The Hobbes Theorem has obvious affinities with the realist position in political science, and this contention over the distributive consequences of cooperation is also posited by realists, and accepted by Keohane, as a barrier to cooperation.

Coase has addressed this problem in a manner that is not theoretically rigorous, but perhaps is persuasive. Coase recognizes, interestingly, that the holdout problem is *not* simply a transaction costs problem, but a problem of assumptions regarding human motivation and behavior, and responds in a commonsensical tone to the effect that people are likely to find a way to reach agreement. 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, the instinct seems correct, and may be growing in applicability to the international system as interdependence grows. The instinct seems even more correct 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. Game theory predicts that each player's dominant strategy for the prisoner's dilemma will be non-cooperative. Of course, the prisoner's dilerruna, a non-cooperative game, assumes that the parties cannot communicate with or bind one another. However, law and institutions may serve to promote conummication and binding agreement that may resolve the prisoner's dilemma, transforming the game into a coordination game, and allowing cooperative solutions.

There are a number of difficulties that arise in transposing the theory of the firm to the international sphere. First, although the assumption of rationality of individuals is under attack, an assumption of rationality may be even less acceptable for application to states. Groups, like individuals, exhibit limitations on information searching and processing, although 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 address the rationality of group decisions. Arrows' impossibility theorem and Buchanan's methodological individualism indicate that organizations have no rationality of their own, but intermediate, imperfectly, for individuals.

> "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." (James G. March & Johan P. Olsen, *The New Institutionalism: Organizational Factors in Political Life*, 78 Am. POLIT. Sci. REv. 734, 739 (1984).)

Rationalist international relations theory assumes that states are rational evaluative maximizers of their own preferences. Liberal institutionalism recognizes the need to get inside the "billiard ball" for analytical purposes, and understand how state preferences are formed and expressed.

One clear distinction between firms and IOs is that generally, IOs 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 a corporate shareholder, residual control means that 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 they contract away authority; they retain power (except to the extent that injunctive relief might restrict them) to breach their contracts. In this connection, state sovereignty and shareholder sovereignty seem similar.

Like corporate shareholders, states that are members of currently existing 10s generally claim the right to residual control over those of their affairs that they have not assigned to the 10. 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 10. It might be argued that there are important counter-examples to such residual control, including the European Community, 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.) 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 10. 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, there are two more difficult questions that arise in considering whether the theory of the firm may be useful in considering 10s. 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. From a positive standpoint, and from a traditional realist standpoint, the answer may be no, but the answer ultimately depends in practice on the responsiveness of the relevant state government, or perhaps more accurately, its representatives. Thus, from a positive theoretical standpoint, the real party in interest is indeterminate: states are neither billiard balls nor simple conduits but, like other institutions, are complex mediating prisms that transmit the interests of individuals at varying speeds, with varying intensities and with varying degrees of distortion.

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 vis-a-vis IOs in the role of portfolio companies. From this perspective, states intermediate. From the standpoint of individuals, in addition to their direct functions, states serve as agents for entering into international relations. From the standpoint of the 10, 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 IOs. Are IOs 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. Our working assumption is that nations do not themselves have interests, but simply represent, albeit imperfectly, individuals that do.

Accepting the fact that states intermediate, and that state governments generally control the exercise of states' rights, in IOs (subject to successful claims of a democracy deficit), there are important implications for the maximization equation suggested by this essay. *The values maximized through transactions are not directly those of individuals, but are the values expressed through state governments.* This essay does not address the extent of congruence between the values of governments and the values of their citizens. Stated another way, this essay seeks to address the institutional issues in IOs; it leaves for public choice theorists who address national governments the analysis of institutional issues in states, while recognizing sadly that it is impossible to evaluate the utility of an 10 without evaluating the intermediation of the states that comprise the 10.

Thus, while corporations certainly have structures that differ from those of most 10s, the structures are at least comparable, allocating competences and rights to make decisions in various ways. Indeed, as all of these organizations constitute means of establishing artificial persons to act on behalf of the constituents, it is not surprising that they have common issues. There is an extensive corporate governance literature concerning the problem of agency costs and conflicts of interest, attempting to ensure the fidelity of corporate managers to shareholder welfare. The public choice perspective on 10s exhibits similar concerns regarding the pursuit by (i) national governments, and (ii) their delegates to 10s, of their own respective interests, rather than citizen interests. It is important to recall, however, that we are using a comparative institutional analysis. Thus, of course we would like to reduce these agency-type costs, but we must be mindful of the costs of their reduction, and of the availability of institutional substitutes. Thus, 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 10, on another.

Obviously an 10 is not a business firm and does not have profit maximization as a goal. 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 essay is not that IOs 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 10s. Even more fundamentally, this essay argues that 10s can be explained in the same currency as business firms: the currency of comparative institutional analysis using transaction costs economizing.

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. For example, agreements within the European Community to engage in mutual recognition of regulation are a kind of barter. All trade negotiations are essentially complex, usually multiparty, barter. Trade negotiators try to value the concessions they make and receive, but this is done in an extremely inexact manner. The growing liquidity of this market-increasing frequency and scope of exchange-will facilitate, and will be facilitated by, increasing monetization 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 money 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. While price theory-based economic analysis is made more difficult, the type of institutional analysis described in this essay does not rely on monetization, and is very similar in its application to the private firm and to the 10.

Finally, even preferences that are monetized, and money itself, may not be commensurable. However, this is not an argument against the institutional analysis suggested here, but an argument about the limitations of price-theory based mathematical economics. The theoretical perspective of this essay 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. The model is drawn between the Scylla of assuming avariciousness for simplicity and the Charybdis of problems of incommensurability. Second, the theoretical perspective of this essay 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.

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 corttractarian approach to allocatim and rules. In organizational terms, "an organization is considered to be efficient if the members unanimously accept the general rules under which it operates." (Bruno S. Frey & Beat Bygi, *International Organizations from the Constitutional Point of View,* in *The Political Economy of International Organizations,* 58, 60 (Roland Vaubel and Thomas D. Willett, eds.)(1991), *citing* Geoffrey Brennan and James M. Buchanan, *The Reason of Rules: Constitutional Political Economy* (1985).) Thus, the test for Pareto efficiency of an I0 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. 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.

The concept of potential Pareto efficiency ("PPE"), 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 (and regardless of whether that person is satisfied with the level of compensation). This essay assumes that the appropriate test is PPE: if the winner's gain is large enough, it may (potentially but not necessarily) compensate the loser so that both the winner and loser derive a net benefit. Note that 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 as 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, and assumes that trade will occur to reach that higher aggregate net benefit.

A cost-benefit analysis that considers aggregate net benefits, without concern for 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 IOs, 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 co incides with efficiency in the constitutional perspective ... However, international organizations' activities are not valued in markets .... (Frey & Gygi, *supra* 2, at 62.)

Thus we have what seems like a critical difference between 10s and firms: the output of 10s is not monetized, and the utilities sought through 10s cannot be aggregated. There is no monetized market that may reveal valuation of particular goods. Thus, the only available test of the Pareto efficiency or PPE of the rules of an 10 is whether these rules are accepted by the constituents. From a policy perspective, comparative institutional analysis may, given an articulated set of preferences and priorities, 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 *eventu*ally replace all the planks in the hull while it remains afloat." (Robert D. Cooter, *The Best Right Laws: Value Foundations Of the Economic Analysis of Law, 64* NOTRE DAME L. REv. 817, 822 (1989).)

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 it has left behind. 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. 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.

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

3. Attempts to Operationalize the Theory of the Firm Using Concepts of Asset Specificity

This section examines attempts to operationalize the transaction costs approach to institutions. The major problem with generating testable hypotheses is that it is often difficult to measure transaction gains, transaction losses and transaction costs on a comparative basis. 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. 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. "The discriminating alignment hypothesis to which transaction-cost economics owes much of its predictive content holds that transactions, 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." (Oliver E. Williamson, *Comparative Economic Organization: The Analysis of Discrete Structural Alternatives,* 36 ADNEN. *Sci. Q.* 269, 277 (1991).)

For the reasons set forth below, such simplification, too, seems problematic. Rather, this essay 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.

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 arises from the fact that one party makes an investment in transaction-specific assets. The classic example of Fisher Body and General Motors is used to illustrate 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. 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 asset specificity distinguishes the market and firm models. The market works well where asset specificity is negligible. Asset specificity, as used by Williamson, is too narrowly defined. It is too narrowly defined if it excludes otherwise indistinguishable reasons why parties might decide to contract or enter into firms or other organizations. Williamson uses as examples 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, but 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. 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 transaction 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 nontariff barriers. While it might be argued that this is 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, 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, it may be that the

injured state is not permitted to withdraw concessions on a non-MFN basis, or it may be that it is difficult to calculate and agree on the value of the concession. In addition, the entry into an I0 itself may have high political costs, again 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, and 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. Here, it becomes important to recognize, as Williamson does, that between market and hierarchy is a broad continuum of "hybrid" structures, including for example, 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. Williamson suggests three main transaction dimensions that may be used to develop a predictive theory of economic organization: asset specificity, uncertainty and frequency. 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 will be the incentives for and costs of opportunism, requiring and justifying 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 level of complexity of a relationship, and the degree of uncertainty about the future about the relative future value 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, it might be said that 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.

Thus, asset specificity indicates the potential utility of institutions, but does not alone indicate the kind of institutions needed. However, with higher magnitudes of asset specificity, and with 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 be applied in future when particular issues arise. In other words, greater integration is necessary.

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 VVTO or European Union.

Thus far, this essay has been concerned largely with the delegation of responsibilities to IOs 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: once an 10 exists, and has plenary power (albeit cabined within limited authorizations), what powers should it exercise at the center, and 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 10. Of course, we know that all other things are not often equal, and 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 United States federal system and the European Community, this is somewhat blurred. In the United States 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 hand. In the European Union, the blur is generated by the tension between the limited purposes 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, and, for example, at the Solange opinions of the German Constitutional Court.

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 10, it must consider how the 10 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." (PAUL MILGROM & JOHN ROBERTS, ECONOMICS, ORGANIZATION AND MANAGEMENT at 114 (1992).)

Finally, when authority is delegated to an 10, it is necessary to ask how that authority will be exercised: what is the decision-making process within the 10? 10s may be delegated authority, but the internal decision-making process may, for example by requiring unanimity prior to action, 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 10 may be accorded responsibility for a particular issue area as a whole, while the decision-making structure preserves intergovem-mentalism in some respects, and allows greater integration in other respects. In this sense, the structure of horizontal federalism-relations between legislatures, executives and judiciaries-may replicate or complement vertical federalism-relations between the center and the components.

4. Methodological Implications

Given the difficulties in operationalizing the theory of the firm described above, this essay 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

(1) NG = net gains
(2) TG = transaction gains
(3) TL = transaction losses
(4) TC = transaction costs

NG must be positive for trade-for international agreement-to be worthwhile. It is worth noting that there are two kinds of transaction costs, which we will distinguish below. The first kind is intra-institutional transaction costs: the costs of reaching agreement within the established institutional setting. The second kind is extra-institutional transaction costs: the costs of modifying the institutional setting. The above equation refers to intra-institutional transaction costs. However, if the net gains from trade (NG) is less than the cost of transition, no transition would be expected to take place.

The most direct methodology would choose a particular institutional context, establish a comparative foil, and calculate or evaluate each of the four factors listed above. If hypothetically substituting the comparative foil in the relevant institutional setting would increase net gains 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. 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. Perhaps the problem of operationalization may be resolved through narrow definition of the institutions evaluated. Given sufficiently narrow definition, a full transaction costs and transaction 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?

Thus, the method indicated by the above theory is comparative institutional analysis. 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 method. 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, 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.

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: cross-jurisdictional, historical and constructed, or speculative.

The initial 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 to optimize for local conditions.

5. Concluding Observations

This essay has argued that 10s, 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 regard directly to the preferences of individual constituents. This separation must be recognized to be artificial, but arises from the need to analyze discrete institutions. Once discrete institutions are analyzed, perhaps analyses may be stitched together. In this regard, it seems that the design of 10s 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.

Finally, while integration may provide benefits, it is clear that integration has costs. A normative theory of integration would suggest integration when, but only when, the maximization formula described here indicates positive net gain.

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Applying the Theory of the Firm to International Organizations
The Importance Transactions Costs Engineering

Applying the theory of the firm to international organizations ("I0") intuitively makes perfect sense. Just as firms are composed of a bundle of contracts that maximize the joint interests of stockholders and bondholders, IO's maximize the joint interests of the member states. If stockholders, bondholders, or member states could improve their relative positions by ending their association with a firm or an I0, presumably they would. While applying the theory of the firm to IO's makes sense, the application of the theory of the firm to I0's will be useful only to the extent that analysts move beyond a tautological understanding of "transactions costs" and delve deeply into how and why nations attempt to engineer transactions costs to their benefit.

As Victor Goldberg feared, the term "transactions costs" has become the "imperfect capital markets" of the 1980s, "the all-purpose answer that tells us nothing." Victor P. Goldberg, "Production Functions, Transactions Costs and the New Institutionalism" in *Issues in Contemporary Microeconomics,* edited by George Feweil, at 395. In a way, that transactions costs has become tautological shouldn't be surprising, as Coase never really defined the term, nor did he explore the concept of transactions costs in any in-depth way. Rather, Coase seems to have viewed transactions costs as some residual variable that economists were ignoring. Trachtman's use of a broad definition of transactions costs ("the costs of coordinated production") likely will not prove useful in attempting to apply the theory of the firm to IO's.

Tautological assumptions about transactions costs facing business firms - especially thickly traded business firms - are easier to deal with analytically than are tautological assumptions about transactions costs facing I0s. This is so because business firm relationships for the most part boil down to the net present value of cash flows. The only assumptions fundamental to present value analysis involve forecasted cash flows and the opportunity cost of capital. While financial economist estimate these values, generally the estimated figures are supported by similar transactions occurring in our thickly traded financial markets. Any residual not captured by an apple-to-apple comparison of the present value of the cash flows can be, and typically is, considered "noise" by financial economists.

International Organizations' relationships, by contrast, are not driven by near-perfectly fungible flows; rather, I0 relationships are driven by noise -- political, cultural, and other apple-to-orange factors. While I0 relationships likely generate positive net benefits, these benefits cannot be estimated in any reasonable or meaningful way. Nation states have highly subjective preferences, and whether a nation enters an I0 will depend on a series of extremely unique relationships, such as the relationship the nation has with other nations seeking to join the I0, the relationship among the branches of government within a member state, and the relationship between the national government and its own people. For example, the U.S. owes the United Nations a significant sum of money, and the U.S. executive branch would like to pay it; however, the U.S. legislative branch, which controls capital outflows, will not pay. Curiously - or maybe not so curiously, depending on our understanding of the transactions costs that drive the relationship - the United Nations has taken no substantive action against the U.S. for failing to pay this debt. Thus, understanding and carefully deffi-dng tautological terms, such as transactions costs, is critical to applying the theory of the firm to 10s.

To better operationalize the term transactions costs, Goldberg suggests dividing the universe of transactions costs into two parts: 1) the costs associated with transacting and 2) costs that could be avoided under alternative institutional arrangements. Id. at 395-402. This distinction recognizes that engaging in any transaction requires resources. On the one hand, every agreement requires bargaining, negotiating, and some degree of monitoring, and firms and I0's are willing to engage in these activities because they value the result achieved. On the other hand, the way an institutional arrangement is defined will dictate wealth effects and any dead-weight loss associated with transacting.

No matter how nations define an I0, nations will incur costs associated with transacting. Nations will employ personnel, conduct research, and purchase plane tickets and hotel rooms in order to transact. Parties to the I0 will incur these costs because they feel that they want to transact. If a nation did not believe it useful to transact, presumably the nation would not explore joining the I0 in the first place.

How the nations organize themselves to transact and analysis of the costs avoided by alternative I0 arrangements is another matter entirely. Once a group of nations decide to come together to form an I0, the transactions costs engineered to run the I0 will serve to allocate to each nation the benefits - wealth effects - gained by entering the I0. One nation may be willing to pay money in order to maintain control and limit the amount of sovereignty lost to the I0. Another nation may be willing to give up sovereignty in order to get resources from the I0. If a nation feels that it is not getting its fair share of the wealth effects generated by the I0, then the nation will not join the I0.

Trachtman argues that the "institutional engineer seeks to engineer institutions that do useful things with low transactions costs." Trachtman at I0. While this in some sense is true, an institutional engineer also will seek to use transactions costs to funnel the highest net benefits to its nation. For example, permanent members of the United Nations Security Council are very expensive to deal with as each can veto any measure it does not like. In the European Union, qualified majority voting favors larger states. The veto and qualified majority voting are just two examples of how states can make themselves more expensive to transact with. Some states presumably can extract such benefits because they bring more to the table than other states.

In forming an I0, nations are likely to use transactions costs engineering to hold out for the best position possible among competing nations. In the classic hold-out problem, one party of many supposedly equally affected parties refuses to deal with a group in order to extract the highest possible benefit at the expense of the other parties. Typically it is

assumed that the hold out would benefit by agreeing to the proposed transaction as is, but refuses to do so. Essentially, the hold out is viewed as acting opportunistically and as a net drain on an otherwise efficiency-enhancing transaction.

When applied to I0's, a hold out nation may be viewed as attempting to engineer the level of transactions costs the nation feels is most commensurate with its stature as compared to other nations entering the I0. If the U.S. is to have a veto, then China will require a veto as well. Brazil may desire a veto too, but lacks the bargaining power to extract this wealth effect from the other nations. To the I0 membership as a whole, it may be more important to have the U.S. and China as parties to the agreement than to have Brazil. And if not, the U.S. and China may feel that they would rather not belong to the I0 at all if they cannot engineer transactions costs sufficient to limit their exposure to any loss of sovereignty required by joining the I0.

Holding out for protection from sovereignty loss also may be politically important to a nation as it attempts to explain to its people the benefits of joining the 10. In the U.S., we believe that the sovereignty of the federal government emanates from the people's will, and the federal government should cede sovereignty to an I0 only in very limited and controlled circumstances.

In addition to holding out in an effort to influence the formation of the I0, nations also will use transactions costs to minimize the impact of agency costs once the I0 is formed. In the I0 context, agency costs may arise from the divergence of interests between a member state and the I0. For example, the I0 could attempt to interpret its authority in a way a nation state views as beyond the sovereignty granted the I0. The nation state may use transactions costs to check agency costs ex ante.

In the end, applying the theory of the firm to I0's likely will provide insight into the nature of IO's. This brief note has argued, however, that the insight provided by applying theory of the firm to IO's may be dependent on how well analysts develop an understanding of transactions costs, which typically are treated tautologically when using theory of the firm to understand traditional businesses. In business firms, transactions costs typically amount to a residual, as thick markets drive the analysis. In IO's, the converse is true, markets do not exist, and transactions costs drive the analysis. Thus, an understanding of how nations engineer transactions costs to their advantage in forming I0's likely is critical to any analysis that applies theory of the firm to IO's.

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A Comment on Trachtman's, "' The Theory of the Firm Applied to International Organization"

It is said that Yogi Berra coined the phrase, "It's dejavu allover again." Perhaps I will be pardoned for feeling that way about Professor Trachtman's article. The thesis of his paper is that "states use and design international institutions to maximize the members' net gains," using an expansive definition of institutions. He relies on the theory of the firm, particularly work by Ronald Coase and Oliver Williamson, to do so.

In 1984 I published a book entitled After Hegemony, which developed precisely this thesis. Chapter 6, entitled "A Functional Theory of International Regimes," begins with a section on "political market failure and the Coase theorem" and continues with an effort to explain international institutions as responses to market failure. Subsequent work by myself and many other scholars has sought to extend these insights and to show that they apply to many international organizations. Indeed, in this literature the deficiency that Professor Trachtman identifies in his own paper - that it is "heavy on theory and light on empiricism" - has largely been corrected. Five years ago Beth and Robert Yarbrough applied this perspective to international trade. Using related arguments, Lisa Martin has examined economic sanctions; Ronald Mitchell has explored pollution by tankers at sea; Jeffry Frieden has sought to explain colonialism; Robert McCalla has studied the persistence of NATO; Barbara Connolly has investigated international environmental institutions; Mark Zacher and Brent Sutton have analyzed international regimes for transportation and communications.

Professor Trachtman notes that the editors have asked him to keep footnotes and references to a minimum, and in fairness, his essay does allude to work not referenced or cited. Nevertheless, it does appear that the most useful commentary I can make is to provide a short bibliographical list of works not cited by him, which have made the connection between the theory of the firm and international relations, and which have used the resulting theory to investigate a variety of issue areas in world politics.

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Analyzing the Application of the Theory of the Firm to International Organizations: The Integration Curve

In his paper *The Theory of the Firm Applied to International Organizations,* Professor Joel Trachtman posits that the theory of the firm may be transported from the realm of business organizations to the realm of international organizations. The theory has merit in the sense that the state may choose to surrender some sovereignty after it calculates losses plus transactions costs and subtracts them from trade gains. Some of the difficult questions that Professor Trachtman raises he too quickly dismisses, and should be examined further. The power the international organization has goes beyond mere economic gain into questions of whether sovereignty is commodifiable and whether transactions costs are too high for meaningful choice. Nations do, however, make that choice and tradeoff between integration and gain. The question is where, along the continuum between nonintegration and total integration, a state will locate.

The first part of this comment will look at Professor Trachtman's main hypothesis that states design and use international institutions to maximize net gains. It will examine his analogy of the private market for goods and services with the market for international power, and the idea of rationality and maximization as transported from the Coase Theorem and the theory of the firm. It will raise some additional concerns that arise in looking at international institutions from an economic viewpoint, specifically the international organization as a single market, and the implications of that concerning the issues of monopoly, and treaty as “contract."

The second part of this comment will present an application of Tractman's Net Gains formula into an "integration curve," which attempts to explain how a nation chooses how much to integrate into a supra-national relationship. Some of the problems addressed in the first part of the comment will be re-addressed in the second part. Finally, a brief look at the lifespan of IO’s using physics is attempted.

1. The Analogy Between the Private Market and the Market for International Power

The idea of the importance of transactions costs driving the decision-making process is valid and can be employed in a variety of contexts, whenever an individual or groups of individuals are faced with self producing, as opposed to allowing others to produce. Coase's *Nature of the Firm* relied on the principle of marginalism, which is that at the margin, a firm will organize its factors of production within itself if the costs are equal to either the costs of organizing in another firm, or the costs of leaving that factor to be organized by the price mechanism. In a pure trade sense this applies to a sovereign state when it designs or joins an international organization.

States may maximize their gains from trade by, in effect, cartelizing with other states in order to form a stronger, broader and more global market. In simple terms, a nation joins an international organization because its leaders believe that the state will become wealthier by doing so. just as the firm chooses its method of production with the end in mind, which is profit, supposedly the state joins an international organization to maximize the wealth of its citizens. As Professor Trachtman theorizes, states interact and cooperate with each other on particular issues in order to maximize their utility functions (Trachtman 1997:7).

A sovereign nation has characteristics of both a "firm" and a "market," but in reality is neither. Professor Trachtman defines a nation as closer to a market if it retains more competence and closer to a firm the more it integrates into the I0. He correctly recognizes that no line of demarcation exists between a firm and a market.

However, since an I0's constitutive sources are from power derived from sovereign governments (whether through a market transaction or by firm behavior), its powers are necessarily governmental. If states bond together to pool governmental authority by forming an international organization, at the very least, the new, supra-national organization must be a quasi-governmental organism. The organization becomes a political power broker between nations both in its territory (intrastate) and outside the scope of the I0 (interstate).

A government does not fit the paradigm of a market because it is not subject to market forces, especially when brokering power. It is really a monopoly, because it is not subject to competition. A government also does not fit the prototype of the firm. As Professor Trachtman admits, the firm produces to make a profit; the international organization does not (Trachtman 1997:17). The firm pays dividends to shareholders; the international organization does not (Trachtman 1997:14). In an indirect sense the member-states get dividends through trade gains from cartelization through the international organization. This is much farther removed from the relationship of a firm who pays dividends to a shareholder, which is a direct payment. The firm may also take some of its profit and reinvest it; the international organization has no such ability.

Another point of departure is that even the largest firm loses its power and influence when it loses its customers. Who are the international organization's customers? The answer must be the member-states. How does the international organization lose its customers? We will come back to this later in part II of this comment.

In a free market, an individual, or entity, may integrate into the market in whatever way he chooses. The individual may choose to surrender some freedom in order to receive some gain. That is the true meaning of economic freedom, and is where this theory works. In the world of IO's, nations choose to surrender freedom to the I0 in order to receive perceived gain, as in Professor Trachtman's theory.

One must look at the ability of the state to bargain away its sovereign powers to an organization that will direct its movements. It is important to note that sovereignty comes not from the state itself, but the citizens of the state. Inalienability historically meant that a king theoretically would not alienate his subjects without their consent (Meron 1995:5). As the American Declaration of Independence declares, "Governments deriv[e] their just powers from the consent of the governed." Of course, the Declaration goes on to say, "That whenever the Government becomes destructive of [its] ends, it is the right of the People to alter or abolish it and to institute new Government, laying its foundations on such principles and organizing its Powers in such forms, as to them shall seem most likely to effect their Safety and Happiness." This goes straight to the heart of information asymmetry. The question is, do the people know to what degree their sovereignty has been bargained away? I suggest that they can not possibly know the scope of agreements that their governors have agreed to until it is too late for the political process to remedy the situation. This begs the question, is state sovereignty commodifiable? (Agreeing to abide by all provisions of a binding economic treaty starts a "crack in the states' sacrosanct sovereignty." (Hemandez-Truyol,1996:1115).

Two primary international instruments concerning sovereignty are the United Nations General Assembly Resolution on Permanent Sovereignty over National Resources, and United Nations Resolution 3281, which contains the Charter of Economic Rights and Duties of States. Both of these documents declare that "[e]very State has and shall freely exercise full and permanent sovereignty, including possession, use and disposal over all its wealth, natural resources and economic activities." But, if sovereignty can not be given, sold, or traded away without diminishing the state substantively. (If a citizen can not sell his vote, can a state sell its sovereignty? See *Rose-Ackerman,1985)). "Nothing* can destroy a government more quickly than its failure to observe its own laws, or worse, its disregard of the charter of its own existence." (Mapp v. Ohio, 367 U.S. 642, 659 (1961)). Is selling power on Tractman's "international market for power" legitimate.? Maybe so, but the price may either be too high (information cost), or unknowable to realistically factor the consequences into the transaction cost formula, even under an unknown factor assumption.

When the power to direct movement is given away, the state is choosing to diminish itself. By bargaining away the ability to direct economic policy the state is sacrificing the freedom of its citizens. The citizens of the state must now abide by the directives of the supra-national organization (and may only have a negligible say in that organization - at the very least a watered-down say). The analogy is that a slave must do what the master orders him to do but a free man (or free state) may choose its own path. (Question: Are sovereign freedoms illusory because without economic freedom a state sells itself into a form of slavery - in other words, once the state agrees to abide by the directives of the 10, does it have any true economic freedom?)

Ludwig Von Mises once said, "Society under the market economy, under the conditions of ‘economica libre’ means a state of affairs which everybody serves his fellow citizens and is served by them in return." (Von Mises 1989:19). This citizen servanthood is by choice. An entity binds itself into servanthood based on precisely the cost/ benefit analysis that Professor Trachtman is applying to the 10. But, a question arises in international organization analysis: will the interests of the stronger states necessarily overpower the interests of the weaker, smaller states? The nations are not in the organization merely to serve each other. When would the strong state subordinate its needs (or gain) to a smaller state? Probably never, unless the wealth gain it derived was great enough to justify that subordination. So, why would a small state decide to join an international organization when it would find its interests overpowered by the stronger states?

The answer is that often a nation binds itself for gain in the short run. And the small nation will get benefit by binding itself, but probably not all that it would like to. In general, to sign a multilateral treaty a country must sign on to all provisions. A treaty is not usually a buffet of arrangements that a nation may pick and choose from. The Coase Theorem would submit that a nation would weigh all the costs of signing on to a treat)~ including the loss of sovereignty and unknown factors, and if the gains were great enough would agree to the whole bundle of provisions. Perhaps the leaders of a state are unable to accomplish politically on the local level what they can accomplish on a multi-national level. So, they place themselves (the national government) as an unblamable layer of government between their citizens and the change operators. This way the present social goal can be initiated by an outside, supra-national party. Although Professor Trachtman leaves the details of this argument to others, it is important to note that politicians indeed may, and often do, sacrifice the long-term effect for a short-term goal. Although I refer to this analysis later in this comment, note that one must presuppose that to have political remedies against abuse the citizens of the state must have meaningful participatory rights in the political process. 'Citizens will never attain sufficient power to advance their own welfare unless they possess a voice in the decisions of their government." (Fox, 1992: 595). This may not be a problem in North America or the vast majority of Europe. But it is a real problem in some countries in Latin America, Africa and of course countries like China, Vietnam and North Korea.

A. Lack of Meaningful Choice

Often nations may feel compelled to join the international organization: they are caught in the hard place of conform or die (or perhaps wither away). Would Luxembourg survive alone while all the other European nations formed an economic union' If Luxembourg made its laws favorable to foreign investment, it might. But, the larger economic union could also place trade barriers so high that it would force Luxembourg out of a meaningful market. Nations working by themselves likely will find that they can not put up their own protective barriers in the face of a huge cartel. So, in order for Luxembourg to continue to exist, it must sell itself into "slavery" and sign the economic union treaty~ (Though it might be politically difficult to rise above the cries of special interests, a country might also attempt to form its own free market. For example, a country like Switzerland (because it has the resources) could refuse to join the EU, anchor its currency to the gold standard, and take steps to "Hong-Kongize" its market (and tax structure, as when Hong Kong was still a British colony), so it becomes a desirable place to do business. This of course would be an amazing feat; one which would be fun to see.)

This doesn't happen to the firm. A firm can sell itself off or renegotiate a contract if it finds itself in a losing position. It can try several methods of recapitalizing. A firm can reorganize under a different name. A firm can move its factors of production to another geographic location. However, it won't submit to slavery without receiving a usable profit. A nation, on the other hand, may find itself in the impossible position of submission without substantive gain.

A smaller, weaker state will find itself in the position of needing subsidies from the larger, stronger states to survive (Jacobs 1984:202-203). Of course this is a boon to politicians that want to keep their region viable. Luxembourg may not be able to compete with Germany, but if it joins the economic union, the union will likely have to divert income from the vibrant centers to support the smaller provinces. For the international organization to maintain its "empire" it will have to engage in policies that produce economic decline in the long run (Jabobs 1984). Although the merging of political units (by submission or by coercion) and the ensuing removal of tariff or movement barriers, and installation of a common currency and laws allows economic efficiency, it also creates an *ever*-expanding bureaucracy to deal with the welfare of the weaker members. History is full of *examples* of *empires* crumbling because of the rise of the welfare state. One may look at the British Empire, the Roman Empire and the Soviet Empire as cases in point. In those empires the allocation of resources that went toward propping up the social welfare eventually grew so large as to undermine the other functions of the governments and greatly contributed, if not caused, their decline. This also somewhat answers Trachtman's question as to why there is not just one big one (I0).

Treaties create binding rights, obligations and law. One gain the state does achieve is that by signing a treaty it also preserves its sovereignty. It can try to demand that counter-majoritarian rights be given preference in the international organization. But, how meaningful are those rights? Will the state actually gain? Or, will it just be lip service to placate the minority? Does *competenz-competenz* really have teeth when it comes to the weaker state which has in reality may have been compelled to join the organization?

Transporting the idea of freedom to contract from the sphere of the firm into international organizations suggests that "if a state may validly consent to intervention in the present, it may validly consent by treaty to intervention in the future." (Wippman 1995:615). In the S.S. "Wimbledon" case the Permanent Court of International justice held that "the right of entering into international engagements is an attribute of sovereignty," and therefore the limitations a state accepts under a treaty cannot later be renounced as an impermissible infringement on that state's sovereignty (Wippman 1995:616). The state is as bound by treaty as an individual would be in contract.

This is where the "unknown" factor becomes critical. Often international treaties include expansive elastic clauses. For example, article 235 in the Treaty of Rome (1957) permits any action by the European Community "necessary to attain, in the course of the operation of the common market, one of the objectives of the Community and this Treaty has not provided necessary powers." All countries acquiescing to the treaty hand over broad authority with the belief that the subsidiarity principle will limit EU powers. The leaders of the countries knew they were allowing the Community extensive power, but did they know they were agreeing to eventual expansive political power? Maybe; certainly some did. But did the citizens of the member-states? Again, some suspected, but certainly not the majority.

The European Union's desire is to interfere in the market phenomena. It has jurisdiction over prices, wage rates, duties and customs taxes, and any and all physical barriers to trade. The original goal was to facilitate free trade between the member-states. Now it does that and much more, including brokering between the single European market and all other outside markets. The international organization, as government, will decide to order the economic affairs of the member-states in different ways than perhaps an individual member-state may have decided (more likely than not). The motives of the organization are to restrict the supremacy of the member-states to decide their own factors of production, so to speak.

The organization, by its expansive authority, has abrogated to itself the power or at the very least some of the power that would normally be in the dominion of the member-state.

Interference in the market always brings about effects, and it's a slippery slope. When a government, or here a quasi-government, tries to manage an economy, it will constantly be tinkering with the factors of production and trying to fix market failure. There is an upward spiraling cycle of continual fixing and continual abrogation of power to acquire the competence to fix the effects of the previous intervention. (Although this may be too cynical a view, the creation of formal structure such as parliaments and courts of justice may be a move to shield the organization from the supposition that the creation of the organization is a vehicle for a raw power grab.)

And why is it not okay for the organization to interfere and fix things a little bit if it will help "everyone gain"; when it seems to be a Pareto efficient intervention? The fact is that interference is never isolated. Even interference in a

seemingly insignificant way may bring about an effect that is far reaching (Von Mises 1989:37-56). The externalities of interference, even a small bit, are great.

In reality, the member-states are submitting themselves to governmental police power. The objective starts out as an economic goal, and ultimately to accomplish that goal, political power must be achieved. Encroachment upon freedoms, economic or otherwise, is justified and explained by declaring that the governmental plan requires an act, procedure or directive limiting or controlling that particular liberty. Treaties such as Rome (and Maastrict) included some attempt at checks against majoritarian rule or abuse of power. But the process is slow and creeping incrementalism; it goes almost unnoticed. For example, now that the economic objectives of the EU have been "achieved," under Maastrict, the political goals are to be tackled.

B. Loss of Identity

Joining an international organization necessarily means breaking down national identity. The individuality of the member-state must diminish. Besides the European Union one can look at Mexico and Canada under NAFTA, or the United Nations or the World Bank in LDCs. Nations don't exist in a vacuum. They aren't dependent or independent. Countries necessarily influence one another. People and nations are different. In a natural state of freedom they will inevitably be unequal.

European Union supporters say that the Union is opening trade by removing internal physical barriers. But, by smashing the smaller markets and setting up Community-wide external barriers, the European single market reduces the choices available to foreign investors. If the market is essentially the same in Italy as in Belgium, it doesn't matter a great deal (outside of local tax and zoning policies - which can't be far in the future on the Community's agenda) where a company establishes. Now the feasibility of any given project is about the same anywhere in the market, give or take a few local factors, whereas before it may have worked better or worse in fourteen of the fifteen other markets. This effectively removes the desire to create and develop new ideas if they don't work in the single marketplace.

One must question the effect of an international organization on foreign investment. The effects of an international organization are far greater than the effects of a single firm. The creation of a single market by the international organization is a monopoly that will place a drag on the marketplace. The analogy of the firm breaks down here as well. Using the General Motors/Fisher Body example, it is true that General Motors will calculate the transactions costs along with the profit or loss of either building the auto bodies itself, or contracting production out to Fisher. But, what if General Motors is the only carmaker on the continent? It will have incredible power over Fisher. Will Fisher have a meaningful choice over the terms of the agreement with General Motors? Probably not. General Motors will say to Fisher, "You must produce this particular way and we will pay you this much (profit). Take it or leave it, otherwise we will produce our own auto bodies and you will not have a customer." And, of course, the offer will benefit General Motors better than if they built the bodies in house, or else they wouldn't offer Fisher a contract at all. How is this any different from an international organization that has a monopoly in a particular geographic region?

Does the Netherlands have the ability to join NAFTA? No. It must join the European Union. There is no meaningful choice; there is no meaningful "portfolio" of possible international organizations to join. Even if a group of nations decides to design a competing international organization, will it be able to survive a single, stronger competitor? Probably not. (For example look at the European Free Trade Association's history).

An international organization seeks to disperse the factors of production throughout the state. Instead of each member-state bidding for factors of production, creating diverse transactions costs across the territory~ the greatest element of transactions costs becomes the cost of meeting the single international organization's regulations. At the same time you are creating a big market, you are smashing lots of little markets, and substitution is limited to a great extent. These are implications of an anti-trust situation.

For countries depending heavily on the export of a single product (marmalade from England, beer from Germany, pasta from Italy), supra-national "governmental" control simply does not work. These countries are now barred from having a comparative advantage over other member-states in the export of their particular product. The organization steps in and requires, for example, that labeling is consistent from state to state. This reduces competition because the international organization, justifying its intervention for "the good of all the member-states," removes at least part of the economic calculation. If the factors of production are roughly equivalent anywhere within the territory of the organization then fewer innovations will come to reality.

When the international organization abolishes all the smaller markets we say it is good - we reduce trade barriers. But, at the same time, we are creating a huge cartel. "A single market is just a pretend market - just like kids play school."(Von Mises 1989:33). Protectionism in the international market works the same as in a domestic market. The government institutes an external tariff which has the effect of raising the price of a commodity within the market above that which is in the free marketplace outside the government's territory. Because of that, producers inside the market can form cartels. The existence of cartels gives the government (here the international organization) a reason to interfere and pass directives to stop the cartel. The very environment that the government creates, justifies its intervention and protectionism.

If the organization did not start the vicious cycle, and had let the market take its course, the encroaching governmental control would not be necessary. In the long run, it is the citizens of the member states who pay the price. First, they lose the ability to determine what they want to produce and at what price in order to make a profit in the market. Second, the single market places a single external barrier to the whole market, setting up an environment for internal cartels, driving internal prices higher and justifying more control. Third, because the governmental (international organization) body has an objective of consistency over the entire market, meaningful substitution is reduced, also driving up prices. Essentially the member-states become so similar to one another that their identity begins to decline.

Earlier we raised the question of how an international organization loses customers. The answer is that it almost never does. How does a member state ever back out or choose another international organization? The member-state is bound by the treaty and will only be allowed out with the permission of the other member-states or by conflict. Empires do not usually give up pieces of their territory or domain easily. A firm, on the other hand, can buy itself out of its contracts.

What does a nation look for when it designs and uses international organizations? More efficient trade relations with other countries, wealth thorough the sale of products and services, employment for its citizens, in essence it is looking for a larger piece of the economic pie. I'm not so sure that's what even, country gets. The essential question becomes, whether a nation is viewed as a market or a firm, who will give better service at a lower cost? For some countries, using the international organization will give it a bigger gain at a lower cost. For some countries, joining the international organization will cost it a lot but will save it from being eclipsed altogether. True, the cost of joining will not be as high as the possible losses of not joining. But, when there is no meaningful choice, and the member-state must still go into decline by joining, is the state behaving like the firm? A firm would sell off its assets first, and close down before it sold itself into slavery. A firm can throw off its shackles but a nation is bound.

II. The Integration Curve

If we apply a "Lafferian" type of analysis to Trachtman's Net Gains formula, we can come up with what I will call the "integration curve." (Wanniski 1978). States have a choice (meaningful or not) as to how much they would like to integrate with other countries into a bilateral or multilateral supranational organization (at the very least, treaty). Integration can be either zero, where a state may totally isolate itself and retain full sovereignty over what it produces in both its money economy and political structure, or it can be at 100, where the state completely surrenders its economy and political structure to the international organization and ceases to be a unique "sovereign" nation. Of course, the cultural identity of the people remains, though as the region integrates into the larger entity the particular characteristics will necessarily be watered-down and traditions may change or end.

If a country decides not to integrate at all, erects huge trade barriers, and retains its own, non-exchangeable currency, disallows movement over its borders, then it actually may lose production ability. By becoming a completely closed economy, it provides disincentives for innovation, as the entrepreneur, inventor, or businessperson will not be allowed to capture his own gains. It is likely that the government will have to nationalize its industry (or capture it through regulatory means). The government wedge will grow because in order to "effectively" distribute the goods and services within the country it will require control over the capital. When government owns capital, obviously, citizens have lost all incentive to produce, hence a net loss to the country (in money and intellectual). A government cannot mitigate market failure with out also eliminating opportunity.

On the other end of the continuum, if a nation fully integrates with another country or into an international union, it abdicates its autonomy and allows the supra-national organization to fully dominate its economy and political structure. The state no longer holds out a unique location for individuals or firms to locate within its borders. Choice of law or forum shopping becomes irrelevant because that particular market is eclipsed. Comparative advantage is lost.

At this point on the continuum, the possibility of coercion may become reality. If the tanks are sitting in the streets in front of the presidential palace or at the doors of the nation's parliament, a state will likely "relinquish" control, and the other nation, or "union" will appropriate the country's sovereignty. If the entity forcing the seizure is totalitarian in nature (presuming the takeover is not an internal rebellion or coup d'etat) the occupying government may "rape" the factors of production and capture the gains for itself, driving the former nation into the loss territory.

Somewhere along the continuum, between zero and 100, is a point where there is an optimum trade off. This is the perfect point at which the nation has integrated just enough to realize maximum or most efficient net gain. This is where Trachtman's formula sits on the curve. His formula is: NG=TG(TL+TC) (Trachtman 1997:29), where

NG = net gains,
TG = transactions gains,
TL = transactions losses; and
TC = transactions costs.

The graph contains no numbers other than zero and 100 because the optimum point, what I will call MNG (maximum net gain) is a variable number. For symmetrical graphing purposes I will place the point (and line) at approximately 50, though it may or may not be placed there by an individual state. (Interestingly enough, this is exactly the point at which, in European Union terms, *competenz-competenz* or the subsidiarity principle kicks in.) The position of MNG will be different for each country. Some countries may receive maximum net gain when they integrate at 20%; others may max out at 80%. This is where public choice may have a great impact, as the electorate will have to decide what they are willing to give up in order to receive maximum gains from the integration.

There may be several reasons for this. One may be that a nation has nonmonetary reasons to limit its trade with a particular country or set of countries. For example, the United States Congress is currently considering legislation to impose trade sanctions, and limit exchange, with nations that discriminate or persecute on religious grounds or allow patterns of abuse because individual faith. The U.S. has decided it retains a supra-monetary interest in the guarantee of religious freedom. In view of this, one must also look at the role philosophy takes in the decision process.

Another reason may be the individual self-preservation of the state leadership who plans the economy. As Hayek (1945) said, "the real planning issue is not whether individuals should plan their affairs, but rather who should plan their affairs. The question is whether a politician is making decisions based on his own preference as opposed to the preferences of the public, or in the 'public interest." Of course, it is impossible for the politician to divorce himself from his own affairs. As Epstein (1997)(and others) has said, society "tends to place the power of decision in the hands of the people who lack the necessary information and whose own self-interest leads them to use the information that they do have in socially destructive ways." However, a politician's choice is not immutable to the state. New leadership may be elected, or the governor(s) may be overruled or die. The electorate may also respond to the constraint by pushing through new legislation to find a substitute or alternative method of claiming or realizing the gain. Or, the individuals in the electorate will find a way to pursue the profit themselves. This gain, however, may not be accrued to the entire state and move it to MNG.

Naturally, a government will want to retain as much competence as it can. If it can't locate at MNG it would prefer to locate at B, rather than D. Sometimes, however, especially when negotiating in multi-lateral situations, the state does not have a great deal of choice and may find itself necessarily locating a D. For example, member-states that signed the Treaty of Rome (1957) which created the European Community have since found themselves moving along the continuum toward 100. AS the EU issues directives, nations may find themselves in the position of surrendering a competence that they didn't expect to. The product labeling cases, again, are a good example. Great Britain wanted to retain its own marmalade standard, Germany its beer standard, Italy its pasta standard. After Maastricht (1992), where it was declared that economic objectives are near completion, the EU is now in the position to encroach on political territory, likely beyond the NING point on each country's integration curve.

The nation's choice of where to locate on the curve is in some sense path-dependent. A nation will look at the order of the other nations who integrate before it, their experiences with and information regarding whether than can trust the entity (or member-states of the entity) that they are deciding to join. In fact, this is a transaction cost. If the unknown harms are dismissed the integration will become more attractive. As nations become repeat players in the international market, their reputations become known and transactions costs decline. Of course expectations based on reputation can be exploited if a huge gain can be captures, and the nation may become like "an ox going to the slaughter ... little knowing it will cost him his life." (Proverbs 7:21-23).

If we create a graph for each country in an international organization, and then stack them (3dimensionally), we can slide an imaginary rod through them, or use a statistical analysis, to find the market-clearing point of least dispersion from each country's MNG. That is the point at which the international organization should incorporate. This point may or may not be Pareto-efficient, where the allocation of competences is the most efficient and any other arrangement would reduce the welfare and gain of the member states. Or, this point may be Kaldor-Hicks efficient (also known as potential Pareto efficient or PPE) where one or more nations is not at their MNG point but could be (but not required to be) compensated by those who are at their MNG point, while still retaining some net gain. In the international treaty situation, the parties could, theoretically, vary the terms of the treaty to achieve this efficiency and require the compensation.

The question that remains is how to get rid of 10s that have out-lived their usefulness. In order to retain power, those who have incentive to realize personal gain at the helm or in the ranks of the organization will perhaps "create problems" or exaggerate gains to the member-states.

We can apply the laws of physics to this problem. Newton's first law is the law of inertia. When a thing (here the I0) is moving it does nothing of itself to change its motion. It will go on moving forever in exactly the same direction and at the same speed unless some other force stops it, turns it or makes it go slower or faster. (The other half of this law is that when a thing is at rest it will remain at rest until something moves upon it.) The second law to be transported here is that the force required to stop (or set) a body already in motion is greater, the greater the mass. As international organizations grow, the force needed to stop them will necessarily need to be more and more powerful. For example, only a very strong nation (such as the United States) will have enough power to stop (or sustain) the United Nations. Of course, action and reaction are equal and opposite (Newton's third law) so the I0 will react to protect itself with as much force as the country or entity trying to dismantle it.

Power tends to concentrate and this is true of IO’s as well as anything. Since the power for the I0is drawn from the member states, it follows that they lose that power. The I0 will tend to suck up more and more power as it "deems" it necessary, just like one of those incredible growing sponge toys. Note also that power takes in an element of time, and over time the IO's power is increased. Therefore, the force required to stop it becomes greater and greater over time. Instead of Trachtman's "prism" effect (1997:15), I see more of a suction effect. The welfare state also has an incredible sucking effect. It may be a reactive force (as it has shown itself to be over history) with enough strength to pull down the I0, or empire, as discussed in part one. Although we are continually moving toward "one big one," the gravitational effect of welfare will put the I0 in decline.

Conclusion

This comment looked at some of the questions raised by Professor Trachtman's application of the theory of the firm to international organizations. In part one we looked at whether an international organization behaves like a firm or like a market (it behaves like both and neither), commodification of state sovereignty and implications of meaningful choice, and the effect of integration into a single market. Part II attempted to explain how much a nation chooses to integrate depending on the gains to be achieved with an integration curve, readdressed some of the problems with integration looked at in part I, and finally, imported rules of physics as to the momentum force of international organization.

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International Economic Organization

International law has developed to serve the needs of the governments of "states" -- territorially-based collections of populations, united in subjection to their "sovereign" rulers. Other international organizations have long existed - the Virginia Company, the East India Company, and the Royal African Company provide early and influential examples - but without much formal recognition in developing international legal structures. Now their day has come, and eager academics seek to apply the insights of institutional economics, law and economics and industrial organization to international law, to demarcate new lines of competence between states and other international organizations.

The basic premise of most such studies has been the so-called "Coase theorem", which concentrates on "transaction costs" to explain (and evaluate) most structures in society. Everything should be organized to minimize transaction costs. That Coase never said or wrote any such thing does not diminish the influence of this norm, particularly

among lawyers. Applied to international law by Joel Trachtman, this becomes an assertion that international institutions exist to maximize net gains "from engaging in the transaction in power" minus transaction costs. Any constraint imposed on a state, according to this definition, is a "transaction in power", which states undertake to make gains in other areas.

Transactions in Power

States have power. A government's power or control over people and territory is what makes states states. States relinquish this grudgingly, and if they relinquish too much, cease to be "states" in the international sense, becoming mere administrative units of larger federations, like the states of the American union. Power can be spent to buy cooperation from other states, or retained to force cooperation by threats or coercion. When states retain power, a "state of nature" can be said to exist. When they trade power, new law will be created.

Thus the market in power sets the frontiers of municipal law, diminishing states to empower other organizations. States allow this for the "gains" such trades bring in wealth or happiness, but always at the cost of power, which must be displaced, by definition, for a "transaction in power" to have taken place. When States cede jurisdiction to gain peace or profit, they exit the "market" of autonomous individual powers, and enter the "firm" of international organization.

Coase-based theories ascribe the choice between "market" and "firm"-like organization to their relative transaction costs. States will simply trade directly for what they want when it is easy to do so. When it is not ' they often prefer to create non-state organizations to coordinate their transactions. The "best" arrangement, in the eyes of "economically" minded lawyers such as Joel Trachtman, will be the method that allows people to obtain the maximum of what they want, with the minimum transaction costs. Large gains may justify large transaction costs. Small gains maybe acceptable if transaction costs are negligible. But power will only be sold for some valuable benefit, or to cheapen transaction costs.

The Purpose of Government

Applying the "Coase" theorem to states in this way reveals the enormous difference between governments and most firms. Markets in goods exchanged for profit may realize absolute gains by minimizing transaction costs. "Markets" in power trade sovereignty for peace or protection as often as for commerce or wealth. Some states exist to maximize the wealth of their rulers, but others seek the common good of their citizens, or of a faction, or world justice, or some religious mandate. "Transaction costs" is a very awkward description of what matters in most international transactions -

All states claim to serve the common good of their citizens. Some claim to serve "justice" or the common good of humanity. In neither case does "gain" provide a very helpful description of what is sought, or "transaction costs" accurately capture the difficulties of getting it. In a "republic", for example, (a state actually committed to pursuing of the common good), the primary constitutional question in both external and internal affairs will be how best to identify the common good. The constitution or "firm" established by such states will seek to minimize mistakes. To call these mistakes "transaction costs" would be misleading.

Perhaps one might understand corruption as the "transaction costs" of republican governments. Self-dealing (on this theory) will be present in any structure that seeks justice, and should be minimized. But speaking of "firms" and transaction costs" in such situations only confuses the discussion. This will be true of most "transactions in power". States relinquish power to serve determinate ends, and the main question to be asked when states cede power to international organizations should be whether these ends will be served by the transaction. Does this international organization serve justice better than the state can?

Justice

"Justice" and "the common good" have a resonance in relations between states that the vocabulary of economic theory entirely fails to capture. The comparative-transaction-cost methodology facilitates innovation by viewing institutions as contingent. But this benefit palls when it sacrifices the vocabulary of liberty and justice, which delegitin-Lize bad structures of government much better, with more fidelity to ordinary usage and what issues are really at stake. Economically minded lawyers tend to speak and write of "satisfying" the preferences of all countries (or their citizens), rather than shaping or judging these preferences - the primary purpose of "law" of any kind.

The "Coase" theorem applied to law implies a faulty theory of human values and motivation that

vitiates its usefulness as a heuristic device. All law claims to be just. Systems of power that do not claim to seek justice are not law. Human nature tends to self-justification, and even repressive systems justify themselves to themselves as serving the common good. This makes interest-based conceptions of law inaccurate, unless one defines justice as an "interest" like any other. But in legal systems justice is not an interest like any other. To describe or explain it in this way (even if possible) would be confusing and misleading.

Lawyers apply the theory of the firm to international institutions to promote cooperative solutions to inter-state coordination problems. Creating an international regime that minimizes the friction involved in necessary international transactions would be a valuable achievement. But any such arrangement not founded on justice will be unstable, or undesirable, or both. Some lawyers may feel, with John Rawls, that justice is found best by avoiding substantive morality, which fosters the transaction cost of self-righteousness. But "efficiency" is not a standard to rally around either. Laws in general and international law in particular depend on justice for their binding force. Economic tactics will never produce agreement about the issues that really matter in international law.

International Organization

Perhaps this is all really just an argument about how best to constitute the international system to serve the purposes of international cooperation -whatever they are. For those who like justice, a lawyer-economist might say, we can talk about how best to find justice. For those who like trade, we can talk about maximizing trade. Those who like their own private unfettered world dominion can evaluate international organizations according to how these serve that end - All governments (or the individuals who control them) have interests, and international organizations serve those interests, or they would not exist.

Legal theorists, in such a scheme, write either to describe this situation, or at best to point out how it could run more smoothly. The theory of the firm might be useful here to show how two states could coordinate their disparate interests to achieve mutually satisfactory results, with a minimum of transaction costs. The trouble is that states do not necessarily aim at such cooperation, nor should they. States often prefer to impose their will on others. States do not only trade power for interest. They also use power for domination. Force is just or unjust, lawful or unlawful, according to the ends it serves. International organizations do and should exist, not simply to facilitate the interests of states, but also to promote certain ends over others. Efficiency is usually a secondary interest.

Some states originated as profit-seeking shareholding corporations. Virginia and Massachusetts still retain traces of their earliest corporate charters in institutions that provided a model for many Western democracies. The analogy between states and corporations is not absurd**.** States that choose to cooperate through the mediation of international organizations may look a bit like corporations that merge into a single holding company. But this does not mean that international institutions should exist only when their agency costs are smaller than the alternative transaction costs of the same allocation through the market, as Coase might have it. International organizations exist to prevent power transactions, and to impose goals that frustrate normal "markets" - not make them more efficient.

The Market for Power

International organizations supersede states, in pursuit of certain goals. They emerge not from a "market for power" but from a desire for justice. States control each other's excesses by deferring to international institutions. Some international relationships could be described in Coasian vocabulary. War incurs high transaction costs. A just world order would be a valuable transaction gain, possibly outweighed by the transaction costs of imposing or achieving justice. Simply to speak or to write in these terms illustrates the vacuity of doing so.

International organizations concerned with commerce may fit the "Coasian" model better, because they really are economic, and concerned with self-interest in the narrowest, monetarily quantifiable sense that most economic models necessarily assume. International economic integration may follow the theory of the firm in ways that would permit the application (in some narrow circumstances) of economic formulas computing the net gains from transactions, after subtracting the transaction costs.

The market for power is not a market in goods or interests, but a market in moral perceptions, where states must justify their use of power to themselves, and sometimes to others. Governments that relinquish power, do so either because they are forced to (in which case they never fully enjoyed power at all) or because they are convinced that some interest outside the state justifies weakening the state to serve a greater good. Speaking in terms of the market undermines the moral constraints that sometimes lead to the (rare) abdications of power that make international institutions possible at all.

Conclusion

Joel Trachtman rightly observes that the best laboratories for analyzing legal institutions will always be comparative and historical. Everything else is pure speculation. Those who propose change must look to what has worked before, in comparable situations. The greatest difficulty lies in identifying what is "comparable", and the proper standards of evaluation. The theory of the firm and other "Coasian" constructs mislead as a basis for comparison, because their circumstances are so different from those of states. They also fail as standards of evaluation, because they rest on economic premises that contravene the basic purposes of law.

Law schools have seen a great vogue for importing techniques from other social science disciplines. This reflects a widespread loss of faith in the integrity of law as its own discipline, the study of justice. Unfortunately, techniques from other disciplines usually, carry their own ethos with them. The values of the business world are overwhelmingly self-interested and generally mercenary. These may be appropriate in the economic sphere, but they are highly pernicious to community and justice. The vocabulary lawyers use colors the results that they can and will achieve. "Coasian" terms are not appropriate to principled legal discourse.

International law, more than most law, depends on moral weight for compliance, particularly when powerful interests are at stake. The language of institutional economics, law and economics and industrial organization, which carry no such weight, provide a feeble basis for demarcating new lines of competence between states and other international organizations. Their use puts off the day when better institutions will facilitate transactions among well-intentioned states.

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