Patterns of Regional Integration in Europe and North America: Insights from Incomplete Contracting Theory

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I. Introduction

The international system has profoundly changed since the end of World War II. The number of states has multiplied more than fourfold while empires have receded into the past. From one vantage point this is the heyday of a system of sovereign states. The system is structurally anarchic.[1]

But closer inspection reveals a more complex reality in which states sometimes surrender considerable rights to other states or international organizations. Taking sovereign rights as a bundle of rights it becomes apparent that governments do not always possess this complete bundle, but enter into exchanges of rights with other actors. Between the two extremes of empire (which completely denies sovereignty to the subservient polity), and anarchy (which sees states as fully in control of their sovereign rights and denies any higher locus of authority), there are multiple intermediate arrangements.[2]

[1] Kenneth Waltz, *Theory of International Politics* (Reading, MA: Addison Wesley, 1979).
[2] David A Lake, 'Anarchy, Hierarchy, and the Variety of International Relations', *International Organization,* (Vol. 50, No.1, 1996), pp. 1-33. David Lake, *Entangling Relations: American Foreign Policy in Its Century*, (Princeton, N.J.: Princeton University Press, 1999), Stephen Krasner, *Sovereignty: Organized Hypocrisy*, (Princeton, N.J.: Princeton University Press, 1999).

Institutional economics, particularly incomplete contracting theory, can shed light on the nature and the consequences of such hybrid sovereignty arrangements.[3] Incomplete contracting theory distinguishes between complete contracts, which are agreements that aim to cover every contingency, and incomplete contracts, which leave terms to be specified in the future. As economists and political scientists have noted, institutions arise when actors cannot independently reach cooperative arrangements.[4]

I do not assert that institutions determine preferences. Indeed, the initial choice for particular institutional arrangements will greatly hinge on the preferences of the agents involved. Preferences are exogenous to the model. However, institutions, once created, provide opportunities and constraints. Rules induce roles. Consequently, how states choose to exchange sovereign rights (either through complete or incomplete agreements) and how they potentially delegate such rights to third parties, will greatly affect their subsequent pattern of interactions.

This theory has relevance for explaining post-colonial arrangements, overseas basing arrangements, accords on natural resource exploitation, and distinct modes of federalist arrangement. However, in this article I intend to illuminate how initial choices for particular institutions in the formative phases of European and North American integration subsequently influenced regional integration in both geographic areas.

II. From Relational Specific Assets to Incomplete Contracting

Oliver Williamson's well-known analysis posits that the frequency of transactions and the nature of the assets involved determine the level and mode of governance.[5] Specifically, when transactions are frequent and assets are idiosyncratic or "specific," vertical governance or hierarchy will result.[6] Williamson reasons that hierarchical organizations alleviate the hold-up problems generated by relationally-specific exchanges in a manner that can-

[3] For a full articulation of the theory and application to various issue areas, see Alexander Cooley and Hendrik Spruyt, *Contracting Sovereignty: Sovereign Transfers in International Relations,* (Princeton, N.J.: Princeton University Press, 2009).

[4] Robert Keohane, *After Hegemony: Cooperation and Discord in the World Political Economy,* (Princeton N.J.: Princeton University Press, 1984); Thrainn Eggertsson, *Economic Behavior and Institutions,* (New York: Cambridge University Press, 1990).

[5] Oliver Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (New York: Free Press, 1975); Oliver Williamson, *The Economic Institutions of Capitalism* (New York: Free Press, 1985).

[6] Various types of specificity include site-specific investments, physical asset-specificity, human-specificity and dedicated assets. Oliver Williamson, *The Economic Institutions of Capitalism,* (New York: Free Press, 1985), pp. 95-96.

not be guaranteed by comparable independent actors involved in market-based exchanges.

Applications of the Williamsonian model to various aspects of international relations have yielded significant conceptual breakthroughs.[7] Although the Williamsonian theory is powerful, it has also been criticized from a variety of perspectives.[8] Consequently, while Williamson's arguments provide substantial insight, they require some amendment. Institutional economists, inspired by Oliver Hart, have developed an alternate way of thinking about the organizational boundaries of the firm and the processes through which governance arrangements emerge.[9] The Hart model builds upon several insights provided by neoclassical theories of the firm, agency theory, and Williamsonian transaction costs economics, and adds the concepts of incomplete contracting and property rights.

The distinction between complete contracts and incomplete contracts reflects the standard distinctions drawn between neoclassical rationality and bounded rationality. Under neoclassical assumptions of rationality, agents choose the best complete contract that is available. Both parties carefully craft an optimal contract that explicitly specifies the rights and obligations that each party would assume in the relationship.

In addition, a truly "complete" contract would also specify certain provisions in anticipation of the circumstances or contingencies that might arise to alter the terms specified above. Up to a certain point, parties could presumably anticipate the routine events or circumstances that might affect the terms of their initial agreement. These contingencies and potential remedies (i.e. price adjustments, arbitration, etc.) would also be included in the initial contract.

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[7] Jeffrey Frieden, 'International Investment and Colonial Control: A New Interpretation', *International Organization* (Vol. 48, No. 4, 1994), pp. 559-93. Keohane *op cit* focuses less on transaction-specificity and more on how international institutions mitigate transaction costs. See also the work by Beth Yarbrough and Robert M. Yarbrough, *Cooperation and Governance in International Trade: The Strategic Organizational Approach,* (Princeton, N.J.: Princeton University Press, 1992); Katja Weber, *Hierarchy Amidst Anarchy: Transaction Costs and Institutional Choice,* (Albany, N.Y: State University of New York Press, 2000); Katja Weber and Mark Hallerberg, 'Explaining Variation in Institutional Integration in the European Union: Why Firms may Prefer European Solutions', *Journal of European Policy,* (Vol. 8, No. 2, 2001), pp. 171-191.

[8] For a critical view of Williamsonian theory from a business and economic perspective, see N.M Kay, 'Markets, False Hierarchies, and the Evolution of the Modern Corporation', *Journal of Economic Behavior and Organization* (Vol. 17, No. 3, 1995) pp. 315-333; Gregory Dow, 'The Function of Authority in Transaction Costs Economics', *Journal of Economic Behavior and Organization* (Vol. 8, No. 1, 1987), pp. 13-38.

[9] Hart, Oliver, *Firms, Contracts and Financial Structure* (New York: Oxford University Press, 1995); Oliver Hart and John Moore, 'Property Rights and the Nature of the Firm', *Journal of Political Economy* (Vol. 98, No. 6, 1990), pp. 1119-11158; Sanford Grossman and Oliver Hart, 'The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration', *Journal of Political Economy* (Vol. 94, No. 4, 1986), pp. 691-719.

By contrast, the incomplete contracting approach assumes that in long-term relationships, the imperfections of the market place will force the parties to renegotiate many aspects of the initial contract. The process of long-term contracting is itself costly and fraught with different types of transaction costs that actors cannot foresee or specify in advance.[10] Contracting environments are characterized by a great deal of uncertainty. In a changing and unpredictable world, it is difficult for parties to think of the types of unforeseen contingencies that might arise in the future. Even if the parties can successfully negotiate a contract, they must do so in a manner that is readily verifiable to an outside observer or a third-party enforcer such as a court or external arbitrator. Thus, the resulting "incomplete contract" will provide the starting point but not necessarily the long-term specifics for the relationship between two firms.

A) Varieties of Property Rights

Although we often think about property rights as embodying exclusive ownership arrangements, the Hart model unbundles the various property rights that govern the ownership of assets. A key insight of the property rights approach is distinguishing control rights and use rights.[11] Control rights allocate the power to make decisions on how to use an asset, such as the ability to sell, transfer, or even destroy an asset. Use rights, on the other hand, specify the rights to receive the benefits and to incur the costs from the deployment of an asset.[12]

In addition one can distinguish residual rights of control. These rights convey the privilege to use the asset in any manner beyond what is specified in the initial contract. Residual rights of control are critical because they alter the bargaining power of parties in the subsequent renegotiations. When contracts are incomplete, bargaining leverage will be static as the contract will fully specify the terms up front.[13] With incomplete contracting, the holder of residual rights, however, will have the latitude and thus the bargaining leverage to change the terms of the bargain during the later renegotiation stages. [14]

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[10] Ibid., pp. 24-27.

[11] For a useful discussion, see Maxim Boycko, Andrei Shleiffer and Robert Vishny, *Privatizing Russia*, (Cambridge, M.A.: MIT Press, 1995).

[12] For a discussion see Alexander Cooley, 'Imperial Wreckage: Property Rights, Sovereignty and Security in the Post-Soviet Space', *International Security* (Vol. 26, No. 3, 2000/01), pp. 100-127.

[13] See the General Motors (GM) - Fisher auto body case. Hart, op. cit. in note 9, pp. 6-8; and Benjamin Klein, 'Vertical Integration as Organizational Ownership: The Fisher Body-General Motors Relationship Revisited', *Journal of Law, Economics, and Organization* (Vol. 4, No. 1, 1998), pp. 199-213.

[14] Our approach shares much in common with Barbara Koremenos, Charles Lipson, and Duncan Snidal, 'The Rational Design of International Institutions', *International Organization* (Vol. 55, No. 4, 2001), p.76 who see institutions as negotiated arrangements.

III. Towards a Causal Model of Governance Structures

Formal integration in the realm of international politics (empire) is often not possible given the long-term uncertainty of the international system, international norms against hierarchy or occupation, and political concerns over ceding sovereignty. Incomplete contracts allow intermediate institutional arrangements to emerge that are politically preferable to allocating exclusive sovereignty over an asset or function to a single political actor.

Following our discussion of property rights and contracting, sovereignty rights can be divided into "control rights," or formal ownership rights (as for example rights over natural resources), and "use rights," the right to derive the benefits and incur the costs from using a given asset. States can retain both rights or can divide them, for example, by granting another state (or multinational company) the right to exploit some of its natural resources. Additionally, states can transfer rights to a third party or supranational body.[15]

Of key importance will be the decision who gets the residual rights of control over certain sovereign functions. Residual rights in this domain mean the privilege to expropriate additional rents and make use of new functions or rights that emerge during subsequent stages of interaction, and that were previously unforeseen. For example, if a country (A) grants residual rights of control over a territory to another state (B), say for the exploitation of oil resources, then additional rents that might come from this exploitation, or new uses (say the use of that territory as an airfield) and which were not foreseen in the original contract would flow to the state with the residual rights (B).

Residual rights of control would also give the holder of such rights the privilege to determine further allocation of rights. That is, the holder of residual rights will determine who had particular rights and privileges in legal domains that only emerged in subsequent stages, what legal doctrine regards as "kompetenz, kompetenz."

A) Incomplete Contracting as a Dependent Variable: The Choice of Governance structures

Admittedly, the factors that influence the initial choices of political elites, that is, the factors that determine preferences, are largely exogenous

[15]Walter Mattli, *The Logic of Regional Integration*, (New York: Cambridge University Press, 1999). Furthermore, states are increasingly sharing sovereignty by agreeing to binding arbitration over commercial and/or even border disputes. See Beth Simmons, 'Capacity, Commitment, and Compliance: International Institutions and Territorial Disputes', *Journal of Conflict Resolution* (Vol. 46, No. 6, 2002), pp. 829-56.

to the model. Whether states wish to pursue hierarchy, grant independence to a colony, or agree to some hybrid governance form such as regional integration, will depend on a myriad of contextual factors. Preferences will be influenced by changes in geostrategy; previous patterns of interaction; and even technological transformations. In tracing preferences we inevitably must rely on inductive observations of the historical record, and use structured focused comparison and process tracing to substantiate our findings.[16] This does not mean we need to turn our back on deductive theorizing. An analytic narrative approach can combine theoretical insight and historical contextualization[17]

We expect that political elites will evaluate the relative merits of different governance arrangements. However, the relative distribution of power will set material constraints on what is feasible. For example, if we are dealing with a declining great power and ascending nationalist movement, the symmetry of power will make it very costly to impose a colonial solution. The French attempt to hold Algeria was prohibitively more costly than Britain's desire to hold on to Diego Garcia.

Furthermore, the creation of a particular governance structure will be influenced by the ability of the respective parties to commit. Given that incomplete contracts are subject to future renegotiations all parties will be concerned with the subsequent distribution of rights and assets (at t+1). Consequently, contracting actors will face credibility problems given the concerns about bargaining leverage and the forward momentum of the agreement.

The credibility problems arise particularly for the actor who holds the residual rights of control and they are accentuated if power asymmetries are stark. With regional integration agreements the smaller states will be concerned about their ability to influence more powerful economies in subsequent rounds of negotiations. Small states will be reluctant to enter into incomplete contracts unless the more powerful states credibly commit to the agreement by tying their hands and by transferring residual rights to a third party.

[16] Alexander L. George, 'Case Studies and Theory Development: The Method of Structured, Focused Comparison', In Paul Gordon Lauren (ed.), *Diplomacy: New Approaches in History, Theory, and Policy* (New York: Free Press, 1979).
[17] Bates, Robert, *et. al.*, *Analytic Narratives (*Princeton: Princeton University Press, 1998), p. 10.

B) Incomplete Contracting as an Independent Variable: Downstream Consequences of Hybrid Sovereignty Arrangements

An incomplete contracting perspective can generate several deductive propositions regarding the consequences of complete and incomplete contracting.

Table 1 General Propositions

Bargaining Leverage among Contracting States

B1: Upon renegotiation of a bilateral incomplete contract at t+1, the holders of the residual rights of control will have leverage. They will engage in hard bargaining so as to alter the terms of the initial contract in order to appropriate the ex post surplus.

The Momentum for Sovereign Transfers

M1. In both bilateral and multilateral settings, renegotiation of an incomplete contract at t+1 will more explicitly delineate, specify and codify the governance arrangements of an asset or function. All else being equal, incomplete contracts tend to completeness.

M2: Incomplete contracts will be maintained as long as: a). joint supply gains are institutionalized (sometimes through issue linkage); and/or b). states lack alternate contracting partners.

Credibility of Commitment Problems

C1: Incomplete contracts will be easier to conclude when the parties can credibly commitment through institutional or reputational mechanisms.

C2: The burden of credible commitment falls particularly on the holder of residual rights of control

1. Bargaining leverage

Incomplete contracts generate potential rents and surpluses that can be appropriated by actors who hold the residual rights of control (B1). International actors who own the residual rights of control will use the full extent of the bargaining power afforded to them. In bilateral settings, such as decolonization negotiations or military basing agreements, this bargaining leverage may even be more important than the relative power capabilities of

the contracting parties. Thus, even though a country may possess significant military capabilities, it will still be at a disadvantage in negotiations if it lacks these residual rights. This dynamic has characterized base negotiations between the United States and many of its considerably weaker military base hosts.[18] Of course power asymmetries are not insignificant. However, in complete contracts power asymmetries are dealt with by careful specification of the actual terms of the agreement. With incomplete contracts, the holder of residual rights will have the bargaining advantage even if the distribution of power does not change over time. Thus, the ex post bargaining power that flows to the holder of residual rights has an independent and significant effect on the contours of the renegotiated settlement.

The transfer of residual rights to another state or to a supranational authority has important implications for how hybrid sovereignty arrangements will evolve. For example, with incomplete contracts, supranational bodies with residual rights of control will further attempt to codify and institutionalize these rights. Simon Hix thus explains how the European Parliament exercised its "discretion through rule-interpretation" to shape the incomplete contract of the constitutional negotiations, thereby managing to delineate and increase its own power vis-à-vis member states, well beyond what many of the states originally intended.19 In other words, with the transfer of residual rights to a third party that entity acquires enhanced bargaining leverage as time progresses.

2. The Momentum for Sovereign Transfers

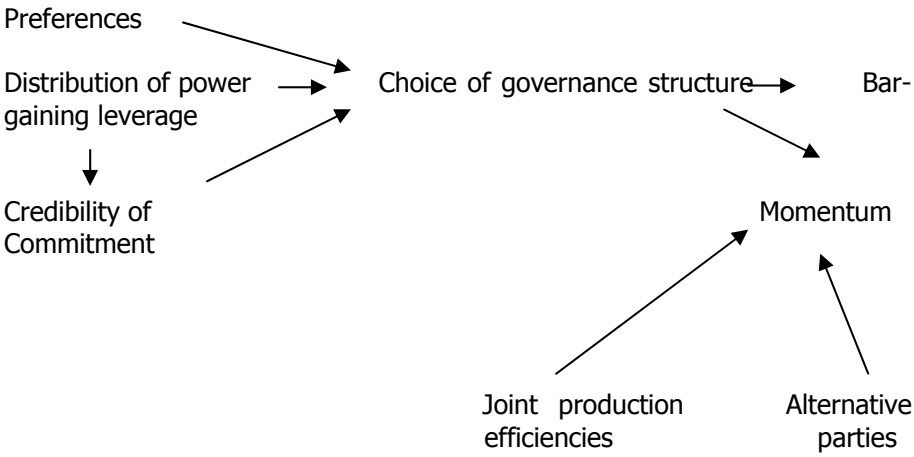
When and under what circumstances do incomplete contracts remain stable and when do they tend to become complete contracts (M1 and M2)? All else being equal, contracts that are incomplete are usually renegotiated and specified. With learning and new information the previously incomplete provisions will become increasingly more specified (or complete).

This natural momentum towards completeness will be enhanced, and thus hybrid sovereignty arrangements will unravel, if alternative contracting parties become available. The entrance of alternative potential partners will allow the owner of residual rights to operate in a competitive market with multiple "consumers." The residual rights holder will increase its demands and try to gain exclusive sovereignty over the governance of the asset or function. For example, prior to the expulsion of the United States from its military base in Uzbekistan in July 2005, Russia signaled that it was willing to enter into a security relationship that would be less intrusive in the internal affairs of Uzbekistan. Consequently Uzbekistan, in possession of

[18] Alexander Cooley, *Base Politics,* (Ithaca, N.Y.: Cornell University Press, 2008).
[19] Simon Hix, 'Constitutional Agenda-Setting through Discretion in Rule-Interpretation: Why the European Parliament Won at Amsterdam', *British Journal of Political Science* (Vol. 32, No. 2, 2002), pp. 259-280.

residual rights of control over the base, switched from the United States to Russia.[20] Conversely, a lack of alternate contracting partners for the residual rights owner will make continuation of the incomplete contract more likely and lead to the institutionalization of joint gains under hybrid sovereignty arrangements. In sum, preferences, power distributions and ability to commit influence institutional choices. These choices subsequently affect bargaining leverage and the momentum towards further integration or not.[21]

Figure 1. Causal Dynamics in the Creation of Hybrid Sovereignty and its Downstream Consequences



IV. A Priori Expectations and Varieties of Regional Integration

The nature of the contract and the degree of delegation to a new institutional site will first of all depend on the relative power of the contracting parties. Governments of weak states will be concerned with the exercise of asymmetric power by the more powerful members. But all states will also be concerned that regional institutions might acquire more residual rights as the integration process proceeds. Thus, member states such as Britain are now also concerned with the supranational institutions within the EU deci-

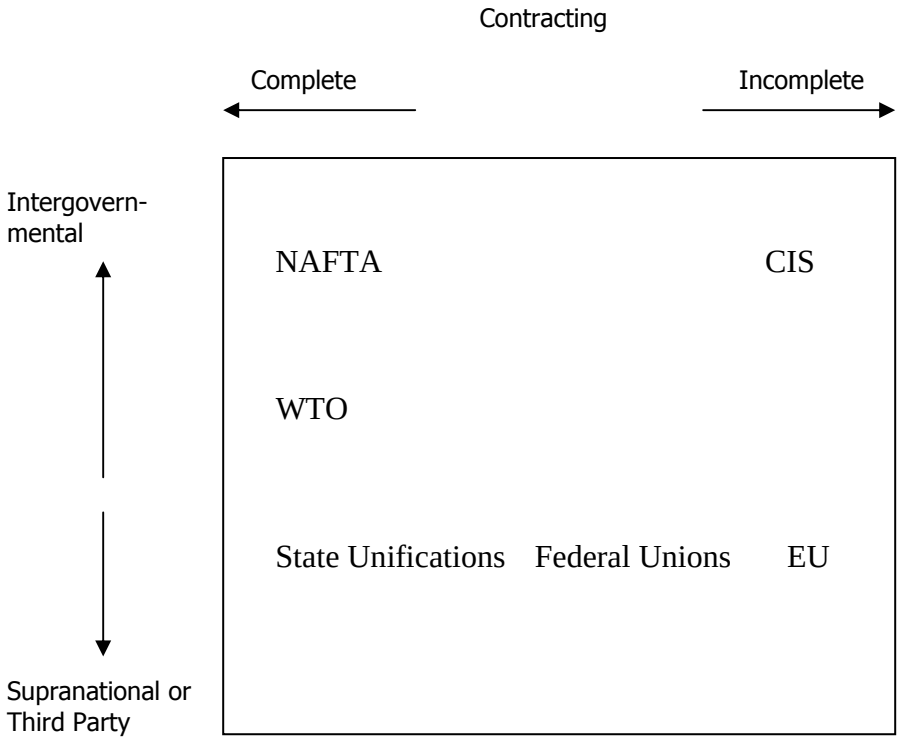
[20] See Alexander Cooley, 'Base Politics', *Foreign Affairs* (Vol. 84, No. 6, 2005), pp. 79-92 and The New York Times, July 31, 2005.

[21] It is important to realize that our analysis focuses on "real" contracts. Parties sign these agreements because they expect that they will govern their relations for some time in the future. These agreements proscribe and authorize particular behavior, and are not merely "window dressing." In this sense they might be distinguished from "pseudo-contracts." My thanks to Robert Keohane for emphasizing this point.

sion making process that have residual rights of control and retain the potential for a subsequent unsanctioned expansion in jurisdictional authority.

Power asymmetries and concerns about expansionist international institutions, thus influence actors' calculations in deciding whether regional arrangements should take on a supranational or inter-governmental character and whether the agreement should take the form of a complete or an incomplete contract. In bilateral settings, this is relatively clear. The holder of residual rights of control, usually the host country, will have bargaining leverage over the home (or investing) country. With regional agreements, sovereign states initially are the holders of residual rights. They have to decide whether to relinquish residual rights of control over various functions or issue areas (i.e., create a supranational entity) or whether to retain their residual rights (as in an inter-governmental agreement). They also have to decide whether they wish to leave the contract relatively open-ended, and thus subject to ex-post contracting, or write—as close as possible—a complete contract ex ante, that is, a fully-specified contract at the time of signing.

Figure 2. Modalities of Integration



There are thus four sets of possible outcomes for states that pursue regional economic integration. With inter-governmental complete contracts, states retain residual rights, and the contract is fully specified ex ante. This process describes regional agreements such as NAFTA. An inter-governmental incomplete contract in bilateral cases confers leverage to the holder of residual rights. In cases of regional integration with incomplete contracting, bargaining leverage might flow to the more powerful economies. Post-colonial economic blocs that are established and dominated by the former metropole power would fit this cell. For instance, this would describe Russian economic dominance of the Commonwealth of Independent States (CIS).[22] In supranational complete contracting, the states confer residual rights to a new institutional site or international organization, but fully specify the terms of the contract ex ante, with little further development beyond the original terms. The WTO, with its bounded authority over trade issues and regularly used dispute-settlement mechanism does not amount to a full transfer to a third party but goes further than the ad-hoc arbitration that typifies the NAFTA agreement.[23] Although the WTO dispute settlement mechanism is partially based on the earlier NAFTA procedures, it differs in that the WTO has a standing permanent organ--the Appellate Body--whereas NAFTA arbitration panels remain ad-hoc.[24] Extending even beyond that point, parties may relinquish their independent status and agree to form a new unit with a distinct authority structure, as occurs, for example, when previously independent units merge to form a new state or strong federal union. They may sign a complete contract, fully allocating authority to the new entity. Finally, with incomplete contracting and the creation of supranational institutions, the contract develops dynamically over time with institutional reconfiguration at the supranational level. Which of these is likely to develop in practice?

V. Foundational Agreements: EEC and NAFTA as Distinct Forms of Contracting

Writing in 1958 one observer doubted whether the Treaty of Rome would stand the test of new challenges and that "a general crisis, arising for example from a major recession, might cause the Treaty almost to become a dead letter."[25] But, to the contrary, the EEC of the late 50s transformed itself into a much larger organization, covering much more than just trade liberalization and acquiring many more members. The move to free trade in

[22] For a comparative discussion of post-imperial economic integration and disengagement, see Rawi E. Abdelal, *National Purpose in the World Economy: Post-Soviet States in Comparative Perspective,* (Ithaca, N.Y.: Cornell University Press, 2001).

[23] As Daniel Drezner notes, even realists concede that the dispute settlement body of the WTO constitutes a significant case of supranational authority when enforcing decisions that go against powerful states. See Daniel Drezner, *All Politics is Global: Explaining International Regulatory Regimes*, (Princeton: Princeton University Press, 2007).

[24] Thus the WTO system establishes a permanent international judicial body, whereas NAFTA establishes a quasi-judicial body or arbitral panels. See the classification in the Project on International Courts and Tribunals. www.pict-pcti.org/publications/synoptic_chart/synoptic_chart1.htm. Also see www.wto.org/english/tratop_e/dispu_e/dispu_e.htm#dsb

[25] Serge Hurtig, 'The European Common Market', *International Conciliation,* (517, 1958), p. 381.

all factors of production has propelled the EU to tackle numerous other issues such as pension payments, gender equality, mutual recognition of standards, monetary union, and the movement of peoples and refugees. While expressing their interest in "ever closer union" the contracting parties of 1957 could hardly foresee the many dimensions that European integration would take.[26]

Given the uncertainties of final objectives and ultimate ends of the nascent regional organization, member states opted for little ex ante legislation. Indeed, the open-endedness of the Treaty conveniently allowed member states to sidestep difficult decisions that would likely precipitate opposition by domestic constituents. This low level of ex ante legislation, however, required members to rely on ex-post arbitration and supranational decision-making, particularly through the Commission. At first, the European Court of Justice (ECJ) was expected to only play a relatively minor part in the process.[27] Nevertheless, the Court has taken on roles heretofore unforeseen. Key principles and Community legislative supremacy emerged without clear stipulation by the national governments that Community law would be supranational and have direct effect. In other words, not dissimilar in impact to American landmark cases as Marbury v. Madison, or Martin v. Hunter's Lessee, the ECJ appropriated an entirely new realm of authority for itself, with the ECJ at the judicial pinnacle.[28]

In other words, no institution has blurred the distinction of anarchy and hierarchy more than the EU.[29] Fifty years after its formation, the European Union shows considerable vertical integration and a high level of supranational decision making over an increased number of issue-areas and functions. Yet the foundational agreement that formed the EEC in the Treaty of Rome in 1957 was remarkably sparse and functioned as a classic incomplete contract. Andrew Moravcsik thus rightly labels the treaty a "framework agreement."[30] Giandomenico Majone similarly describes it in similar terms.

> *A relational contract settles for a general agreement that frames the entire relationship, recognizing that it is impossible to concentrate all the relevant bargaining action at the ex ante con-*

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[26] Overviews of the early stages of European integration and its various institutions are too numerous to count, but see, for example, Clive Archer, *Organizing Western Europe* (London: Edward Arnold, 1990); Desmond Dinan, *Ever Closer Union*, (Boulder, C.O.: Lynne Rienner, 1999); Stephen George, *Politics and Policy in the European Community*, (Oxford: Clarendon Press, 1985).; and Jeffrey Harrop, *The Political Economy of Integration in the European Community*, (Aldershot, U.K.: Edward Alger, 1989).

[27] Andrew Moravcsik, *The Choice for Europe*, (Ithaca, N.Y.: Cornell University Press), p.155.

[28] One could see the U.S. constitution as an example of incomplete contracting as well. Due to the brevity and vagueness of the founding document, the Supreme Court had to step in as a supreme arbitrator and settle many issues ex-post.

[29] The European Union is the name for the organization since the Treaty of Maastricht (1992). Depending on the time frame I also refer to the European Economic Community (EEC) or the European Community (EC).

[30] Ibid, pp. 152, 157.

tracting stage. The Rome Treaty, for example, may be conceived of as a relational contract.[31]

He further notes that in such agreements actors do not delineate specifics but decide on who has the power to act in unforeseen circumstances. In other words, who has the authority to allocate new authority relations (kompetenz, kompetenz). Thus, the European integration process exemplifies a case of incomplete contracting with creation of supranational institutions.

NAFTA, although arguably the most institutionalized regional organization after the EU, demonstrates a low degree of transfers of sovereignty to supranational decision making, and a much higher degree of ex ante precision in legislation. Frederick Abbott thus observes:

NAFTA embodies a high degree of precision and obligation and a moderate degree of delegation of decision making authority. The European Union, in contrast, embodies a high degree of obligation and delegation and a moderate level of precision. [32]

Indeed, European integration from the outset looked markedly different. The brevity of original treaties, wide in scope but short in details, contrasts with the length of the North American agreement which was far more limited in its aims but highly detailed. The European states embarked on their course with many of the details still to be worked out. Important elements of European integration, such as the Common Agricultural Policy (1962), the relation of European laws to national laws, and regulations on fiscal policy, only emerged years after the 1957 Treaty of Rome.

The level of supranational decision making in the European case was also higher from the outset. The ECSC institutionalized supranationality through the High Commission and was intended to regulate the key coal and steel sectors of the West European economy.[33] Supranational decision making expanded in the years after the beginning of the Community--even if the organization had to deal with periodic setbacks such as the Luxembourg compromise in 1965. Similarly, the European Commission was created to forward European objectives rather than narrow state interests (the latter

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[31] Giandomenico Majone, *Dilemmas of European Integration*, (Oxford: Oxford University Press, 2005), p. 73.

[32] See Frederick Abbott, 'NAFTA and the Legalization of World Politics: A Case Study', *International Organization,* (Vol. 54, No. 3, 2000), pp. 519-547.

[33] The locus classicus is Ernst B. Haas, *The Uniting of Europe*, (Notre Dame (Ind.): Notre Dame University Press, 2004 [1958]). Also see Raymond Mikesell, 'The Lessons of Benelux and the European Coal and Steel Community for the European Economic Community', *The American Economic Review* , (Vol. 48, No. 2, 1958), pp. 428-441; Richard L. Gordon, 'Coal Price Regulation in the European Community, 1946-1961', *The Journal of Industrial Economics,* (Vol. 10, No. 3, 1962), pp. 188-203.

were to be represented by the Council of Ministers), and with multiple directorates and large bureaucracy, it lacks any equivalent in NAFTA.

Their respective judicial milieus also differ markedly. The European Court of Justice (ECJ) has taken a key role in codifying these transfers of sovereignty by asserting the supremacy of EU law over national legislation, to the extent that some observers suggest "governments do not control legal integration in any determinative sense and therefore cannot control European integration more broadly."[34] Arbitration in NAFTA, by contrast, remains an inter-governmental, not supranational, ad-hoc settlement mechanism. Indeed, any claim to the contrary would meet an American constitutional challenge. NAFTA thus constitutes a case of inter-governmental, complete contracting.

What explains the institutional variation between NAFTA and the EU? Simply put, why was NAFTA set up as an inter-governmental complete contract while the creation of the EEC constituted incomplete contracting with transfers to supranational entities? What consequences do these different modes of contracting have on the subsequent institutional development of these organizations?

VI. Bargaining over Sovereignty in European Integration

I focus on three issues. First, I clarify the divergent motives for political elites leading to the formation of the ECSC in 1951, the EEC in 1957, the FTA in 1987, and NAFTA in 1994. As said, admittedly these factors are exogenous to contracting theory proper. For example, some of these variables, as the German reunification question, are clearly idiosyncratic to the case at hand. I do not claim to provide new insights into the European or North American states motivations to contract with each other.[35]

Subsequently, I build on the insights from various authors to show how specific motives influenced rational elites to choose particular alloca-

[34] Alec Stone Sweet and Thomas Brunell, 'Constructing a Supranational Constitution: Dispute Resolution and Governance in the European Community', *American Political Science Review*, (Vol. 92, No.1, 1998), p. 73. They submit that inter-governmentalists, who argue that the EU institutions cater to and are the result of negotiations aimed to foster state interests, are wrong. See also the discussions by Anne-Marie Burley and Walter Mattli, 'Europe Before the Court: A Political Theory of Legal Integration', *International Organization* (Vol. 47, No. 1, 2003), pp. 41-76 ; and Karen Alter, 'Who Are the 'Masters of the Treaty'?: European Governments and the European Court of Justice', *International Organization* (Vol. 52, No.1, 1998), pp. 121-147, 'The European Union's Legal System and Domestic Policy: Spillover or Backlash?', *International Organization,* (Vol. 54, No. 3, 2000), pp. 489-518.

[35] For further discussion of motives, see Edelgard Mahant, *Birthmarks of Europe: The Origins of the European Community Reconsidered*, (Aldershot, U.K.: Ashgate, 2004); Alan Milward, '*The European Rescue of the Nation-State',* (Berkeley, C.A.: University of California Press, 1992); Moravcsik, op. cit. in note 27; Craig Parsons, '*A Certain Idea of Europe',* (Ithaca, N.Y.: Cornell University Press, 2003).

tions of residual rights of control. Using insights following from an incomplete contracting perspective I show why residual rights were allocated differently in the two cases, and why we would expect the institutional designs to aim at addressing the concerns of the parties ceding such rights.

Finally, I will argue that due to the divergent allocation of such rights at their foundation, the subsequent trajectories of these organizations show marked divergence rather than convergence. NAFTA will continue to resemble clear-in and clear-out specific contracting, little vertical integration, a high degree of ex ante legislation, and only ad-hoc arbitration. The European integrative process, by contrast, will continue to exemplify incomplete contracting, ex-post legislation, and supranational adjudication over sovereign issues and functions.

A) European Motives

European political elites, commercial interests, and the general public were profoundly affected by the experiences of the Second World War. To prevent another conflict Federalists favored a lofty goal of full integration. Others, by contrast, were reluctant to surrender national prerogatives. Yet others were motivated more by concerns about European economic decline and American ambitions than security issues. In the midst of such discussions the French-German axis emerged as a critical force in propelling European integration. What enticed these states to surrender some of their sovereign rights to these nascent European institutions?

The relative symmetry of power and relative symmetry in demand influenced the institutional choices of the states in question. Symmetry of power made credible commitments possible and unilateral hegemony impossible. Mutual interdependence, the relative symmetry in demand, as all stood to gain considerably from integration, made such integration desirable.

Realists are also correct that security concerns greatly influenced the choices of Paris and Bonn. Initially France pursued policies aimed at diminishing German power and any chance at revival. But with deteriorating relations with the Soviet Union, the United Kingdom and the U.S. opposed such a strategy. Instead France together with the U.K., the Benelux, Germany and the U.S. formed the International Ruhr Authority (1949) which aimed to control coke, coal and steel in the area. With the recognition of the sovereign Federal Republic of Germany in that same year, Germany soon opposed such control over its resources and wanted alternative arrangements. Given its war time past it had to temper its desire to gain full sovereign control by consenting to institutional mechanisms that checked such a revival of German power. Britain and the Americans simultaneously pushed for a re-

vived and more integrated Europe. They soon fixed their gaze on the coal and steel sector where economic and security interests combined.

This sector was a critical component of re-industrialization and a key component of any war effort. With the war only a few years past, there was general unease about a rebuilt Germany. Economically the French steel industry was also dependent on German coke. All West European countries also feared that their governments lacked adequate control given the high degree of cartelization in the private sector.[36]

A strong proponent of federalism, Jean Monnet, drafted the treaty for the ECSC. While Monnet's idea of a supranational planning body ultimately failed, the treaty did establish important institutional components that would later inform the EEC. The High Authority was constructed as a supranational agency above the Member States (the Benelux countries, France, Germany, and Italy). The European Court of Justice was created to arbitrate disputes. The common market in this sector prohibited import and export duties, quantitative restrictions and discriminatory practices.[37] Importantly the ECSC also sought to eliminate an important source of price distortions by equalizing transport rates—which represented 20-25 % of the price of steel.[38]

The common market in coal and steel was thus from the outset about much more than lowering barriers to trade. Indeed, as Haas notes "there had been no tariffs applicable to these commodities previously."[39] It involved pricing agreements, control over investments, cartel policy, the elimination of subsidies, etc.[40] The broad scope of this form of integration would make any attempt at complete contracting very difficult. Commenting in 1958 on what the experience of the ECSC forebodes for the EEC Raymond Mikesell concluded:

> *The experience of the High Authority in this field—which has been confined to the problems of regulating competition in only a few related industries is not reassuring. The task for formulating policies and regulations…of perhaps hundred of industries…seems almost overwhelming. Experience in dealing with discrimination and competitive practices indicate a need for an administrative and*

[36] Gordon, op. cit. in note 33; Mikesell, op. cit. in note 33.
[37] Archer, op. cit. in note 26, p. 55.
[38] Mikesell, op. cit. in note 33, p. 436.
[39] Haas, op. cit. in note 33, p. 60.
[40] Karen Alter and David Steinberg, 'The Theory and Reality of the European Coal and Steel Community', in Sophie Meunier and Kathleen McNamara (eds.), *Making History: European Integration and Institutional Change at Fifty* (New York: Oxford University Press, 2007), p. 91.

quasi-judicial authority with supranational powers over a rather broad area.[41]

These experiences entered into the discussions for a more comprehensive community beyond coal and steel. By the mid 1950s, the Cold War had reached its zenith with tensions surrounding Berlin, the Hungarian uprising, and suspected communist meddling in the European colonies. As NATO allies, all six contracting parties shared the threat posed by the USSR.

Furthermore, it had become increasingly clear that Germany would regain its preeminent position on the continent. By 1954 it had joined NATO as a critical ally in the effort to deter the Warsaw Pact, thus becoming once again a "normal" state, rather than the post-war pariah. German economic growth was obvious as well. Consequently, France sought an institutional means to bind Germany to international agreements which would constrain German options.[42] French foreign minister Pineau thus assured the Soviet Union that European integration was not directed against it, but "to insert Germany into a European community."[43]

Common economic interests emerged as well. German industrialists realized that they would bear the costs of protectionist measures, as in agriculture, but they were willing to bear these given the expected benefits of integration.[44]

Political elites thus strategically pursued their national objectives. French and German elites negotiated the institutional contours through which to pursue their aims. Germany sought a means to re-integrate itself within Western Europe, while France sought institutional means to curtail a rising Germany. The smaller states similarly would benefit greatly given that Belgium and the Netherlands were heavily dependent on international trade.

Interdependence in other words was symmetric. Capital movements and increasing intra-regional trade gave German industry an incentive to support a supranational bargain as it stood to gain considerably from further integration. And indeed between 1952-55 intra-community trade in steel and coal increased 170 per cent, trade in other goods by 42 per cent, and trade in capital goods (excluding iron and steel) grew by 59 %.[45]

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[41] Mikesell, op. cit. in note 33, p. 437.
[42] Even as economists debated the benefits of integration, they recognized that a key objective was to embed a rearmed and economically strong Germany in a European Community. See, for example, Franz Gehrels and Bruce Johnston, 'The Economic Gains of European Integration', *The Journal of Political Economy,* (Vol. 63, No. 4, 1955), pp. 275-292.
[43] As cited in Mahant, op. cit. in note 33, p. 132.
[44] Ibid, pp. 45, 47, 62.
[45] Mikesell, op. cit. in note 33, p. 438.

B) Credible Commitments and Relative Power Symmetries

The European geopolitical and economic environment thus propelled a disposition among political and social elites to tolerate a significant degree of supranational decision making with relatively low levels of precision ex ante in legislation. Nevertheless, they still required institutional safeguards before they actually yielded sovereign prerogatives.

The Benelux states worried that the more powerful states (France and Germany) would gradually usurp more power in such institutions. Consequently, the larger states needed to make credible commitments, without which weaker contracting parties would refrain from any initial agreement. How were the six member states able to establish credibility of commitment?

First, the six negotiating parties faced modest power asymmetries—measured in terms of relative comparability in overall economic strength. The moderate power asymmetries within Europe provided the smaller states (the Netherlands, Belgium, and Luxembourg) some measure of comfort in signing on to the founding treaty. Although the German economic miracle ("Wirtschaftswunder") was making Germany the pre-eminent economic power by the late 1950s, it still had to contend with a substantial French economy (in 1955 actually still larger than Germany's), as well as with Italy.

Moreover, the three smallest states, which stood to gain the most from trade liberalization, operated jointly on several issues. Indeed it was the joint action of the Benelux at the ministers' conference in Messina in June 1955 that initiated the subsequent negotiations that lead to the EEC. The Benelux also entered negotiations on the common external tariff as a coherent unit, countering the French preference for a common external tariff that would be higher than the tariff that the Benelux already had negotiated at an earlier date.[46] The small states showed they could band together for bargaining leverage. Furthermore, the weighted voting system then envisioned, guaranteed that the 3 smaller states could not be outvoted by the three larger ones.[47]

Thus, although it was evident that West Germany would soon be the pre-eminent European power it could not have accomplished its objectives without binding itself, as it could be checked by other relatively powerful actors as France and Italy, or the Benelux, when it acted as a coherent unit. With moderate power asymmetries Germany could not have unilaterally dictated the terms of agreement.[48] Moreover, France clearly wanted to bind

[46] Hurtig, op. cit. in note 25, p. 348. The end result was a common external tariff based on the arithmetical average of the duties in the four customs territories.
[47] Mahant, op. cit. in note 35, p. 94; Moravcsik, op. cit. in note 27, p. 153.
[48] The German war record of course would make such a unilateralist effort even more problematic.

Germany, and Adenauer understood that self-binding by Germany was a sine qua non for his nation to be accepted as a "normal" state. Consequently, Bonn had both the will to commit to supranationality while the configuration of forces also allowed it to do so in a credible manner.[49]

This does not mean that the states fully envisioned the depth of contemporary European integration from the outset. Although the Commission could initiate legislative proposals, the Council of Ministers had the ability to block proposals.[50] Also, the European Parliament at this stage had feeble powers at best, and a direct election of the parliament was not to occur until two decades had past. The ECJ, too, was not envisaged with broad powers.[51] While the Court soon took on vastly expanded powers in broad interpretations of its jurisdictional competency, it has also realized that in substantive matters, legislation from the member states could nullify aims of the Court. Thus the Court selectively expanded its prerogatives. However, the incomplete contract would logically impel further supranational development.

In sum, the EEC started from the outset with supranational institutions in its makeup—even if their subsequent powers were still unrecognized. Furthermore, given the vast scope of the intended integration the Treaty could not hope to resolve all related issues ex ante. Indeed the agreements that truly opened up the movement of persons and capital, the Schengen agreements and the European Monetary Union, would take decades to achieve. In other words, the Treaty was an incomplete agreement with many key issues held over for future legislation and adjudication. The formative treaty of European integration constitutes an exemplar of incomplete contracting with supranational institutionalization.

C) The Consequences of Assigning Residual Rights to Supranational Institutions

As a consequence of incomplete contracting and the low level of specificity, the contracting states have had to allow the ECJ to develop meaningful review of national decision making and test government policies against EEC legislation. The ECJ has gradually expanded its powers to become a truly supranational force. Already in 1963 the ECJ proclaimed in the Van Gend and Loos case that European Community legislation had direct effect. The Court, not national governments, would test the applicability of

[49] Even Joseph Grieco who sets out to defend a realist perspective of integration, ends up pointing to the modest power asymmetries and the willingness and ability of German to credibly commit—blending neoliberal institutionalist arguments with realist views. See Joseph Grieco, 'The Maastricht Treaty, Economic and Monetary Union, and the Neo-Realist Research Programme', *Review of International Studies, (*Vol. 21, January, 1995), pp. 21-40.
[50] Mahant, op cit. in note 35, p. 95.
[51] Moravcsik, op. cit. in note 27, p. 155.

EEC law in the particular case. Individuals, moreover, had standing in proceedings against their own government. As the Court stated "the Community constitutes a new legal order of international law for the benefit of which the states have limited their sovereign rights."[52] The Costa v. Enel case, decided one year later, reinforced the van Gend and Loos decision.[53] Contrary to the Italian monist view that international law needed national transformation in order to be effective (and thus that later national law superseded earlier international agreements), the Court decided that EEC law was directly applicable and thus supreme to national law. In later decisions the ECJ also passed judgment on direct effect of directives beyond regulations and decisions. Subsequent Court decisions over the past decades have expanded the prerogatives and the judicial scope of the Court. [54]

Importantly, such decisions from the ECJ came at the very time that political elites, particularly the French government, balked at any further inroads to supranationality.[55] The ability of the ECJ to proceed while political elites, particularly in France, sought to limit the powers of the Commission and curtail supranational legislation suggests that the particular status of the Court was instrumental to the entire European integration process. That is, elites were willing to go along with the expansion of juridical powers because integration required procedural solutions to the problems associated with incomplete contracting and little ex ante legislation. The Court had to be given great leeway because elites could not know where long term contracting would lead and could not engage in highly specific ex ante legislation.[56]

Germany and France have, by and large, followed ECJ decisions that have gone against them. That is, without the ability to unilaterally dictate the terms of subsequent ex-post legislation and decision making, the larger states have consciously sought to tie their own hands. Even France, although the most ardent proponent of state sovereignty, now concurs with the monist position of EU law.

Thus the Court did not simply interpret regulations and directives but took an active stance in actually propelling integration forward. The ECJ

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[52] van Gend and Loos v. Nederlandse Administratie Belastingen, ECJ 26/62 1963.

[53] Costa v. Ente Nazionale per L'Energia Elettrica (Enel), 6/64 1964. The Simmenthal decision (1978) further expanded on this. National courts were instructed to see to it that community law was implemented and "to set aside any provisions of national law which conflict with it." See Dinan, op. cit. in note 26, p. 34.

[54] See the numerous examples in Alter, op. cit. in note 34, 1998; and Alter, op. cit. in note 34, 2000.

[55] For the argument that the ECJ had an important independent role in moving supranational decision making forward, see Burley and Mattli, op. cit. in note 34.

[56] In a similar vein Moravcsik notes that delegation occurs when joint gains are available, distribution conflicts are moderate, and the environment is highly uncertain. See Moravcsik, op. cit. in note 27, p. 75.

has handled cases ranging from tariffs and non-tariff barriers, to equal pay (the Defrenne case).

VII. Regional Integration in North America

As noted above, in contrast to European integration, NAFTA, since its adoption, has manifested complete contracting. In contrast to the EU, NAFTA evinces a much higher degree of ex ante contract stipulation and less ex-post judicial and legal activism.[57] NAFTA remains limited to a free trade agreement, whereas the EEC set out to form a customs union and an economic community from the outset.

As with my analysis of regional integration in Europe I focus on three questions. First, what were the underlying motives of the contracting parties to the agreements? Second, why did the actors design these particular institutions? Third, how did these institutions and in particular the allocation of residual rights influence the subsequent development of regional integration?

A) Motives and Objectives of the Contracting Parties

Similar to the European states, the North American contracting parties were motivated by a mix of geopolitical considerations and economic concerns. To a considerable extent, movement toward regional integration in North America was driven by the developments in European integration. In all three states domestic political and economic elites also started to converge in their preferred policies for trade liberalization.

NAFTA is a direct extension of the FTA between Canada and the United States in 1987. The latter built on the Canadian-American automobile accord two decades earlier.[58] Despite the automobile accord, the United States and Canada had not pursued further integration. Canada still opted for a more interventionist government policy than the United States. It also still retained ties to the UK and the Commonwealth preference system. The United States on its side, still pursued a global liberal agenda, even if by 1972 it had to retreat from fixed exchange rates.

By the 1980s, the situation had changed dramatically.[59] Canadian Conservative Prime Minister Mulroney was far less inclined to interventionism than his predecessor Pierre Trudeau. With 80% of Canadian exports going

[57] Abbott, op. cit. in note 32.
[58] See the discussion in Gilbert Winham, 'Why Canada Acted?', in William Diebold (ed.), *Multilateralism and Canada in U.S. Trade Policy (*Cambridge, M.A.: Ballinger Publishing, 1998); and Gary Hufbauer, Gary and Jeffrey Schott, *North American Free Trade* (Washington, D.C.: Institute for International Economics, 1992), ch. 1, 2.
[59] Winham, op. cit. in note 58, pp. 44-6.

to the United States, Ottawa became increasingly interested in opening up the cross border trade with its powerful southern neighbor, particularly in view of its weak domestic market in the 1980s.

However, despite economic setbacks in the 1970s, the United States, with its multilateral rather than regional focus, still proved a reluctant partner. Only fears of relative U.S. decline, the threat of a "fortress Europe" following the SEA, and the difficulties of getting the Uruguay Round started made the United States think of a regional alternative.[60] The "NAFTA" track would pressure the Europeans and Japanese to be more amenable to American demands. The carrot of an agreement on GATT was balanced by the stick of a regional alternative.

A similar set of calculations informed U.S.-Mexico negotiations in the late 1980s. Mexico had initially pursued protectionist policies and had frowned on foreign influences on its economy. Lopez Portillo's government had thus walked away from a very favorable GATT protocol in 1979, which gave Mexico 15 years to adjust.[61]

But the fall in oil prices in 1980 and the debt crisis changed Mexican views.[62] The governments of de la Madrid and Salinas did a dramatic about face, pursuing export led growth and foreign investors. Salinas, a product of the de la Madrid "camarilla" expanded on de la Madrid's turn to trade liberalization.[63] Staffing his administration with technocrats, de la Madrid and Salinas forged a coalition between state elites favoring liberalization and the peak associations of large business enterprises.[64] In particular, the lure of American investments in Mexico proved enticing to these corporations. The way forward lay in pursuing access to the North American market, while at the same time seeking GATT membership.[65]

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[60] Jagdish Bhagwati, 'Beyond NAFTA: Clinton's Trading Choices', *Foreign Policy* (Vol. 91, 1993), pp. 155-162.

[61] Maxwell Cameron and Brian Tomlin, *The Making of NAFTA: How the Deal Was Done* (Ithaca, N.Y.: Cornell University Press, 2000), pp. 57-8.

[62] See, for example, Stephanie Golob, 'Beyond the Policy Frontier: Canada, Mexico, and the Ideological Origins of NAFTA', *World Politics* (Vol. 55, No. 3, 2003), pp. 361-98.

[63] Camp describes the importance of this camarilla (clique) in Mexican politics. See Roderic Camp, 'Camarillas in Mexican Politics: The Case of the Salinas Cabinet', *Mexican Studies* (Vol. 6, No. 1, 1990), pp. 85-107.

[64] Strom Thacker, 'NAFTA Coalitions and the Political Viability of Neoliberalism in Mexico', *Journal of Interamerican Studies and World Affairs* (Vol. 41, No. 2, 1999), pp. 57-89. The losers in the process were farmers, urban poor, and the middle class, who were kept out of this ruling coalition and the deliberations on NAFTA.

[65] Mexico gained GATT membership in 1986 on much less favorable terms than were offered in 1979. See Gunter Dufey, Gunter and Michael Ryan, *NAFTA: Honda Motor Company or Free Trade in the Real World* , (Washington, D.C.: Institute for the Study of Diplomacy, Georgetown University, 1994).

Once again, the United States was reluctant as it remained focused on progress in the Uruguay Round. However, a GATT agreement by the late 1980s seemed more remote than ever with disagreements on agriculture, services, and the protection of property rights. A broader regional fall back option, beyond the bilateral deal with the Canadians, gained gradual momentum in Washington.[66]

Canada, too, was initially uninterested in a trilateral agreement, though it had started bilateral discussions with Mexico. It had few economic connections with Mexico and Mulroney did not see a broad North American deal emerge in the 1980s.[67] Canada, nevertheless, also changed its position. The Canadian government feared that the United States and Mexico would sign a bilateral deal, thereby allowing Washington to create a hub and spoke pattern through its treaties with its neighbor to the north and south.

Thus, by the 1980s Canada and then Mexico sought to pursue greater liberalization in North America. Demand, however, was asymmetric. Mexico and Canada sorely needed access to the American market, whereas the United States had multiple options. Its trading relations across North America, East Asia, and Europe made a North American agreement less imperative for the United States than for the smaller economies. U.S. officials could thus clearly set the terms of the agreement. For example, from the outset, Washington stipulated to the Mexican government that any mention of free movement of labor would terminate the discussion.[68] Other issues that were likely to arouse controversy were bracketed and addressed in side deals.[69] Yet other items required last minute concessions by Mexico, such as on sugar and citrus.

While all states opted for North American liberalization, the asymmetric demand worked wholly in favor of the United States.[70] Washington,

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[66] Domestic rifts in the U.S. were significant with many labor and environmental groups opposing and larger businesses favoring the deal. Erstwhile Presidential candidate Ross Perot became one of the vocal critics of NAFTA. In the end the agreements passed its biggest hurdle, the House of Representatives, with a 34 vote margin. Keith Bradsher, 'After Vote, Labor is Bitter but Big Business is Elated,' New York Times, Nov. 18, 1993, A21. See also David Rosenbaum, 'House Back Free Trade Pact in Major Victory for Clinton after a Long Hunt for Votes,' New York Times, Nov. 18, 1993, A1.

[67] Hufbauer and Schott, op. cit. in note 58, p. 24. The Canadian public also seemed less than enthusiastic about what the FTA had yielded. See, for example, Clyde Farnsworth, 'Canada's U.S. Trade Experience Fuels Opposition to the New Pact', New York Times Oct. 3, 1993, 1.

[68] Cameron and Tomlin, op. cit. in note 61, p. 71.

[69] The environment thus required a side agreement to allay some opposition. See Annette Baker-Fox, 'Environment and Trade: The NAFTA Case' *Political Science Quarterly* (Vol. 110, No. 1, 1995), pp. 49-68.

[70] To give a recent example, when the Mexican government asked for a renegotiation of the opening of its corn and beans market in 2008, Washington flatly refused. The Mexican government responded in turn that it would dutifully abide by the earlier terms, even though roughly 3 million small and less efficient Mexican farmers fear the adverse effects of U.S. competition. Bloomberg.com, June 6, 2006.

therefore, had little incentive or need to submit to supranational organizations or to third-party binding arbitration that might hinder the pursuit of American objectives.

B) The Distribution of Power

The asymmetry of power, moreover, prevented the creation of credible binding mechanisms. This asymmetry was far more pronounced than between most of the European member states. In 1984 American GNP came to 3,947 billion dollars, dwarfing that of Canada ($346 billion).[71] The inclusion of Mexico in the accord in 1994 similarly highlighted power disparities between Mexico and its counterparts. The American GDP in 1991 was still nine times that of Canada and more than 20 times larger than the Mexican GDP.[72] The Mexican GDP per capita was 1/7 of that in Canada and the United States. In the European case, although the German economy was strong, it accounted for only 1/5 of EC output whereas the U.S. economy accounted for almost 85% of the NAFTA region.[73] With only a few contracting negotiating states, there was no hope of an offsetting coalition. Consequently, Canada and Mexico had to distrust American hegemony.[74]

Mexico, in particular, had to fear "being too far from God and too close to the United States" as dictator Porfirio Diaz once lamented. Even Salinas, while staunchly advocating multilateral liberalization, feared as late as 1988 that "there is such a different economic level between the United States and Mexico that I do not believe such a common market would provide an advantage to either country."[75]

Canadian and Mexican dependence on access to the American market, and the ability of the United States to pursue multilateral options, gave Washington the ability to renege unilaterally if it so chose. That is, the very preponderance of the United States made it difficult to design institutions that could credibly constrain the hegemon.

Consequently, without agreements that would constrain American pre-eminence, the weaker parties had little incentive to put their fate in a relatively open-ended agreement. The contracting parties preferred to negotiate complete contracts and exchange specific quid-pro-quos up front, ra-

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[71] Bueno 1988, 107. Figures from World Development Report 1987.
[72] Hufbauer and Schott, op. cit. in note 58, p. 5.
[73] Joseph Grieco, *Variation in Regional Economic Institutions in Western Europe, East Asia, and the Americas: Magnitude and Sources*, (Karl W. Deutsch Professorship, Discussion Paper. Wissenschaftszentrum Berlin, 1994).
[74] Cameron and Tomlin, op. cit. in note 61, pp. 48, 49. As one observer rightly noted, "it was Mr. Salinas who staked his Presidency on the trade agreement, often dragging a reluctant nation into partnership with a powerful neighbor it has always feared." Tim Golden, 'Mexican Leader a Big Winner As the Trade Pact Advances,' New York Times, Nov. 19, 1993, A1.
[75] Quoted in Cameron and Tomlin, op. cit. in note 61, p. 59.

ther than relegate points to further negotiations. Given the high level of ex ante formalization and the high level of complete contracting, ad-hoc arbitration became the norm, not ex-post legislation or supranational adjudication.

C) The Consequences of Complete Contracting and Inter-Governmentalism

Because the residual rights of control reside with the contracting parties, NAFTA has not progressed much beyond the terms of the initial agreement. Unlike European integration, which quickly expanded into various areas of economic and political cooperation, and many more members, NAFTA has expanded little. Canada, despite gaining from liberalization with the United States, remains weary of domination by its more powerful neighbor and has excluded certain areas from the regional agreements, such as sectors deemed important to its cultural heritage. Canada has also been reluctant to accept a customs union and has explicitly sought to capitalize on foreign investment in Canada (particularly by Japan), using Canada as a convenient back door entry into the U.S. market.[76]

With the extension of the FTA to Mexico, both the United States and Canada have excluded full factor mobility, specifically of labor. Environmental concerns about a rush to the bottom have weighed in as well. The agreement has remained limited to diminishing trade barriers between these states rather than creating a customs union, let alone full economic integration. In lieu of common external tariffs, the parties have instead devised more stringent local content laws and "transformation tests."

In NAFTA ad-hoc arbitration has sufficed because ex ante stipulations were far more extensive. Arbitration has also been rare. By one count the number of cases brought under chapter 18 and 19 FTA clauses, and chapter 19 and 20 of the NAFTA numbered no more than 81 by 1999.[77] Actors know what the terms of the agreement are and their preferences have been incorporated into the agreement's original terms. Most cases have been relatively straightforward, with the norm being consensus decisions.[78]

In short, the NAFTA agreement differed in two key aspects from the European agreements for integration. These differences have had profound

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[76] See, for example, Dufey and Ryan, op. cit. in note 65.

[77] Matthew Stevenson, 'Bias and the NAFTA Dispute Panels: Controversies and Counter-Evidence', *The American Review of Canadian Studies*, (Spring, 2000), pp. 19-33.

[78] Judith Goldstein, Judith, 'International Law and Domestic Institutions: Reconciling North American 'Unfair' Trade Laws', *International Organization* (Vol. 50, No. 4, 1996), pp. 541-64; and Stevenson op. cit., in note 77. For a discussion of the general settlement mechanism, see Gary Hufbauer and Jeffrey Schott, *NAFTA: An Assessment,* (Washington, D.C.: Institute for International Economics, 1993), pp. 102-04.

effects on the subsequent process. First, NAFTA institutions lack the supranational equivalent of the Commission, Parliament, or Court. Instead, political leaders brokered the terms of the agreement ex ante and in great detail, whereas the inter-governmental bargain in the EU only set the broad contours of agreement.

Second, arbitration panels in NAFTA are ad-hoc and their composition needs the approval of the contracting parties. Panels decide single complaints rather than expand the domain of regional legislation. With no standing court, there is not an institutionalized mechanism through which the arbitration procedure can establish precedent and expand the supranational aspects of integration. Consequently, fears of a loss of sovereignty and usurpation by the regional organization remain moot.

Incomplete contracting with supranational institutions builds into the agreement--indeed virtually demands--further development along supranational principles, and creates dynamic incentives for further integrations. Inter-governmental complete contracting, by contrast, virtually precludes such developments.

VIII. Conclusion

The argument I proposed differs from the view that regional organizations are simply extensions of the state interests.[79] That argument holds for NAFTA, as it is an inter-governmental complete contract. However, the institutions created by the EEC, and which now form the basis of the EU, are not simply agents acting at the behest of their governments. While the initial choices in the creation of the European Community no doubt reflected state interests, subsequently that Community has entered a realm of supranational decision making. Once institutionalized, these supranational bodies have rarely transferred authority back to the member states.

Nor should EU institutional autonomy be seen as a lack of principal (the member states) oversight over its agents (the EU organizations).[80] EU activism is not the consequence of a loss of principal control over an agent. EU institutions, such as the ECJ were not, and indeed given the logic of the incomplete contract, could not be, mere agents. Instead, I support Giando-

[79] Geoffrey Garrett, 'The Politics of Legal Integration in the European Union', *International Organization* (Vol. 49, No. 1, 1995), pp.171-81; and Geoffrey Garrett, Geoffrey, Daniel Keleman and Heiner Schulz, 'The European Court of Justice, National Governments, and Legal Integration in the European Union', *International Organization* (Vol. 52, No. 1, 1998), pp. 149-76.

[80] For discussions of agency theory, see Kathleen M. Eisenardt, "'Agency Theory: An Assessment and Review', *Academy of Management Review* (Vol. 14, No. 1, 1989), pp. 57-74. Doleys has sketched some of these concerns for the EU. See Thomans J. Doleys, 'Member States and the European Commission: Theoretical Insights from the New Economics of Organization', *Journal of European Public Policy* (Vol. 7, No 4, 2000), pp. 532-53.

menico Majone's claim that principal-agency theory misunderstands the nature of European Community structures. Simple delegation on an intergovernmental basis would not greatly enhance credibility. Majone, therefore, argues for an alternative understanding of the relation of national governments to European level institutions, which he calls fiduciary delegation. Discussing the role of the ECJ in this mode, he observes:

> In policy areas where the Community is exclusively competent, the power to exercise public authority has been irrevocably transferred…Since the treaties did not contain an explicit list of areas of exclusive Community competence, it has been up to the Court to build up such a list.[81]

As a result of the incomplete contracting nature of the EEC Treaty, and because of the need to credibly commit, European Community institutions required the states to give up meaningful authority. This is not simply a question of principal-agency "slippage", but a logical response to how state elites can solve contracting problems.

At the same time this argument differs from, but does not contradict, Burley and Mattli's argument. They suggest that the ECJ worked as a "technocratic" institution outside the purview of political oversight.[82] I argue instead that the ECJ gained considerable independent powers, exactly because it provides a logical function in the incomplete contracting process of the EU. It was not because of a lack of oversight but because credible commitment in such incomplete contracts requires that such supranational institutions must be given latitude outside of immediate state oversight. Similarly, the Commission capitalized on the residual rights granted to it by the initial Treaty to expand and institutionalize its authority. As Mark Pollack notes, although various oversight mechanisms are in place to curtail the power of the Commission, these oversight mechanisms are costly, thereby giving the Commission considerable latitude.[83]

This analysis also challenges realist expectations that European regionalization would stall with the end of the Cold War and the declining American presence. Concerns about relative gains would in that view become more pronounced with fears of German dominance.[84] Instead, as the logic of incomplete contracting has explained, EU institutions have become catalysts, driving the integration process forward even with diminished external threats. Given the incomplete nature of the European foundational

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[81] Majone, op. cit. in note 31, p. 77.
[82] Burley and Mattli, op. cit. in note 34.
[83] Mark Pollack, 'Delegation, Agency, and Agenda Setting in the European Community', *International Organization* (Vol. 51, No. 1, 1997), pp. 99-134.
[84] Grieco, op. cit. in note 49; and John Mearsheimer, 'The False Promise of International Institutions', *International Security* (Vol. 19, No. 3, 1994/5), pp. 5-49.

treaties, these institutions inevitably acquired broad mandates to expand on the earlier agreements. The very incompleteness of the contract required further action in order for states to capture the full benefits of the founding treaty.

To conclude, the EU and NAFTA will continue along divergent paths with diverse institutional practices through which they pursue the benefits of regional integration. Their institutional configurations launched the signatories on diverse trajectories, which each had their own intrinsic logic and which determined the subsequent path of regional development. The EU proceeds with a built in dynamism which will lead to further vertical and horizontal integration. Horizontally, starting with a mere six states, it has expanded more than four-fold, with many states, such as Turkey, seeking to join in the near future. Vertically, it has taken on more and more functions. NAFTA, by contrast, from its beginning was intended as a complete contract and hence has had few means to expand into other areas and has had difficulty extending its membership.

Whether or not other regional organizations such as ASEAN and MERCOSUR will come to resemble either the EU or NAFTA will greatly depend on whether their member states choose to adopt incomplete contracting or a complete contract as a governance mechanism. If they opt for the NAFTA model, there will no doubt be significant gains, but the likelihood that such an organization will pick up new members or expand greatly beyond the original treaty will be low. A European model, by contrast, will show the converse.

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