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# THE ECONOMIC INSTITUTIONS OF THE NAFTA

by
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for the degree of Doctor of Philosophy

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## ABSTRACT

This study applies the lessons of the new institutional economics to the understanding of the development and operation of the North American Free Trade Agreement (NAFTA). Institutions, as defined by new institutional economists are the "humanly devised constraints that structure political, economic and social interaction. They consist of both informal constraints (sanctions, taboos, customs traditions, and codes of conduct) and formal rules (constitutions, laws, property rights)." The central claim of the new institutional economists is that "institutions matter" for economic performance and the central claim of this study is that the institutions of the NAFTA, in terms of formal rules like constitutions, laws, and property rights, have been just as important in shaping economic performance in the micro- and macroeconomies of all three NAFTA partners. Whereas there is a vast literature in public policy, international relations, diplomatic history, and economics and economics on the NAFTA, all of which describe the NAFTA as a set of rules, little work has been done on the economics of the NAFTA as a set of formal rules– institutions.

This study attempts to fill that gap and advance the understanding of the NAFTA as a formal set of institutions by explicitly applying the theoretical approaches used by institutional economists to the NAFTA. In doing so, this study sheds light on the power of institutional constraints to alter NAFTA area property rights, initiate firm-level changes to organizational structures, and provide a framework for viewing institutional



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change that argues for further study and development of the formal rules of international trade as mechanisms for governance of global trade and investment relations rather than focusing so heavily on the construction of new organizations and adjudicatory bodies as mechanisms for deepening North American integration. In making this argument, this study borrows much from institutional economists in that their work has repeatedly demonstrated that the formal rules of our economic system are highly determinative of economic performance. The NAFTA is just one set, albeit an important set, of rules that structure and constrain the choice sets of economic decision makers in ways that broaden the insights and analysis of the NAFTA already provided by the standard neoclassical model.

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## PREFACE AND ACKNOWLEDGMENTS

No study of this size is entirely the work of one person, nor has any one individual been responsible for laying the groundwork for getting to the point of completion of what should, at least up to this point, be the best research project I have yet produced. However, while it takes a village (to borrow a phrase) to prepare for and generate this kind of study, there are several individuals that stand out. First and foremost, I would like to thank my wife Jacqueline Leighton for supporting me in so many ways during the many challenging periods that came along during the course of researching and writing this study. I would like to thank the many faculty members at Johns Hopkins/SAIS for their encouragement, their constructive feedback, and the freedom to pursue this topic, especially my supervisor Charles F. Doran.



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# I. INTRODUCTION
# THE PROBLEM, THE LITERATURE, AND WHERE THIS STUDY FITS

As with virtually all studies, this one is the product of a range of influences from my professional and educational background too numerous to recount. Yet, of these, two are particularly pertinent to this study in that they both help set the stage for what follows in terms of my point of view and emphasis as well as beginning to cast this study within to context of the vast and, in many cases, overlapping literatures of economics and political science; the first concerns the broad-based debate over globalization and my experiences inside government trying to design the new rules of the game. The second is more academic, yet practical, and concerns the nexus of economics and history in trying to understand the economic, political, and social world around us.

## Our Globalized World

Before the terrorist attacks of September 2001 dramatically shifted the world's focus toward the politics of terrorism and the of the Middle East, the main topics of focus for scholars and pundits examining the phenomenon of globalization were international trade and finance. The 1990s were a period of dramatic, although perhaps not unprecedented,[1] growth in the interconnectedness of national economies, their politics,

[1]See Jeffry Frankel, "Globalization of the Economy," in Joseph S. Nye and John D. Donahue, eds., *Governance in a Globalizing World*, (Washington, D.C.: Brookings Institution Press, 2000): 45-71. Frankel concludes that while globalization has advanced dramatically in the post-WWII period, the process



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and cultures. The chalkboard economics of academic economists readily demonstrates the benefits that accrue to nations as a result of liberalization of their current and capital accounts (mainly trade and capital flows). Yet, that same, simple chalkboard theory also demonstrates that there will be winners and losers in the process as economies adjust to these changes. The cleavages generated by the winners and losers, the speed with which liberalization was facilitating, and/or forcing, adjustment, and the growing resentment directed at international organizations like the World Bank, the International Monetary Fund (IMF), the World Economic Forum, and particularly the World Trade Organization (WTO) all seemed to infamously spill over into the streets of Seattle in November 1999.

In April 2001, on the eve of the start of the Summit of the Americas in Quebec City, I sat on a restaurant patio with several of my colleagues from the Office of the Americas in the Office of the United States Trade Representative. We were outside the Oval Room, an attractive little restaurant at the southern end of Connecticut Avenue, a stone's throw from the White House in Washington, D.C. As we discussed a range of trade policy issues, many of them related to the Free Trade Area of the Americas (FTAA), a large group of people began milling about around the U.S. Chamber of Commerce Building just around the corner. Designed to coincide with the much larger, and violent, demonstrations taking place in Quebec City, the chorus of anti-FTAA chants near the Chamber of Commerce grew louder and many of the marchers spilled over into the area near where we were sitting. The disdain for each other and the perception by both the marchers and my government colleagues that the other did not understood the proposed

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of globalization in the half-century after 1900 was actually more dramatic.



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agreement nor the implications of trade for workers or the poor was palpable. Apart from the irony of trade officials, many of whom had actually been responsible for drafting parts of the FTAA, having an after-work drink in the middle of an anti-globalization protest, I was struck by the vast differences between the way my colleagues talked about the creation and operation of global trade rules and the way the protestors depicted them as being so profoundly harmful to labor, the environment, and the poor.

The debate over the desirability of the welfare effects of international trade and finance rules will undoubtedly go on for some time, and will not be resolved by this study. However, in the divergence of opinion between anti-globalization protestors and government officials there is an absence of attention to the way in which trade and investment rules generate incentives for economic activity beyond the standard chalkboard economics of international trade or monetary theory. How these kinds of rules generate incentives is the focus of those academics that look at institutions; not institutions as we commonly see them depicted in the form of the IMF, World Bank, or the WTO, but rather economic institutions, or rules, that guide our economic decision-making, generate incentive structures, reduce uncertainty, and shape our behavior. As the economist Douglass North puts it, "Institutions are the humanly devised constraints that structure political, economic, and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, and property rights)."[2] How these humanly designed constraints function in governing our economic lives is not inconsequential for our economic

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[2]Douglas C. North, "Institutions," *Journal of Economic Perspectives* 5 (Winter 1991): 97.



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development. Understanding why particular institutions evolve, how they operate in terms of providing incentives, and what factors induce institutional change is a key, and under emphasized, component in the operation of our economic system.

Together with the traditional insights into impact of trade liberalization offered by the basic neoclassical economic model the study of economic institutions in the form described above offers a range of insights, that go beyond, but do not replace, the basic insights of the neoclassical model, into how the rules of the North American Free Trade Agreement (NAFTA) are shaping the way we think about economics in North America. The NAFTA is, in effect, a set of these institutions, and their subtle, but important influence on economic activity is the focus of this study.

## What Institutions Are and What they are Not

While a much more detailed exposition of what I mean by institutions will be offered in Chapter II, it is important at the outset to begin to differentiate between institutions as the term will be used here and institutions as typically used by many others. The term "institutions" is thrown around quite liberally in the political science literature, but is seldom defined in very precise terms. For example, Robert Pastor's recent book "Toward a North American Community" contrasts and compares "institutional" structures in the European Community with those in the NAFTA area and concludes that



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while the EU has too many "institutions" the NAFTA has too few.[3] Yet, Pastor, and many others, lump at least two concepts together under the term "institution" which this study seeks to usefully separate. For Pastor and many others, institutions consist of both written rules and the kinds of bricks and mortar organizations that we often see arise to manage them. For instance, when we talk about the International Monetary Fund, we think first of the large complex of buildings just off Pennsylvania Avenue in Washington, D.C. and of the work the IMF does in promoting monetary cooperation and exchange stability. We even refer collectively to it and its sister organization, the World Bank, as the Bretton Woods Institutions since they were formed together in Bretton Woods, New Hampshire in July 1944. Yet, the work of the IMF and World Bank is pursued on the basis of the respective charters (Articles of Agreement in the case of the IMF) that outline the kind of work that the IMF should be engaged in and the boundaries within which they will do it. In essence, the Articles of Agreement are the formal rules by which the IMF operates and conducts its work. The Articles structure the kind of work that gets done, dictate who will do it, how, when, and with what resources the IMF will step in and assist with monetary and exchange issues among its member countries.

While the bricks, mortar, and people of the IMF buildings in Washington are important, as is the particular bureaucratic structure the IMF has adopted, all of these things are as a result of the rules contained in the Articles of Agreement– they are the organizational structures that have formed as a result of the Articles. In arguing that the

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[3]Robert A. Pastor, *Toward a North American Community: Lessons from the Old World for the New*, (Washington, D.C.: Institute for International Economics, 2001).



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NAFTA needs more "institutions," Pastor may well be on solid analytical ground, particularly as "institutions" are commonly understood. However, in calling for new "institutions" Pastor and others are actually calling for both institutions– in the form of rules– and organizations– in the form of bricks, mortar, and people– to manage and work within the rules. To be specific, Pastor calls for a fundamental re-write to the preamble of the NAFTA that would contain language reflective of the fact that the trilateral relationship is broader than economics. Such changes would be changes to rules. Pastor also calls for the creation of four separate "institutions" including a North American Commission, a North American Parliamentary Group, a Permanent North American Court on Trade and Investment, and a fourth institution that would coordinate regular meetings of Cabinet Ministers from each country. [4] In each instance, Pastor is essentially calling for the creation of bricks, mortar, and people to help manage the trilateral relationship. The "institutions" described by Pastor are really the organizations that he envisions arising from changes to the formal rules, much the same way the bricks, mortar, and people of the IMF have functioned in Washington, D.C. as a result of the 1944 Articles of Agreement.

Formal rules structure nearly every aspect of an organization. As Pastor rightly points out, the NAFTA has no permanent organizational bodies ("institutions" in his terms), but it is full of rules-- institutions as the term will be used in this study. This study is about the importance of those institutions for economic performance.

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[4]Pastor, *Toward a North American Community*, Chapter 5.



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## The Nexus of Economics and Economic History

Yet, just saying that we are going to focus on the formal rules of the NAFTA is of little use to us unless we can say something about the rules beyond the basic political history of the Agreement, the realm of chalkboard economic welfare analysis, or a basic reading of the Agreement. Enter economic history, the second of two broad influences that will inform this study. There are two basic approaches to economic history. The first is to use economic theory to advance our understanding of history; in essence, what can economics tell us about an historical event that is missing from our basic history. The second is to use history as a laboratory for economic theory; how does history square with what economic theory tells use ought to occur. To some degree, this study is about both of these approaches, but most fundamentally about the latter.

Behind the study of institutions is an increasingly well-developed, but still emerging, economic theory of institutions. The central ideas of institutional economics will be dealt with in the next chapter, but the goal of this study is to assess whether the ideas of institutional economics hold up when tested against the historical account of the emergence and operation of the NAFTA. In order to assess the utility of institutional economic theory in helping us understand the NAFTA, this study takes a three pronged approach in its research design and hypothesis formation that examines the NAFTA and the theory from microeconomic, macroeconomic, and, for lack of a better term, "systems" points of view.

Looking at the NAFTA from the point of view of institutions, this study will attempt to address a broad research question by posing three slightly different hypotheses



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about institutions and their relationship to the NAFTA. *Broadly speaking, the point of this study is to assess the utility of the explicit consideration of institutions (in the sense of formal and informal rules and norms) in understanding the recent history of North American economic development, and in particular the NAFTA itself.*

The overriding assertion put forward by those who study the impact of institutions on economic performance is simply that 'institutions matter' for economic performance. More specifically, the analysis of the impact of institutions on economic performance suggests a direct link between the prevailing institutional choice set (incentive structure) and wealth creation. Differing sets of institutions, it is argued, will necessarily result in different outcomes in terms of the creation of wealth simply because of the differences in the incentive structure that those institutions shape. Debates over the virtues of deeper North American Integration in recent years have focused primarily on whether the reduction of border measures has improved economic performance in various sectors or throughout the macro-economies of all three NAFTA partners. **Hypothesis I**: I hypothesize that changes to the institutional matrix in North American economic relations have resulted in economic outcomes that are as much a result of the institutional matrix itself as they are the result of predictions made by neoclassical economic models demonstrating the gains from liberalization.

If institutions matter for economic performance, then the advent of the U.S.-Canada Free Trade Agreement and the North American Free Trade Agreement should have altered the incentive structure around which organizations (firms) structure their activities within the North American economic zone. According to the theory of the firm,



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the main function of the firm is to reduce the impact of transactions costs by internalizing them within the firm's production structure. **Hypothesis II**: I hypothesize, therefore, that the institutions embodied by the Canada-U.S. Free Trade Agreement (CUFTA) and the NAFTA have themselves had a significant impact on micro-level economic performance by inducing changes in organizational structures to take advantage of the new incentives presented to them by institutions and shape the way actors think cognitively about their economic choice set.

**Hypothesis III**: I hypothesize that the framework put forward by the New Institutional Economics can help us better understand the dynamic of institutional change and the impact on economic performance. How? Underlying the economics of institutions is the basic neoclassical economic model first articulated by the likes of Adam Smith and David Ricardo. Economists are used to thinking about economic performance as the product of factors of production (land, labor, capital, widgets, etc). Yet, the neoclassical model is limited in its explanatory power because it does not explicitly consider the link between basic institutional structures such as property rights (defined by the range of productive uses rights holders can put their property to) and the creation of wealth. Such rights are bought, sold, subdivided, or leased so as to allow them to be employed to bring about their greatest market value. The institutional matrix that governs how property rights are exchanged and enforced will determine just how productively they will be employed.

This largely reflects my first hypothesis; namely that institutions are determinative of economic performance. However, the institutional matrix faced by economic actors is



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never static for long and is the product of a range of social, political, and economic influences that are not captured by the traditional, static neoclassical model's concern with inputs and production functions. Institutional approaches argue that institutional change, and therefore variation in incentive structures and economic performance, are the product of a dynamic feedback process between the existing stock of institutions which shape choice sets, the actors and organizations who organize and make decisions around them, the economic outcomes of those decisions, and the political organizations charged with writing and enforcing institutional rules. By extending the basic neoclassical economic model to explicitly consider institutions and institutional change, we can better understand how the NAFTA came into being and how it has affected North American economic development. Institutions are not created in a vacuum nor do they change in the absence of social, historical, political, and psychological influences. By incorporating these elements into a dynamic framework for understanding institutional change, we can better understand the process of institutional change in North America over the last twenty years that led to the NAFTA.

### A Caveat About Institutional Economics

The intuitive reasoning that leads to the conclusion that "institutions matter" for economic performance is, perhaps, overly obvious. After all, we experience the impact of formal and informal rules in shaping our behavior when we drive a car (rules of the road), go to the bank (the terms of our banking privileges), or the customs we encounter (relative levels of customer service). Posted speed limits on our roadways guide our



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decision making while we are behind the wheels of our vehicles. Health and safety regulations help ensure that the products we purchase are not hazardous to our health. And a range of laws structure everything from our labor markets, to building codes, to how much we pay for a ride in a taxi. If we begin to think about institutions as something analogous to rules, their application to the rules-based international trade regime as embodied by the NAFTA or the WTO may seem somewhat obvious. Haven't we always thought about the NAFTA and WTO as a set of rules? Don't the rules of trade help level the playing field, make trade fair, ensure there are fewer cheats? All true, and all part of the public lexicon surrounding the NAFTA. But when talking about international trade rules, we seldom investigate how the rules of the game actually structure incentives and the distribution of available rent when we engage in economic activity. We think of the rules of the game as *de facto* or *de jure* rules that simply must be followed, not changeable structures that shape the range of incentives available to us. Yet, each of us is of necessity a kind of student of institutions. In a variety of ways we each articulate preferences through our decision-making in support of, or opposition to, existing institutions. This is the subject matter of institutional economics.

But, if you demand deterministic conclusions about changes in aggregate welfare, then institutional economics will disappoint. In examining institutions, there is little that can yet be said prescriptively about the relative efficiency of one set of institutions over another for such prescriptions too frequently involve moral judgements. However, institutional economics does have a theory directed toward the prediction of the substantive impacts of institutional alternatives on different groups. It is a field that is



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interested in how individuals form subjective perceptions of concepts like marginal cost, marginal revenue, resource maximization, and how institutions affect those perceptions under uncertainty. It is a point of view that departs from the basic micro-economic rational choice assumptions about self-interest by expanding it to try and understand why we frequently engage in self-less, altruistic behavior. For instance, what role do social standards of behavior, changing preferences, or the role of experience play in shaping our subjectively formed choice set? More importantly for this study, how do the various formal rules further constrain our behavior or present new opportunities. For hard-core econometricians, this might all seem interesting, but far too imprecise because of its reliance on anecdotal evidence and an absence of large-sample econometric tests. A major obstacle in studying the impact of institutions on economic performance is the absence of the kind of data required to perform such econometric tests. One could charge that institutional economics is too subjective, that because behavior and performance are never determined by institutions alone, but also by a range of other exogenous factors that individuals must consider, institutional analysis is virtually impossible. In some sense it becomes a kind of unmanageable, certainly untestable, theory of everything– at least from a hard-core econometric point of view. Institutional approaches to human behavior are further complicated by the fact that behavior, to the extent that institutions shape it, is influenced by a matrix of institutions, some formal, some informal. We could try and isolate individual behavior by putting it a kind of black box and make observations relating different patterns of institutions to different performance characteristics. After all, it is not necessary to know what is in the black box to show a relationship between speed



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limits and auto accidents or the price of an import with or without a tariff. However, as the study of institutions makes clear, understanding the black box behavior relating to institutions could obviously be useful in the realm of public policy where behavioral responses to institutional incentives are all important.

The chapters that follow may at times seem like an overly critical attack on the basic neoclassical economic model and some of its assumptions. Yet, as I will hopefully make clear below, this study is all about the neoclassical model and its emphasis on choice under constraint. This study is simply about those constraints in the context of international trade and investment and how the designs of those institutions constrain our economic choice sets.

## Where Does This Study Fit?

The reader will surmise from the discussion thus far that this study is most heavily focused on the economic literature related to institutions and institutional change, much of which will be detailed in the next chapter. However, in addition to the heavy influence of economic historians, this study is also highly multi-disciplinary in that it crosses several other academic disciplines, as well as the ever-deepening public policy literature covering international trade, economics, development, international law, and of course the NAFTA itself. The sheer volume of literature concerning the NAFTA alone, much less the relevant literatures in a variety of other disciplines, defy easy description or summary. In 1996, just two years after the NAFTA's implementation, Allen Metz



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compiled a NAFTA bibliography that merited nearly five hundred pages.[5] In lieu of a comprehensive review of these large and distinct literatures, the following is a sample of the primary influences from the literatures from which this study draws.

Public Policy

The NAFTA related public policy literature can be loosely lumped into two principal camps; those studies that have attempted to assess the impact and operation of the NAFTA in economic, political, and social terms, and those who have engaged in overt advocacy in favor of or, more often, against the NAFTA.[6] A significant proportion of the assessment work has emerged from think-tanks and organizations such as the Institute for International Economics in Washington, D.C.,[7] the World Bank,[8] and Canada's C.D. Howe Institute.[9] While it is difficult to generalize about the work of these bodies, they

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[5]Alan Metz, *A NAFTA Bibliography*, (Westport, CT: Greenwood Press, 1996).

[6]There is, of course, the kind of advocacy in favor of the NAFTA that emerges from the government agencies responsible for administering the Agreement. It offers an almost universally favorable, some might say overly favorable, assessment of the NAFTA and its benefits. The information released by government agencies about the NAFTA often counters the NAFTA's frequently ill-informed critics, but is itself often guilty of exaggerating the facts.

[7]See Garry Hufbauer and Jeffrey Schott, *NAFTA: A Ten-Year Appraisal* (Washington, D.C.: Institute for International Economics, 2004); Gary Clyde Hufbauer, Daniel C. Esty, Diana Orejas, Luis Rubio and Jeffrey J. Schott, *NAFTA and the Environment: Seven Years Later*, Policy Analyses in International Economics 61 (Washington, D.C.: Institute for International Economics, 2000); I.M Destler, *American Trade Politics*, 3rd ed. (Washington, D.C.: Institute for International Economics, 1995).

[8]Daniel Lederman, William F. Maloney and Luis Serven, *Lessons From NAFTA: for Latin America and the Caribbean Countries* (Washington, D.C.: The World Bank, 2003); International Monetary Fund, *Developments in the Doha Round and Selected Activities of Interest to the Fund*, (Washington, D.C.: International Monetary Fund, April 2003).

[9]Wendy Dobson, "Shaping the Future of the North American Economic Space: A Framework for Action," *C.D. Howe Institute Commentary* 162 (April 2002): 1-32; Patrick Macrory, "Dispute Resolution in the NAFTA: A Surprising Record of Success," *C.D. Howe Institute Commentary* 168 (September



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have generally taken an even-handed, often critical approach to the NAFTA and concluded that, on balance, the overall impact of the Agreement in areas such as trade creation, productivity, and standards of living has been positive, if somewhat uneven, for all three countries. Within each of these, the authors acknowledge deficiencies in the structure and operation of the Agreement in areas ranging from dispute resolution mechanisms, to the inefficiencies with rules of origin, to the social impact of the adjustment process. There is also an array of non-government organizations, everything from consumer watch-dog groups, to environmental organizations, to private development agencies, which have taken a range of positions on the NAFTA. Public Citizen, for instance, has become one of the loudest, most consistent critics of the NAFTA and the impact the adjustment process has had on workers. Oxfam International has recently offered a mixed assessment of trade liberalization in calling the Doha Development Round of the WTO pivotal for developing countries in alleviating poverty.[10] At the same time, Oxfam is also much less sanguine about prospects for the Free Trade Area of the Americas to alleviate poverty in the Western Hemisphere saying it is based too heavily on the failed NAFTA model.[11] There are of course a plethora of non-governmental organizations and pseudo non-governmental organizations who regularly publish on topics related to trade and the NAFTA, some of which are ill-informed, but

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2002): 1-24; Bill Dymond and Michael Hart, "Canada and the Global Challenge: Finding a Place to Stand," *C.D. Howe Institute Commentary* 180 (March 2003): 1-25.

[10]Oxfam International, "Running Into the Sand: Why Failure at the Cancun Trade Talks Threatens the World's Poorest People," *Oxfam Briefing Paper* No. 53 (August 2003).

[11]Oxfam International, "From Cancun to Miami: The FTAA Threat to Development in the Hemisphere," *Oxfam Briefing Note* (November 2003).



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nevertheless still influence the debate over the Agreement. This brand of academic literature is particularly important because this study aspires to make a contribution to this literature that differs from most studies which focus on the public policy implications of outcomes and instead suggests that if we want to understand outcomes, we need a closer look at process.

*Psychology/Cognition*

Although all of social science is involved with the study of the human condition, none have been as concerned with the human reasoning so important to this study as psychology. In fact, where ever we look in other social sciences, the work of psychologists is pervasive in influencing the work of economists, political scientists, sociologists, anthropologists and others. No one has blurred the disciplinary lines between psychology and others as much as Herbert Simon who began is career as an economist and has since become one of the most important influences in psychology and, more specifically, its cognitive branch. Simon introduced the important concept of "bounded rationality" that has become an important qualification to the rational choice assumptions of the neoclassical economic model. Simon's work suggests that when humans are confronted with uncertainty and the high costs of gathering the information with which we make decisions, we rarely reach solutions in the neat linear fashion depicted by the neoclassical model. In short, humans become "satisficers" rather than the maximizers of the neoclassical model, in settling for imperfect, often inefficient solutions. The work of Simon, detailed more extensively below, has been elaborated upon by others, including



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Daniel Kahneman and Amos Tversky,[12] who have also repeatedly demonstrated that humans routinely violate the most basic tenets of rational choice models, even when engaged in the simplest kinds of decision making. This line of research is critical for both this study and the work of others in helping to emphasize the important role institutions play in helping shape our economic decision making processes.

*Conflict Management/Negotiations*

The work of psychologists on human decision making has an obvious extension into decision making patterns where the interests of individuals and groups come into conflict with each other and inevitably require forms of cooperation and compromise. Understanding the process of negotiation and compromise undertaken across the bargaining table, both domestically and internationally, is the domain of students of bargaining and negotiation (conflict management). While the argument being made in this study is that the NAFTA is a set of institutions that shape our choice set and decision making processes, the Agreement is nevertheless still an international agreement reached through several years of negotiations. Students of conflict management seek an understanding of negotiated outcomes through an understanding of the value of the means used by each side in the negotiation– namely the implements of power–,[13] value of the

[12]See, Amos Tversky and Daniel Kahneman, "Judgement Under Uncertainty: Heuristics and Biases," *Science* 185 (September 1974): 1124-1131; Amos Tversky and Daniel Kahneman, "The Framing of Decisions and the Psychology of Choice," *Science* 211 (January 1981): 453-458.

[13]P. Terrence Hopmann, *The Negotiation Process and the Resolution of International Conflicts*, (Columbia, SC: University of South Carolina Press, 1998), Chapter 7. See Gilbert R. Winham and Elizabeth DeBoer, "Asymmetry in Negotiation the Canada-U.S. Free Trade Agreement, 1985-1987," in I. William Zartman and Jeffery Z. Rubin eds., *Power and Negotiation*, (Ann Arbor: The University of



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end goals of a negotiation,[14] the structure of the process itself,[15] and, of course, the role of individuals involved.[16] Contributions to this field have relied heavily upon game theoretic approaches to conflict resolution,[17] questioned the process leading to parties effectively splitting their differences (the so-called 50 percent solution) and examined the impact of the dynamics of a negotiation on final outcomes. These studies are important influences because they suggest that institutional change is a dynamic process, one that may generate unexpected (possibly inefficient) outcomes acceptable to all parties.

*International Relations*

While the literature on conflict management focusing on negotiations can help us understand many of the dynamics leading to and surrounding the negotiating table, this work has a natural extension into the more traditional literature in international relations that is particularly informative for this study. The key question for theorists of international relations is understanding the sources of cooperation and conflict in an international system whose main characteristic is anarchy. This is particularly important

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Michigan Press, 2000): 35-52.

[14]Robert Axelrod, "Prisoner's Dilemma," *Journal of Conflict Resolution* 24 (1) (March 1980):3-26; Hopmann, *The Negotiation Process*, Chapter 4.

[15]See Hopmann, *The Negotiation Process*, Chapters 5 and 10. See also I.W. Zartman, *The Negotiating Process: Theories and Applications*, (Beverly Hills, CA: Sage Publications, 1978), Chapters 1, 2, and 7.

[16]See P. Terrence Hopmann, *The Negotiation Process,* Chapter 8; Daniel Druckman, "Stages, Turning Points, and Crisis," *Journal of Conflict Resolution* 30(2) (June 1986): 327-360.

[17]Kenneth A. Oye, "Explaining Cooperation Under Anarchy: Hypotheses and Strategies," *World Politics* 38 (1) (October 1985): 1-24; Robert Axelrod and Robert O. Keohane, "Achieving Cooperation Under Anarchy: Strategies and Institutions," *World Politics* 38 (1) (October 1985): 226-254.



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for trying to understand institutional change under the NAFTA, for while we might be able to understand how institutions change domestically, achieving institutional change internationally is an intuitively more complex process. Particularly important for our understanding of institutional change under the NAFTA is the literature dealing with cooperation in international affairs; in particular that dealing with regimes and regime formation as well as the increasingly important concept of interdependence. Beginning with an important article by Kenneth Waltz in 1964, neorealists have argued that the structure of the international system can have an especially profound influence on the conduct of international affairs-- in this instance peace and stability in the international system via a bipolar system anchored by two opposing superpowers armed with nuclear weapons.[18] However, that structure, such as it is, is nevertheless anarchic in nature with the most powerful states exercising and enforcing effective control over many of the actions of others. If we think of the international system as a billiard table full of balls of different relative sizes, each of which represent a state, states are free to move around the table at will, subject only to the power and influence of the heaviest billiard balls.

Yet, casual observation suggests that there are a range of sub-state entities which have a significant influence on the course of international affairs. States themselves, be they small or large, also appear to have considerable autonomy within the structure of the

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[18]Kenneth Waltz, "The Stability of the Bipolar World," *Daedalus* 93 (Summer 1964): 881-909; Kenneth Waltz, "The Spread of Nuclear Weapons: More May Be Better," *Adelphi Papers* No. 171 (London: International Institute for Strategic Studies, 1981); see also Richard Rosecrance, "Bipolarity, Multipolarity, and the Future," *Journal of Conflict Resolution* 10 (September 1966):314-327; John J. Mearsheimer, "The False Promise of International Institutions," *International Security* 19 (3) (Winter 1994/1995): 5-49; Robert Osgood and Robert Tucker, *Force, Order, and Justice*, (Baltimore: Johns Hopkins University Press, 1967); Robert Gilpin, *War and Change in World Politics*, (Cambridge: Cambridge University Press, 1981).



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international system, some of which is dependent on a state's own perception of its role in the international system.[19] The notion that the anarchic, billiard table-like international system is perhaps not so anarchic after all has been advanced by several well-known political scientists under the banner of interdependence or regime theorists who begin with the premise that realist's over emphasis on security masks the importance of many other issues for states, namely those of an economic nature.[20] These scholars go on to paint the international system more in terms of a billiard table full of balls, but connected to each other as though with cob-webs that represent the various constraints on state behavior, agreements and treaties between them, as well as the need for states to rely upon one another for their survival.[21] Marxist theorists, such as Immanuel Wallerstein, have gone one step further by putting forward a kind of economic determinism in

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[19]See Alexander Wendt, "Anarchy is What States Make of It: The Social Construction of Power Politics," *International Organization* 46 (2) (Spring 1992): 391-425.

[20]See Joseph Nye and Robert Keohane, *Power and Interdependence*, (Glenview, IL: Scott, Foresman, 1989); Stephen Krasner, "Structural Causes and Regime Consequences: Regimes as Intervening Variables," *International Organization* 36 (2) (1982): 1-21; Robert Keohane, *After Hegemony*, (Princeton: Princeton University Press, 1984); Joseph S. Nye and John D. Donahue eds., *Governance in a Globalizing World*, (Washington, D.C.: Brookings Institution Press, 2000); Judith Goldstein and Robert Keohane, "Ideas and Foreign Policy: An Analytical Framework," in Judith Goldstein and Robert Keohane, *Ideas and Foreign Policy: Beliefs, Institutions, and Political Change,* (Ithica, NY: Cornell University Press, 1993), 3-30; Stephen Krasner, "The Accomplishments of International Political Economy," in Steve Smith, Ken Booth, and Marysia Zalewski, eds., *International Theory: Positivism and Beyond*, (Cambridge: Cambridge University Press, 1996): 108-127.

[21]See Stephen Krasner, "Compromising Westphalia," *International Security* 20 (3) (Winter 1995/96): 115-151; Mark W. Zacher, "The Decaying Pillars of the Wesphalian Temple: Implications for International Order and Governance," in James Rosenau and Otto Czempiel, eds., *Governance Without Government: Order and Change in World Politics*, (Cambridge: Cambridge University Press, 1992): 58-101.



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international relations governed by a broad capitalist super-structure.[22]

Finally, while international relations theorists have rightly been focused on concepts of power and defining and the role of power in shaping international affairs, the psychology of power is an oft-ignored aspect of the use of power of some importance for this study. Charles Doran's work on power cycle is obviously preoccupied with the components of state power and state power relations in the international system. However, in addition to the many components of power that can be used in defining it and assessing relative power capabilities, there is also the much more subjective component of power that involves the self-assessment by statesmen of the relative and absolute capabilities of the state internationally; Doran refers to it as a state's "foreign policy role."[23] If we begin viewing the international system as set of formal and informal rules of the game, Doran is suggestive of how important the cognitive assessment of the way that system operates is for state behavior within it; the system structures the way statesmen think about international affairs.

*Foreign Economic Policy*

For scholars of U.S. foreign economic policy, in particular, the following study

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[22]Immanuel Wallerstein, "The Inter-State Structure of the Modern World-System," in Steve Smith, Ken Booth, and Marysia Zalewski, eds., *International Theory: Positivism and Beyond*, (Cambridge: Cambridge University Press, 1996): 87-107; Immanuel Wallerstein, "The Rise and Future Demise of the World Capitalist System: Concepts for Comparative Analysis," *Comparative Studies in Society and History* 16 (4) (September 1974): 387-415.

[23]Charles Doran, "Economics, Philosophy of History, and the 'Single Dynamic' of Power Cycle Theory: Expectations, Competition, and Statecraft," *International Political Science Review* 24 (1) (2003): 13-49; see also Charles Doran, *Systems in Crisis: New Imperatives of High Politics at Century's End*, (New York: Cambridge University Press, 1991), Chapter 3 and 4.



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may seem familiar, even in the use of some of the same terms and modes of thinking about policy outcomes.[24] Take, for example, John Ikenberry's conclusion to 1988's special issue of *International Organization* devoted to "institutions."[25] Ikenberry writes that "institutional structures shape and constrain the capacities of groups and individuals within them."[26] However, the definition of institutions used by these scholars is more expansive than the one which will be developed in this study and includes "both the organizational characteristics of groups and... the rules and norms that guide the relationships between actors."[27] Ikenberry and others seek explanations for public policy outcomes by examining the impact social, state, and societal actors have on policy outcomes. This includes both the bureaucratic structures, the rules and laws that created them, as well as the actors that operate within them. This study does not deny the importance of these factors or the insights of this line of work. But this study does seek to draw a useful distinction between institutions and organizations (Chapter II and throughout) to better assess how the rules of the NAFTA have constrained and shaped the way we think about economics in North America.

In one way or another, each of these fields and approaches aims to understand

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[24]See for example, Goldstein and Keohane, "Ideas and Foreign Policy,"3-30; Stephen Haggard, "The Institutional Foundations of Hegemony: Explaining the Reciprocal Trade Agreements Act of 1934," *International Organization* 42 (1) (Winter 1988): 91-119; See also, I.M. Destler, *American Trade Politics* 3rd ed., (Washington, D.C.: Institute for International Economics, 1995).

[25]G. John Ikenberry. "Conclusion: An Institutional Approach to American Foreign Economic Policy," *International Organization* 42 (1) (Winter 1988): 219-243.

[26]Ibid., 223.

[27]Ibid.



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human interaction in international affairs. How we interact, whether through conflict or cooperation, the means by which we relate, and the agreed norms which exist or are created that limit and structure our interaction are obvious keys to understanding that interaction. Explaining cooperation or conflict in international relations has been an issue of some debate among scholars. Particularly contentious is the sorting out of causal linkages between the apparent cooperation and regime formation we see in international affairs simultaneously with conflict.[28] If, for example, regimes that foster interdependence are the prime drivers in international affairs, where do these regimes come from? Do some regimes matter more than others? What are the relative influences of formal versus informal regimes in international relations? And, how do we account for a range of international behaviors that seem unaffected by regimes? Are regimes themselves actually supported by a kind of international structure separate from the regime itself– in other words, does the regime owe its existence to the presence of strong, supportive states? Do such regimes ever take on lives of their own to become more important in international affairs than states themselves? International regimes, whether economic, military, or cultural, also go through dramatic changes. But the "how" and especially the "why" behind those changes has been the subject of great debate.[29] These questions are part of

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[28]See Stephen M. Walt, "One World, Many Theories," *Foreign Policy* 110 (Spring 1998): 29-46; Mearsheimer, "The False Promise of International Institutions," 5-49; Robert O. Keohane and Lisa L. Martin, "The False Promise of Institutionalist Theory," *International Security* 20 (1) (Summer 1995): 39-51; John Jerard Ruggie, "The False Premise of Realism," *International Security* 20 (1) (Summer 1995): 62-70.

[29]See Charles Doran, *Systems in Crisis* (New York: Cambridge University Press, 1991); George Modelski, "The Long Cycle of Global Politics and the Nation-State," Comparative Studies in Society and History 20 (2) (April 1978): 214-235; See also special issue of *International Political Science Review* 24 (1) (January 2003), "Power Cycle Theory and Global Politics." Wallerstein, "The Rise and Future Demise



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the ongoing debate in international affairs over the relative importance of states compared with non-state organizations, international agreements, regimes, and other forms of cooperation in international affairs. They are questions that will arise repeatedly throughout this study, and to which, regrettably, this study offers no definitive answers, but aims to offer new insights.

One of the challenges in developing approaches to understanding the human condition is making them sufficiently generalizable to apply across time and situation. In spite of utilizing the same historical facts and information, scholars have come up with theoretical approaches that are almost too numerous to count.[30] However, recall the famous parable of a group of blind men describing an elephant. Each of the men touches a different part of the animal and describes what he senses. Each man offers wildly different accounts of the beast, which while ostensibly at variance with one another, nevertheless when put together describe the whole. It is within this spirit of investigation that this study seeks to make a contribution to the literature on the emergence and operation of the NAFTA.

## Plan of the Study

The plan of this study follows from the three hypotheses posed above. Chapter II will outline in some detail the central relationships between institutions and economic

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of World Capitalist System," 387-415; and Gilpin, *War and Change in World Politics,* (Cambridge: Cambridge University Press, 1981).

[30]Walt, "International Relations: One World, Many Theories," 29-47. Martin Wight, "Why There is No International Theory?" in M.Wight and H. Butterfield eds., *Diplomatic Investigations*, (London: G. Allen and Unwin, 1966): 17-34.



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decision making put forward by those who study the economics of institutions and institutional change. That will be followed by Chapter III which represents a first cut at applying the lense of institutional economics to an analysis of the North American Free Trade Agreement. Chapters IV, V, and VI will then, in turn, address each of the three hypotheses. Chapter IV will focus on how NAFTA Chapter 11's investor state dispute resolution provisions have the potential to alter traditional definitions of property and the relationship between private interests and sovereign states under international law. In doing so, the NAFTA has generated novel new incentive structures for firms in the pursuit of economic rent that are largely the result of the institutions themselves rather than the neoclassical model's predictions regarding changes to economic activity as a result of trade liberalization. Chapter V of this study will then take a micro-level approach to assessing how the institutions of the NAFTA generated incentive structures around which firms then organized their production decisions. Finally, Chapter VI of this study will try and place all of this in broad framework for understanding institutional change in the context of international trade relations and the NAFTA in particular.



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# CHAPTER II
# NEOCLASSICAL THEORY AND INSTITUTIONAL ECONOMICS

The definition of institutions borrowed from Douglass North in Chapter I is useful in terms of directing our efforts at understanding economic activity toward the many humanly devised constraints that structure that activity, but it does not provide us with a clear explanation of what institutions are, what they are not, or where exactly to look for them. In fact, North's definition of institutions as informal constraints (sanctions, taboos, customs, traditions, and codes of conduct) and formal rules (constitutions, laws, and property rights), seems to suggest that institutions might be found everywhere. In fact, institutions are everywhere shaping our economic decision making. That they are such a ubiquitous, and influential, part of our economy argues strongly for including them more explicitly along side neoclassical theory as tools for explaining our economic system.

However, before we can simply assert that institutions are important and pervasive elements in modern economies, we need a fuller understanding of what institutions are, what they are not, where they are, and their relationship to standard neoclassical economic theory. That is the topic of this chapter. What follows is an explication of the three key elements the study of institutions brings to the neoclassical model– transactions costs, property rights, and contractual relations– each of which provides analysts with additional tools with which we can assess the impact of institutional change in North America as a result of the North American Free Trade



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Agreement.

## Fundamental Number One: A Story of Transactions Cost Economics

From the Autarkic Farm to Industrial Capitalism

*Autarky?*

Imagine for a moment a small family farm in the middle of Alberta, circa 1870. Suppose that it is run by a family of five and that they are among the first settlers to the Canadian west. The closest farms are miles away and the location of their farm is far removed from any of the primitive transportation routes in existence in 1870 western Canada. Our family of five essentially lives in an autarkic world in which all that the family consumes it will also have to produce or acquire on their own. Our farmers will likely try and grow a range of products, perhaps raise a few cattle, trap a few animals, and cut down trees for fire wood. Alone in the vastness of the Canadian west, the family is quickly be faced with a range of choices upon which decisions about their survival will depend. They must make difficult choices about what and how much to grow and make decisions about how much labor to expend doing so to ensure their survival through the winter and into the next growing season. Because of available resources, and certainly because they number only five, our isolated family cannot possibly hope to have everything it might want, but will ultimately prioritize and allocate scarce resources to produce as many of the things the family needs as possible. In essence, by confronting a



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range of choices under constraint, our family has become a quintessential economic unit within the neoclassical model.

*The "Market" for Institutions*

But wait a minute, there was no "market" to speak of in Alberta circa 1870. True, in the scenario I have laid out, the family farm operates largely untouched by the markets of the outside world. There are no outlets for trading the excess from a bountiful harvest, nowhere to trade for new livestock, and no readily available pool of labor with which farm production could be expanded. How can the family farm be counted as an example within the neoclassical model? There are three basic reasons.

First, markets are everywhere. Frequently forgotten in the discussion of economic decision-making is how significant even the smallest of decisions can be for economic activity, regardless of the nature of the particular market in which they operate. The popular concept of "the market" is often vague, and seldom explicitly defined. In business reports, the market refers narrowly to buying and selling on the world's stock exchanges. More broadly, the concept of the free market, or a free market system is liberally tossed around to refer to the broader macroeconomy. Yet markets, as important as they are, can be defined simply as anywhere in which a group of people are willing to buy and sell things. The market for sugar is anywhere sugar is bought and sold. It could be on the trading floor at the Chicago mercantile exchange. It could be in the midst of a phone conversation between two people, thousands of miles apart, as they negotiate the sale of sugar. Local markets abound as well. The market for housing in Washington, D.C. is



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confined to Washington, D.C. just as the market for shooting marbles at public school No. 125 in New York City is confined to public school No. 125. There are also numerous examples of economic choices (market choices) that take place apart from the presence of "markets"as we are accustomed to thinking of them. Governments, firms, even families, can be dominated internally by the "invisible hand" of conscious planning, rather than by anonymous instructions from the market.[31] The "invisible hand," whether it operates within a closed market such as the family or a firm, or in one characterized by easy entry and exit, such as that for housing in Washington, D.C., is still one that functions within a framework of choice under constraint. It is choice under constraint, regardless of the form those constraints take, that is the primary obsession of the neoclassical model.

Second, markets are influenced by institutions that help shape the choice set decision makers are confronted with in the market. Our small family farm that operates in an autarkic environment is no different from the dynamics internal to firms or governments. None is unaffected by the constraints imposed on them by the outside world. All have internal, if consciously planned, markets that are shaped by those constraints and have their own set of institutional structures to help deal with those constraints. How are the mechanisms for exchange, say of labor, managed withing the family unit? Institutions! Let's go back to the definition of institutions put forward by Douglass North, institutions as the humanly devised constraints that structure political, economic and social life. On the family farm it will largely be informal constraints such

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[31]Donald McCloskey, "The Economics of Choice: Neoclassical Supply and Demand," in Thomas Rawski, Susan B. Carter, and Richard Sutch, eds., *Economics and the Historian*, (Berkeley: University of California Press, 1996), 125.



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as sanctions, taboos, customs, traditions, and codes of conduct, all enforced by kinship, that help shape their economic choice set thereby influencing their economic decision making process. Such informal institutions affect our economic behavior in many ways. In modern societies, they may come in the form of religious beliefs that shape our decisions regarding shopping for necessities on Saturday or Sunday. They might come in the form of traditions sanctioning duels as a gentlemanly form of dispute resolution, even if actually outlawed by formal law.[32] Or, they may even come in the form of extensions of formal Constitutional rules, such as those in the U.S. Congress governing seniority and committee chair selection.[33] However, it is the ties of culture and family that undeniably exert the strongest informal constraints on our economic choice sets.[34] Such powerful ties form the basis of many family-run businesses who can be assured that family ties will mitigate many of the problems of agency normally associated with impersonal exchange. The bounds of kinship within the family provide a reliable means of monitoring and enforcement of responsibilities amongst them that ensure the survival of them all.

Thirdly, it is important to be cognizant of the fact that markets, where ever they occur, are themselves institutions. Markets facilitate exchange, reduce transaction costs and, as we shall see, where they are present, facilitate the specialization of economic

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[32]Robert Axelrod, "An Evolutionary Approach to Norms," *American Political Science Review* 80 (1986): 1095-1011.

[33]Barry Weingast and William Marshall, "The Industrial Organization of Congress; or Why Legislatures, Like Firms, Are Not Organized Like Markets," *Journal of Political Economy* 96 (1988): 132-163.

[34]See Douglass C. North, *Institutions, Institutional Change, and Economic Performance*, (New York: Cambridge University Press, 1990), 36-45.



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activity that feeds productivity increases and a rising standard of living within an exchange economy.

*Simple Exchange*

However, imagine a slightly more complex economic system emerging around the Alberta farm? Suppose relatives move into the area and begin farming only a few miles away? Suppose that one farm specializes in cultivating crops while the other raises cattle and that a simple exchange economy develops between them in which they both pool and exchange their scarce resources. The fact is that the specialization of labor presupposes exchange, since only exchange can achieve the distribution of rewards necessary to sustain specialization.[35] In a simple model of exchange, the choice set facing the family would still largely be governed by a set of informal institutions such as customs or taboos, all of which would be enforced by kinship ties that prevent opportunistic behavior. But, suppose what was once a single family farm becomes a group of six farms, but that everyone is related. Imagine that it is now 1885 and the completion of the Canadian Pacific Railroad has brought the outside world a little closer to our farmers, other communities have sprung up in the area. If a slightly more complex exchange economy between our extended family of farmers and other local communities develops, whereby excess production from the family farms is exchanged with products produced in other communities, the impact of informal institutions on the decisions of the family

[35]Ian R. Macneil, "The Many Futures of Contracts," *Southern California Law Review* 47 (1974): 696-697.



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remains strong. The customs, traditions, and taboos that govern farm life among our collection of family farms would hold when a subset of them were sent off to negotiate the exchange of goods with another community. In such simple exchange economies, transactions costs (the cost of doing business) are relatively low and informal institutions governing exchange might develop between communities that include such things as "gentleman's handshakes," verbal agreements, or even IOUs.

*Transactions Costs and the Mitigation of Uncertainty*

Like markets, transactions costs are everywhere, and are one of the main preoccupations of those who study the impact of institutions on economic performance. But saying that transactions costs are everywhere is, unfortunately, as specific as the concept of utility curves as expressions of individual preference sets in mircoeconomic text books. We may know they are everywhere, but knowing they are is akin to assuming them out of the model altogether because like utility curves, transactions costs have long been ignored by economists within the neoclassical model, despite more recent empirical work that has suggested transactions costs may account for fifty to sixty percent of net national product in advanced economies.[36] The reason markets and transactions costs go hand in hand, even within the context of a single firm or, in the case of our autarkic Alberta farmers, within the family, is that transactions occur when ever there is specialization, the division of labor and exchange that flows from them.

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[36]Erick G. Furubotn and Rudolf Richter, *Institutions and Economic Theory*, (Ann Arbor: University of Michigan Press, 2000), 39, 49-54.



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Adam Smith's classic example of the manufacture of a pin illustrates the point perfectly. "One man draws out the wire, another straightens it, a third cuts it, a fourth points it, a fifth grinds it at the top for receiving the head,..."[37] As Williamson has observed, "a transaction occurs when a good or service is transferred across a technologically separable interface. One stage of activity terminates and another begins."[38] Where there are transactions, there are also transactions costs.

One of the biggest sources of transactions costs is uncertainty. Although the neoclassical model emphasizes choice under constraint, the constraints that economic actors work under are seldom finite or clearly defined. Although we are confronted on a daily basis with a range of economic choices, we also confront considerable uncertainty about those choices and choice sets. Most of that uncertainty involves the imperfect nature of the information at our disposal to help us make decisions. Economic decision makers much prefer risk to uncertainty. Institutions help mitigate the uncertainty within our choice sets by transforming uncertainty into risk. Rising standards of living depend heavily on increasing productivity which in turn suggests specialization and with it increased complexity in economic exchange, fraught with increasing uncertainty and numerous transactions costs. Were it not for the development of institutions to help guide economic activity, economic actors would be completely lost in a world where the cost and uncertainty of obtaining information upon which to base economic decisions would

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[37]Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Library of Economics and Liberty [Online] http://www.econlib.org/library/Smith/smWN.html; accessed January 6, 2004, Internet.

[38]Oliver Williamson, *The Economic Institutions of Capitalism*, (New York: The Free Press, 1985), 1.



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virtually prohibit economic exchange. Institutions, therefore, necessarily evolve along with economic specialization and serve to transform the uncertainty associated with imperfect information into risk, thereby reducing transactions costs, and facilitating the capture of the potential gains from trade.[39] If neoclassical economic theory is the economics of choice under constraint,[40] then it is institutions that help narrow and define the choice set by which we make economic decisions. Institutions, are analogous to road maps in that while they do not dictate where we choose to drive, nevertheless structure the choices available to us on our trips.

*Complex Markets*

As we will see later, organizations like firms or family units often form to economize on transactions costs and reduce uncertainty, but we first need some appreciation of the impact of those costs once the division of labor expands, complicates the choice set confronting economic decision makers, and significantly raises the cost of each transaction. The problem to be resolved is at once simple and fraught with all kinds of problems. Specialization and the division of labor permit economies of scale in individual production and, along with it, the potential for significant gains from trade. But with trade comes the uncertainty, and associated transactions costs, of impersonal exchange. Whereas familial ties form bonds of trust and obligation in the conduct of commercial activity, there are no such bonds tying people of different social groups,

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[39]North, 99-100.
[40]McCloskey, 122-158.



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regions, or nationalities together to guard against shirking or other opportunistic behavior. Put more simply, how can our family of farmers ensure that transactions conducted with communities with whom they have few personal or familial ties will be conducted to the benefit of both sides? How can the uncertainty of market exchange be transformed into manageable risk? More colloquially, how can both sides ensure they will not be ripped off? In modern industrialized societies, such a question seems moot. Couldn't the farmers simply reach an agreement on the terms of sale for what ever was being exchanged? In other words, agree to a sales contract? It is an obvious suggestion today, but one that in past eras was not so simply arrived at.

The fact that in modern societies the whole notion of contractual arrangements to facilitate impersonal exchange is taken as a given is suggestive of both the importance and subtlety of institutions in a modern society. Here I have sketched a quasi-historical tale of the evolutionary path that institutional development might have taken in the nineteenth century Canadian prairie west. Yet, in nearly any time period, a tale can be found of the evolutionary and path-dependent advance of institutional structures designed to facilitate the process of impersonal exchange. One classic example recounted by North is that of the development of long distance, sea-faring trade.[41] According to North, the development of long-distance trade required a sharp break in the characteristics of past economic activity. It entailed the specialization of exchange by individuals whose livelihood became centered around trading and the development of trading centers, not unlike the situation in our emerging nineteenth century prairie towns. However, the

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[41]North, "Institutions," 99.



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development of long-distance trade poses two particular transaction cost problems. The first is agency which, in a simple economy, is satisfied through the bonds of kinship. Having your brother travel to barter in a local market as your representative is fraught with fewer adverse selection and moral hazard problems than having someone you do not know act as your agent. The second issue that needed to be resolved was the negotiation of agreements that could also be enforced at a distance. According to North, where traditional means of negotiation and enforcement were once ensured through the force of arms and associated high transactions costs, the development of coercive and voluntary institutions such as standardized weights and measures, units of account, mediums of exchange, notaries, consuls, merchant law courts, made long distance trade possible for a greater number of merchants. In essence, the development of a mixture of voluntary and semi-coercive bodies, enabled long-distance trade to occur.[42]

*The Price System*

As important as many of the institutions identified by North as facilitating long distance trade are, perhaps one of the most important institutions to arise as a means of reducing the uncertainty and transactions costs associated with impersonal exchange, and one that has undoubtedly enabled additional efficiency through specialization and the division of labor, is the price system. Whereas within our hypothetical family-based farm economy a series of informal institutions such as taboos and customs facilitates exchange within family, ethnic, or tribal groupings, these sorts of institutions are of little use once

[42]North, "Institutions," 100.



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the complexity of economic activity moves beyond the bounds of family and into the more impersonal forms of exchange. I have already suggested that exchange between relative strangers can take place on the basis of gentleman's handshakes or the exchange of IOUs. But the problems of exchange become more complicated when exchange becomes ever more complex, impersonal, and intertemporal.

Suppose that our family farm economy is sufficiently complex that they would like to trade some of their excess production for some capital equipment, say a threshing machine? Suppose also that not far away from their farm, a small town has emerged as a regional service center for other farmers, none of whom are familiar to our family. When the family tries to sell their grain, a simple contractual arrangement could be made in which they agreed to trade so much grain for the threshing machine. But how would our family know whether it was exchanging a reasonable amount of grain for that threshing machine? In short, how can they know that they are being given a fair exchange for their produce? The answer is the price system of the neoclassical model. It may seem an odd point to emphasize the importance of the price system in structuring economic activity. Yet, it is just these sorts of institutions, along with others such as standardized weights and measures, legal systems, property rights, or other conventions, that economic actors seldom think about, yet are pervasive in shaping the economic choice set we confront on a daily basis.

The textbook analysis of the price system credits it with two principal functions in our modern economic system; a *rationing function* in so far as prices tend to limit excessive claims on scarce supplies; and an *allocative function* in terms of high prices



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providing incentives for entry into particular industries while low prices do the opposite by driving resources out of those industries.

While most economists can lecture at length about the merits and mechanisms of the price system, few have thought as deeply about the price system as Friedrich Hayek.[43] The importance of the price system for Hayek was of much greater philosophical importance than simply the rationing and allocation of scarce resources. For him, the price system was about much more basic questions of social organization, economic liberty, and the utilization of knowledge. In a classic 1945 paper that resonates today, Hayek begins, much as modern institutional economists, by questioning the assumption of perfect information made by economists. "If we," Hayek said, "possessed all relevant information, if we start out from a given set of preferences, and if we command complete knowledge of all available means," the only problem we have in organizing economic activity is merely one of optimization of resources.[44] But, he continues, the world of perfect information and knowable preference sets is emphatically not the one we are living in. The problem societies face in organizing economic activity is coordinating bits and pieces of information from innumerable sources. In Hayek's words, our problem is the "utilization of knowledge not given to anyone in its totality."[45] Under what system can widely-held, disparate information be coordinated for the benefit of all? Could bodies of experts come together to compile and disseminate all of this information? According to

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[43]See also Steven A. Landsburg, *The Armchair Economist: Economics & Everyday Life*, (New York: The Free Press, 1993), 73-82.

[44]F.A. Hayek, "The Use of Knowledge in Society," *American Economic Review* 35 (September 1945), 519.

[45]Hayek, "The Use of Knowledge," 520.



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Hayek, such a task is nearly impossible if some modicum of efficiency is to be maintained.

> Even the single controlling mind, in possession of all the data for some small, self-contained economic system, would not– every time some small adjustment in the allocation of resources had to be made– go explicitly through all the relations between ends and means which might possibly be affected.[46]

The enormity of the task of coordinating masses of disparate and ever changing information is coupled with the fact that individual economic agents need not know the how and why of every shift in economic activity in order to make their own decisions. It does not matter to the individual why at a particular moment in time more widgets of one variety over another are in demand, or why compliments to widgets are more readily available than the widgets themselves, or even why the inputs for making widgets are more difficult to acquire. All that is significant for the individual economic decision maker is how much more or less difficult to procure each of these has become compared with other things with which he or she is concerned.[47]

> It is always a question of the relative importance of the particular things with which he is concerned, and the causes which alter their relative importance are of no interest to him beyond the effect on those concrete things in his own environment.[48]

So how can widely-held bits of information be coordinated and travel throughout a complex economy in the absence of central coordination? How can we get that information to coordinate the separate actions of different people and create incentives

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[46]Hayek, "The Use of Knowledge,"525.
[47]Ibid.
[48]Ibid.



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which will make the individuals do the desirable things without anyone having to tell them what to do.[49] The price system is essentially a communications tool that attaches a numeric value (a price) to those things with which decision makers are most concerned that reflects their relative importance and scarcity. The decisions of individuals act as a whole market, not because any single person is able to survey the whole market and determine prices, but because each person's limited view sufficiently overlaps with others that the bits and pieces of information held by a large number of individuals is communicated to all through prices (ie. Adam Smith's "Invisible Hand"). What makes this system so essential to the operation of a specialized, diverse, and impersonal economic system is that

> ...in a case like that of scarcity of one raw material, without an order being issued, without more than perhaps a handful of people knowing the cause, tens of thousands of people whose identity could not be ascertained by months of investigation, are made to use the material or its products more sparingly; ie. they move in the right direction.[50]

Thus, without the price system as an institution guiding the rational decision-making of economic agents, it would be virtually impossible to have the degree of specialization or division of labor in modern economies that provides for the expansion of wealth.

We are getting some sense of the importance of transactions costs and the role institutions, such as the price system, play in transforming uncertainty into risk. But even with the price system, one could argue that not all the information needed to make

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[49]Hayek, "The Use of Knowledge," 527.
[50]Hayek, "The Use of Knowledge," 527.



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economic decisions is conveyed through the price system.[51] Relative prices, say of equity shares on a stock exchange, tell us a lot about the demand for particular shares, but do not tell us everything we might need to know about a stock before we buy. We naturally want information about the firm, the market for its products, the stability of its suppliers, and the health of its competitors. That information takes time to acquire and acquiring that information entails costs.

*The Importance of Transactions Costs II*

Yet, we need a clearer definition of exactly what these transactions costs are, where they are found, and why institutions are so important for dealing with them. Transactions costs involve three key elements: 1) uncertainty, or rather the resources required to mitigate uncertainty 2) the frequency with which transactions occur (linked to uncertainty and extending the shadow of the future) and 3) the degree to which transactions-specific investment costs are incurred.[52] Although there is little argument that uncertainty and the iteration of exchange are critical to the impact of transactions costs, there has been less attention paid to the issue of investment specific transactions.

*Investment-specific Transactions Costs*

As the heading suggests, transactions costs will fall most heavily on those

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[51]See Williamson, *Economic Institutions of Capitalism*, 9, 16-17.

[52]Oliver Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations," *Journal of Law and Economics* 22 (1979): 239.



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exchanges that involve the most specific and specialized kinds of exchange.[53] Contrast the case of two contracting parties for whom there are numerous other potential suppliers, say parts suppliers for the auto industry, with two parties for whom there are few if any other potential suppliers, say the Defense Department contracting with Boeing for jet fighters.[54] A key issue in any exchange between parties is whether the assets being exchanged are fungible; in other words, how rapidly can you re-deploy assets committed to an exchange relationship should that relationship fall apart?

In the former instance, the specific identity of the buyers and suppliers is unimportant because of the prevalence of alternate sources of supply and the relative ease with which the resources of suppliers are transferred to other potential buyers. Hence, the uncertainty of both parties to exchange is relatively high. Where the identity of the parties is important, as in the case of a government contract for jet fighters, both parties are likely to be more committed to a contract. In a sense, both parties have an interest in fulfilling the terms of the contract because, except where specialized training or investment capital are transferable to alternative buyers or suppliers, both are locked into the terms of the contract and may be more amenable to adapting or renewing contractual relationships-- in a sense the parties become engaged in a kind of exclusive bilateral supply.[55] In either case, parties to a contract are interested in appropriating as much of the rent from a

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[53]Williamson, *The Economic Institutions of Capitalism*, 52-56.

[54]See Patrick Bolton and David S. Scharfstein, "Corporate Finance, the Theory of the Firm, and Organizations," *The Journal of Economic Perspectives* 12 (4) (Autumn 1998): 95-114. Bolton and Scharfstein recount the well-known case of General Motor's 1926 acquisition of Fisher Auto Body in which asset specificity played a major role in determining the dynamic of their contractual relationship and provided incentives for integration under one roof. See also, Oliver Hart and John Moore, "Property Rights and the Nature of the Firm," *The Journal of Political Economy* 98 (6) (December 1990): 1119-1158.

[55]Williamson, "Transaction-Cost Economics," 240-41.



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contract as possible. However, the specificity of the investments within the contractual arrangement will dictate how those rents are distributed, how transactions costs are borne, and what kinds of institutions, many of which may be informal, evolve that frame the rules of the contract. In the case of many buyers and suppliers, the standard spot-market contracting costs will be incurred and institutional structures arise. But in the case of high investment specificity, a special set of institutions may arise to help structure the relationship and reduce the potential impact of transactions costs on the performance of the exchange relationship. These issues obviously arise again in the context of understanding contracting itself as an institution (see below and Appendix C). However, the important point to be made here is that the more highly specialized the assets within an exchange relationship are, the greater is the potential for transactions costs to be significant and hence, the greater the incentives for firms to bring such relationships under one roof through mergers and acquisitions.

*Spot-Market Transactions Costs*

Yet, not all contractual relationships between buyers and sellers are analogous to familial relations or close contractual relations between governments and the suppliers of fighter jets. Whether investment-specific or market oriented contracts, there are obviously transactions costs incurred in the process of negotiation, or the establishment of institutions. The impact of transactions costs also involves maintenance or changes to basic institutional structures such as rules, laws, or rights. The problems facing our Alberta farmers in the 1870s as they entered the broader exchange economy are best



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illustrated by Ronald Coase:

> In order to carry out a market transaction, it is necessary to discover who it is one wishes to deal with, to inform people that one wishes to deal and one what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on. These operations are often extremely costly, sufficiently costly at any rate to prevent many transactions that would be carried out in a world in which the pricing system worked without cost.[56]

In each and every contractual relationship, information, the process of negotiation, and the monitoring and enforcement of agreements entail costs. It may seem an intuitive point to make, but such costs are everywhere and entail everything from the expenses incurred in the search for prospective clients such as advertising, telephone bills, or travel expenses. The information age has placed a premium on market knowledge which new firms must either pay for or expend energy and resources collecting themselves. Beyond that, the price of actually negotiating the terms of contracts is fraught with all kinds of uncertainty, information asymmetries, and, of course, the legal costs of concluding contracts. Finally, once such contracts are in place, the issue of monitoring and enforcement of the contract's terms normally entails more expenditure still, either under the terms of the agreement or because neither party trusts the other leading to rent dissipating monitoring by both.

In addition to efforts to measure the impact of transactions costs on economic activity, scholars have also made attempts to incorporate transactions costs within the

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[56]Ronald Coase, "The Problem of Social Cost," *The Journal of Law and Economics* 3 (October 1960): 15.



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neoclassical model.[57] This basic approach is outlined in Appendix A with the help of several diagrams and helps to begin thinking about the real world impact of transactions costs that result from institutions. However, it is important to note that accounting for the impact of institutions is not just a matter of adding transactions costs to the standard production function Y= f (K,L) as though they were transportation costs. As the discussion below will highlight, the problem with just adding transactions costs to the neoclassical model revolves around information and the concept of "bounded rationality" that are more difficult to incorporate into the neoclassical model simply as additional parts of a knowable production function. However, as important as transactions costs are for an institutional approach to understanding economic activity are the institutions, like private property, that are partially responsible for generating them in the first place.

## Fundamental Number Two: Private Property

### The Building Blocks of Exchange

If the argument regarding the emergence of institutions has been made well to this point, one might observe that if new institutions emerge fostering exchange in the nascent Alberta farm economy, it implies the presence of another basic institution, private property. Indeed, the neoclassical model essentially assumes ownership as a part of the model and does not make the issue of property the focus of analysis, and yet property

[57]D.K. Foley, "Economic Equilibrium and Costly Marketing," *Journal of Economic Theory* 2 (1970): 276-91.



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rights are widely recognized as a basic institutional building block for economic development. In fact, some economists have argued that the entire study of economics is really little more than studying the distribution of rights to scarce resources.[58]

The philosophical debate over private property is nearly as old as recorded history and will be covered in greater detail in Chapter V. Here the discussion of property rights is important because of the role of property in basic economic development. In his study on the link between property and freedom, Richard Pipes suggests that the debate over property has centered around four basic themes:

> 1) Property as a socially stabilizing force and constraint on government vs. property as a source of inequality and attendant social unrest.
>
> 2) The moral argument that property rightly entitles people to the fruits of their labor vs. the criticism that many property owners have acquired their property through no effort of their own and that all should have an equal opportunity to acquire property.
>
> 3) An economic argument that holds property as the most efficient means of producing wealth vs. the critique that economic activity in the pursuit of gain leads to wasteful competition.
>
> 4) A psychological defense of property rights that instill the individual with a sense of identity and self-esteem vs. the charge that property rights are corrupting of the individual because they instill a sense of greed.[59]

Although all four of these represent a debate over the best way in which a society can organize economic activity, point number three bears most directly on this study.

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[58]A.A. Alchian,"Pricing and Society," *Occasional Papers No. 17,* Westminster Institute of Economic Affairs, 1967, 2-3.

[59]Richard Pipes, *Property and Freedom*, (New York: Vintage Books, 1999), 4.



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Development economists have extolled the virtues of private property and the security of property rights under the rule of law in fostering economic growth.[60] The basic point of this line of argument is that you can not fully exploit what you do not own. As Ronald Coase wrote in 1988,

> If rights to perform certain actions can be bought and sold, they will tend to be acquired by those for whom they are most valuable, either for production or enjoyment. In this process, rights will be acquired, subdivided, and combined, so as to allow those actions to be carried out which bring about that outcome which has the greatest value on the market.[61]

Economists and economic historians have examined the merits of private ownership vs. communal or common property rights and discovered time and again that the most efficient use of scarce resources (choice under constraint) flows from private property in physical objects such as land. By contrast, un-priced entry into areas where economic activity is dominated by common property rights leads to the inefficient, even destructive, use of scarce resources, now widely known as the tragedy of the commons.[62] Other studies, such as those that have looked at the economic effects of rent-controls,

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[60]See Hernando de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*, (New York: Basic Books, 2000); Gerald P. O'Driscoll Jr. and Lee Hoskins, *Property Rights: The Key to Economic Development*, Cato Institute Policy Analysis No. 482, (Washington D.C.,: The Cato Institute, 2003); Jakob Svenson, "Investment, Property Rights and Political Instability: Theory and Evidence," *European Economic Review* 42 (7) (July, 1998): 1317-41; See also World Bank, "Land Policies for Growth and Poverty Reduction," June 2003, at http://econ.worldbank.org/prr/land_policy and *The Economist, Survey of Sub-Saharan Africa,* "Breathing Life into Dead Capital," January 15, 2004.

[61]Ronald Coase, *The Firm, The Market, and The Law*, (Chicago: University of Chicago Press, 1988), 12.

[62]See for example, R. Taylor Dennen, "Cattlemen's Associations and Property Rights in Land in the American West," *Explorations in Economic History* 13 (1976): 423-36; Shawn Everett Kantor, "Razorbacks, Ticky Cows and the Closing of the Georgia Open Range: The Dynamics of Institutional Change Uncovered," *The Journal of Economic History* 51 (December 1991): 861-886; John Umbeck, "The California Gold Rush: A Study of Emerging Property Rights," *Explorations in Economic History* 14 (1977): 197-226; Rosemary E. Ommer, "All the Fish of the Post': Resource Property Rights and Development in a Nineteenth-Century Inshore Fishery," *Acadiensis* 10 (Spring 1981): 107-123.



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have similarly demonstrated that fixed price access to apartments inevitably provides few incentives for land owners to maintain buildings through investments in infrastructure. The result, rent controls lead to the deterioration of the buildings themselves, and the perverse effect of leading to a shortage of affordable housing.[63] However, before we reach the conclusion that private property is the panacea of economic efficiency, it is important to remember that the keys to private property as an institution for economic development are fraught with numerous transactions costs in specifying, monitoring, and enforcing those rights, all of which tend to reduce efficiency.

The whole notion of property rights originated from the exploitation of the land itself. The experience of the tragedy of the commons demonstrates that while ownership rights are not a necessary requirement for exploiting resources, it is a virtual necessity if they are going to be exploited efficiently and have the broadest possible economic impact. However, the most important shift in thinking about the institution of property which contributed to development and economic expansion was the one that moved thinking about property from land alone to other assets such as money or commodities.[64]

But why did this shift occur? "The most pervasive answer is economic. The transformation of land into tribal, family, or individual ownership seems to occur, first and foremost, in consequence of population pressures which call for a more rational method of exploitation..."[65] But nothing contributed more to the emergence of private

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[63]William Tucker, "How Rent Control Drives Out Affordable Housing," *Cato Policy Analysis No. 274,* (Washington, D.C.: The Cato Institute, May 1997); See also, "The Great Manhattan Rip-off," in *The Economist*, June 7, 2003: 25-26, Pipes, *Property and Freedom*, 262-65.

[64]Pipes, *Property and Freedom*, 89.

[65]Ibid.



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property as an institution for development than the arrival of urban life in the late Middle Ages. Private property gains importance in a commercial economy, because while it is possible exploit land without ownership, it is impossible to develop an urban and commercial economy in the absence of a more diversified definition of property that also includes outright ownership.[66] According to Roman law traditions the main elements of ownership in property are:

1) The right to make physical use of physical objects (ius intendi)
2) The right to the income from it (ius fruendi)
3) The power of management, including that of alienation (ius abutendi)[67]

Without ownership, virtually nothing can be traded or expanded, and commercial activity in an urban environment is nearly impossible. Absent an expanded definition of property, Europe might not have emerged from the Middle Ages as populated, urbanized, or commercially active as it did.

Yet, the whole notion of property rights has evolved well beyond the basics of physical ownership and now encompass a whole range of rights covering everything from copyrights and patents to intellectual property. Even the concept of human rights, not strictly a property right in the legal sense, has intrigued scholars studying the impact of institutions on economic performance because of the impact concepts such as self-determination and freedom have on human behavior.[68] Although the concept of property

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[66]Ibid., 107.

[67]Furubotn and Richter, *Institutions and Economic Theory*, 77.

[68]See Pipes, *Property and Freedom*, Chapter 5. Pipes makes the case that property is the central feature of economic and political liberty and that the definition of property itself has expanded to include a range of political, social, and economic rights, most of which are now provided by the generous welfare states of advanced countries (entitlements). However, such programs have, in effect seriously eroded individual rights over property because they have come as a result of an electorally-sanctioned



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rights continues to expand, includes rights to tangible (property) and intangible (intellectual property) items, as well as a range of informal rights enforced by etiquette, custom, or taboo (familial ties), property rights can usefully be lumped into two basic categories: absolute and relative property rights. While rights over tangible property are obviously about who gets to exploit scarce commodities, other kinds of rights are also about the distribution of resources– tangible, intangible, or informal– and who gets to exploit them.

Absolute property rights are essentially those rights that are directed against all others. Absolute property rights include all the rights of outright ownership (ius intendi, ius fruendi, ius abutendi), the fragmentation of ownership, or the right to transfer one of the three elements of ownership to someone else, ownership in immaterial rights such as copyright or intellectual property rights.

Relative property rights give the rights holder power which he/she can exercise only against one or more specified people, as is the case with a range of contractual relations. The essential characteristic of relative property rights is the passage of time between the conclusion of a contract and the fulfilment of its obligations. Here there is considerable overlap with absolute property rights in that the fragmentation of ownership entails the conclusion of a contractual relationship between owner and lessor. In all such cases, contracting is fraught with the well-known problems of agency such as adverse selection, asymmetric information, and post-contractual monitoring and enforcement. Relative property rights include a range of contractual property rights such as credit-debt

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expropriation through redistributive taxation.



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or purchase-sale relations, as well as court ordered obligations arising from liability cases.[69]

*Efficiency?*

But the main concern arising from property rights is how the precise allocation of those rights affect economic performance. The preponderance of the development scholarship points to private property as one of the most efficient means of allocating scarce resources, but it is more appropriate to argue that private property as an institution is a necessary, but not sufficient, condition of economic efficiency. There are actually numerous examples of *inefficient* institutional change, one of the most famous of which is the evolution of the standard typewriter/computer keyboard layout. Although several other layouts have been demonstrated to be much more efficient, the QWERTY layout across the top row of modern typewriters and keyboards became the industry standard and has, despite its objective inefficiency, served to reduce confusion and transactions costs that might otherwise result from the use of multiple layouts.[70] In his article on the QWERTY layout, Paul David suggests that it became the industry standard through a process equivalent to a *polya urn* scheme in which an urn is filled with marbles of a variety of colors and repeatedly sampled. Along with each sample, a marble of the same color is also added to the urn. If continued indefinitely, the proportional share of one of

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[69]For a broad, lengthy discussion of the differences between, and implications of, absolute and relative property rights, see Furubotn and Richter, *Institutions and Economic Theory*, Chapters 3 and 4.

[70]Paul A. David, "Clio and the Economics of QWERTY," *The American Economic Review* 75 (May 1985): 332-337.



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the colors will converge to unity. In other words, they will all be one color; become the dominant standard. A range of business practices and phenomenon, such as marketing or leader first-to-market phenomenon could be factors, but there frequently also appears to be an element of randomness. Stories similar to that of QWERTY could well be told about the rise of Microsoft Window's dominance of the personal computer market or the competition between VHS and Beta formats in the market for video cassettes. In each instance, scholars of industrial organization are still trying to understand the mechanisms by which demonstrably inferior standards become dominant.

Institutional change and the efficiency of property rights in the public policy process have also been the topic of study by scholars. Barry Weingast and William Marshall, for example, have examined how non-market forms of exchange in legislatures effectively mitigate many of the rent-seeking problems, such as logrolling, that typically plague the legislative process. Weingast and Marshall argue that, unlike firms, which use contracts to reduce uncertainty regarding transactions costs, legislatures have no system to ensure that vote trading between legislators is enforceable. Instead, they argue, the legislative committee system found in the U.S. Congress has evolved into a system of property rights characterized by seniority and the division of jurisdiction over certain types of policy (i.e. foreign affairs, finance, armed services) which enforce legislative bargains in a manner similar to contracts in private firms.[71]

It is the interaction between institutions and organizations that is the one of the

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[71]Weingast and Marshall, "The Industrial Organization of Congress," 132-163. See also, Barry Weingast, "The Congressional-Bureaucratic System: A Principle Agent Perspective (with applications to the SEC)," *Public Choice* 44 (1984): 147-191.



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most important elements of studying institutional change, and will be the subject of a more detailed discussion below. However, it is important here to note that contracting, as a key element in firm activities within a given institutional structure can involve incurring significant transactions costs. Firms navigate through the myriad problems associated with contracting, all of which can be modeled using the neoclassical framework (see Appendix B). But it is the precise distribution of property rights that is so important to economic performance. As the models of Appendix B suggest, the contracting process can result in pareto efficient outcomes. Yet we know from experience that contracts, and the distribution of rights therein, are full of inefficiencies which organizations such as firms often find difficult to bear. For example, the provisions of long-term labor contracts (relational property rights) concluded in one period often shackle large firms in the next period as market conditions change. Or, adverse selection and asymmetrical information at the outset of contractual negotiations may generate an inefficient distribution of property rights between parties that the market will simply not sustain. The point is that property rights help us form our expectations in exchange with others and that contracting is the most prevalent means of governing the exchange of those rights.[72] However, while contracting is designed to mitigate uncertainty in the exchange of rights, the process of contracting itself is fraught with numerous uncertainties at both the point of negotiation and during the life of the contract.

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[72]Harold Demsetz, "Toward a Theory of Property Rights," *The American Economic Review* 57 (2) (May 1967): 347-359; see also Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations," 239-242.



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Property Rights and the State

Much depends on how the state emerges around nascent property rights and how those rights are enshrined within and protected by the state.[73] As early as 1690, John Locke, in his *Two Treatises of Government*, identified the complementarity of government to property and the necessary trade off between absolute liberty in property and the general defense of the institution of property.[74]

> The functioning of competition not only requires adequate organization of certain institutions like money, markets and channels of information– some of which can never be supplied by private enterprise-- but it depends, above all, on the existence of an appropriate legal system, a legal system designed to preserve competition and to make it operate as beneficially as possible.[75]

In fact, as I will detail in later chapters, the ancient debate over whether the state or property emerged first leans heavily in favor of property, followed by the emergence of the state.[76] State power in the defense of private property through the rule of law has long been held as a central tenant of successful economic development. That the two are mutually complementary comes from the fact that while the state emerges to protect private property, private property is instrumental in protecting that institution from incursion by the state.[77]

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[73]F.A. Hayek, *The Road To Serfdom*, (Chicago: University of Chicago Press, 1944), 43; Pipes, *Property and Freedom*, 94-97.

[74]See Pipes, *Property and Freedom*, 35; See also, John Locke, *Two Treatises of Government*, who argued that "Unless opinions favourable to democracy and to aristocracy, to property and to equality, to co-operation and to competition, to luxury and to abstinence, to sociality and individuality, to liberty and discipline, and all the other standing antagonisms of practical life, are expressed with equal freedom, and enforced and defended with equal talent and energy, there is no chance of both elements obtaining their due; one scale is sure to go up, and the other down." Chapter 2, Para II.36.

[75]F.A. Hayek, *The Road to Serfdom*, 43.

[76]Pipes, *Property and Freedom*, 95.

[77]Ibid., 117.



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## Fundamental Number Three:
## Contracts

Recall that one of the primary preoccupations of those who study the impact of institutions on economic performance is the role institutions play in reducing the impact of uncertainty and transactions costs endemic to the process of exchange. If we lived in the frictionless world of zero-transactions costs, the particular form of organization we employed to govern the process of exchange would be irrelevant.[78] Since we do not live in a purely neoclassical world, particular organizational forms can have a tremendous impact on economic performance. One of the primary means by which we organize economic activity is through the use of contracts, the third pillar of the study of institutions. The literature on contracts can be divided into two large groupings; one that is largely descriptive, and another that has become highly theoretical and mathematical. Although the descriptive approach lacks some of the analytical precision of mathematical derivations, it does have the stronger virtue of being more readily and broadly applicable to the analyses of real world situations.[79] Here, the utility of a descriptive approach to contracts will permit us a basic understanding of how contracts as institutions shape economic activity by transforming the uncertainty and high transaction cost world of exchange into one of more manageable risk (see also Appendix C).

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[78]Ronald H. Coase, "The Nature of the Firm," *Economica* 4 (16) (November 1937): 398-401; Oliver E. Williamson, "The Modern Corporation: Origins, Evolution, Attributes," *Journal of Economic Literature* 19 (4) (December 1981): 1537-1568.

[79]For a detailed exposition of the literature behind the technical side of contract theory, see Furubotn and Richter, Chapter 6.



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As was detailed in brief above, the concept of property rights can be broken down into two basic components; *absolute property rights* which are those rights directed against all others such as outright ownership, the fragmentation of ownership, and the right to transfer elements of ownership to others; and *relative property rights* in which the rights holder can exercise their rights only against one or more specified persons. It is with relative property rights that we begin talking about contracts, the essential characteristic of which is to govern the exchange of rights over property.

In many respects, nearly all economic activity in a modern market-driven industrial economy can be seen in terms of networks of contracts. The concept of a contract is somewhat vague. In fact, a moment's reflection suggests that a wide range of contractual obligations help govern economic activity; everything from a basic sales contract, to leases, employment contracts, or loan agreements. Essentially, a contract is the projection of exchange into the future.[80] We normally think of such contracts as relatively formalized, binding agreements, but can also come in highly informal terms, such as a handshake or verbal agreement.[81] But it is the inter-temporal nature of contracts, whether formal or informal, that is of particular interest where economic performance is concerned because of the unique problems that such contracts must overcome in governing exchange over time, the most important of which is opportunistic behavior. It may seem obvious to suggest that contractual arrangements extended over time have

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[80]Macneil, "The Many Futures of Contracts," 712-13.

[81]Stewart Macaulay, "Non-Contractual Relations in Business: A Preliminary Study," *American Sociological Review* 28 (1) (February 1963): 55-67; See also Ian R. Macneil, "The Many Futures of Contracts," 726-35.



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considerable consequences for behavior and, hence, economic performance. However, the exchange of property rights extended inter-temporally have profound implications for the distribution of economic rents, the mitigation of transactions costs, and the management of risk.

Consider once again the plight of our 19th Century Alberta farmer as he ponders the exchange of his property, likely grain, in a complex marketplace characterized by impersonal exchange. In taking his excess production to market, the farmer will face a range of problems affecting the economic performance of his farm including those associated with inter-temporal exchange, uncertainty and agency.

*Inter-temporal Nature of Exchange*

The purchase of goods in a 21st Century grocery store involves the instantaneous exchange of money (itself an institution)[82] for goods. In doing so, consumers engage in a kind of simultaneous contracting with the grocer, formalized with a sales receipt that is in reality a kind of contract between the consumer and the grocer regarding the exchange. Yet, many forms of exchange are not instantaneous and often take place in two different time periods. For example, if a grocer wants to provide bananas to his customers year-round, he may, because of the limitations of the growing season for bananas, have to contract with suppliers well in advance of the actual production of those bananas. Such a

[82]See Armen A. Alchian, "Why Money," *Journal of Money, Credit and Banking* 9 (1) (February 1977): 133-140. We are taught by standard economics texts that money is a store of value and an intermediary medium of exchange. But we rarely cast the use of money to facilitate exchange as an institution that reduces the impact of imperfect information at the product discovery stage of exchange in the assignment of value to a product or service.



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contract would specify the terms of the future production, delivery, and sale of bananas even though the bananas have not yet been produced. A similar set of problems confronts the 19th Century farmer in seeking outlets for his excess production. His wheat must be planted and grown well in advance of it actually being exchanged for money or goods in the market place. However, in planting crops in advance, the farmer is confronted with the expense, uncertainty, and risk of possibly having either a failed crop or no marketplace buyer for his product. However, if the farmer can find someone with whom to contract for the future sale of his product, he can transform that uncertainty into a form of risk shared by both parties to the contract, rather than born by the farmer alone. Properly written, such a contract could include a range of contingencies, including crop failure.[83] The point is that contracts can overcome the inter-temporal nature of many forms of exchange by setting the terms of sale in advance of actual production and delivery, all contributing to the transformation of uncertainty into risk.

*Agency*

Under relatively undiversified stages of economic development, exchange, even limited impersonal exchange, can be handled within the confines of trusted familial relations. Even if our Alberta farmer elects to sell his excess production at market, he could conceivably appoint a trusted family member to accompany each shipment to

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[83]Note Canadian Wheat Board's function as a single desk seller of Canadian wheat around the world and how it mitigates risk to the farmer. By requiring the pooled sale of grain from individual farmers to the government-backed Wheat Board at an agreed price paid to farmers, the farmers themselves reduce the risk that commodity price fluctuations will affect them negatively. In effect, the government assumes the risk burden should prices fall between the time of purchase from the farmers and sale on the world market.



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market where they would faithfully negotiate the spot-market terms of exchange on behalf of the farmer. In other words, a member of the farmer's family acts as his agent. Yet, in many areas of complex exchange, agency through family ties is impractical and requires the use of impersonal agents to represent the farmer's interests at market. Contracts that spell out the conditions of representation for principals (the farmer) and agents (the farmer's representatives) permit an even greater degree of specialization and exchange than would otherwise be possible with the use of family members alone as agents. In fact, many economists cite the evolution of contractual arrangements as having facilitated the emergence of long-distance trade in the 13th Century, for which the use of familial bonds was impossible.[84]

*Moral Hazard (Opportunistic Behavior)*

A major problem for the Alberta farmer in selecting an agent to represent him at market is opportunism. If a trusted family member is not available, how can the farmer be sure the agent is faithfully representing the farmer's best interests? Impersonal exchange in a complex economy is full of the dangers of opportunism. Once again, contracts can help alleviate the threat of opportunism, albeit often at some expense (really a form of transaction cost) by including performance incentives, penalties for shirking, or strict monitoring provisions. Once again, contracting generates a form of risk in place of uncertainty. However, the presence of opportunism also has the potential to generate

[84]North, "Institutions," 100; See also Ann M. Carlos and Stephen Nicholas, "Agency Problems in Early Chartered Companies: The Case of Hudson's Bay Company," *Journal of Economic History* 50 (4) (December 1990): 853-875.



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transactions costs different from those that the contract was originally intended to eliminate simply because of the need to guard against opportunism. All of this suggests that the precise nature of any contractual arrangement can have profound implications for economic performance.[85] Indeed, one of the more interesting areas in institutional economics is understanding why some contractual relations fail to offset the impact of transactions costs while others succeed.

*Adverse Selection (pre-contractual opportunism)*

Another kind of opportunism occurs at the pre-contractual stage in which parties to a contract possess asymmetric levels of information about one another regarding their capabilities or their products. Such information asymmetries can lead parties to misrepresent themselves at the onset of negotiations. Because time and information are scarce resources, the expenditure and collection of which represent significant transactions costs for economic actors, contracts can again enter the mix and be written so as to mitigate the impact of adverse selection. For instance, in the event that one or both parties are misrepresenting themselves, penalties for breach of contract can be written into contractual arrangements. Again, contracts allow the uncertainties of impersonal exchange to be transformed into a kind of manageable risk.

**Categories of Contract**

With these problems in mind, an understanding of the kinds of contractual

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[85]Carlos and Nicholas, "Agency Problems in Early Chartered Companies," 853-875.



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relationships that can be concluded will help us understand how contracts combat the problems described above, reduce the impact of uncertainty by transforming it into risk, both reduce and create transactions costs, and become determinative of economic performance. Following Oliver Williamson (1979), contract law can be broken down into three basic categories; classical contracts, neo-classical contracts, and relational contracts.[86]

*Classical Contracting*

If the basic purpose of contracting is the facilitation of exchange, classical contracting can be thought of as making provision for each and every aspect of the process of exchange. According to Williamson, "the economic counterpart to complete presentation is contingent-claims contracting– which entails comprehensive contracting whereby all relevant future contingencies pertaining to the supply of a good or service are described and discounted with respect to both likelihood and futurity."[87] Williamson adds to this definition by asserting, first, that under classical contracting, the identity of the parties is irrelevant in that parties to a contract are free and able to contract with others (ie. the presence of a deep market with many buyers and many sellers). Second, the nature of the agreement is carefully delimited, and the formal features of the contract are the primary governance structures (ie. written, legal aspects trump verbal promises). Thirdly,

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[86]Williamson, "Transaction-Cost Economics," 235-238; See also Williamson, *The Economic Institutions of Capitalism*, 68-72.

[87]Oliver Williamson, "Transactions-Cost Economics," 236; See also Ian R. Macneil, "Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law," *Northwestern University Law Review* 72 (1978-1979):854-905.



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the nature of the contract lays out the consequences of non-performance by one or the other party.[88]

*Neoclassical Contracting*

Yet, a moments reflection suggests that many contractual relationships hardly account for every possible future event that changes the exogenous conditions under which contractual obligations are to be fulfilled. Furthermore, there are no means for predicting in advance the precise remedies that could be applied in the midst of changed circumstances. As a result of the inherently unpredictable nature of a range of factors that could impinge on elements of a highly-defined, completely specified contract, changed circumstances could readily lead to costly disputes between parties.[89] According to Williamson, there are three possible means of dealing with exogenously imposed contingencies within contracts, the first being foregoing exchange altogether. The second would be to organize exchange transactions internally, as in the case of firms (see organizations vs. firms below). However, the defining feature of neoclassical contracts is the inclusion of governance structures in the form of arbitration procedures, third-party dispute resolution, or judicial setting that creates flexibility within the contract and protects trading relationships from the negative impact of either exogenous (changed macro or microeconomic circumstances) or endogenous (opportunistic behavior) events.[90]

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[88]Williamson, "Transactions-Cost Economics," 236.
[89]Williamson, "Transaction-Cost Economics," 237.
[90]See also Ian R. Macneil, "Contracts," 865-886.



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*Relational Contracting*

However, as economic relationships become increasingly inter-temporal and complex, the process of exchange has required contracting to move even further beyond the neoclassical variety to an even looser, more flexible form of contract. With relational contracts, notions of discreteness in contracting– the idea that every contingency in exchange can be written into a contract– are completely replaced by an array of norms beyond those centered on the exchange and its immediate process. In fact, relational contracts can be thought of simply as contracts that do not try to take into account all future contingencies, but which nevertheless help govern and facilitate the process of exchange between parties in which past, present, and future relations among the parties are important to the process of exchange itself.

> Often, contracts are necessarily and intentionally incomplete [relational] because of mutual desires for flexible but bounded responses to uncertain future conditions that limit the scope and precision of verifiable terms. Moreover, incomplete contracts often exist deeply embedded in an ongoing relationship. The parties are not strangers; much of their interaction takes place "off the contract," mediated not by visible terms enforceable by a court, but by a particular balance of cooperation and coercion, communication and strategy.[91]

Consider, as Macneil does, the difference between each of the three contractual forms in comparing the purchase of gasoline and marriage.

> The gas purchase is a transactional event in the sense that, except for the expectation of the driver that the station would have gasoline available and the expectation of the station that any driver stopping would have some means of

[91]Gillian K. Hadfield, "Problematic Relations: Franchising and the Law of Incomplete Contracts," *Stanford Law Review* 42 (1990), 927.



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paying, the exchange has no past. There are no precedent relations between the parties. Nor will there be any future relations between the parties. As to the present, two general characteristics dominate the transaction: it is short it is limited in scope. A few minutes to measure its duration, and no one, even the most gregarious, enters into anything approaching a total human relationship in such a situation. In such a transaction the measured exchange, gallons/dollars, is what matters. Without it, the pleasantries, the little extras of service and courtesies have no real meaning; with it those immeasurables are an added fillip and no more.

> Contrast this service station stop with a traditional marriage relation. The latter consists not of a series of discrete transactions, but of what happened before (often long before), of what is happening now ("now" itself often being a very extended period), and of what is expected (in large measure only in the vaguest of ways) to happen in the future.[92]

Recall the earlier discussion of investment-specific transactions costs. Parties to exchange are often interested in maintaining long-term relations due to the specificity of what they are exchanging. In other words, a kind of bilateral dependence develops between the parties that both are interested in preserving. In fact, many elements of long-term, inter-temporal exchange relationships are not governed by the contractual relationship at all and are instead governed by quasi-social relationships.[93]

Return again to Douglass North's concept of institutions put forward in Chapter I and consider the implications within relational contracting. If, as North suggests, institutions are "the humanly devised constraints that structure political, economic, and social interaction" and that they "consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, and

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[92]Macneil, "The Many Futures of Contracts," 720-21.
[93]See Furubotn and Richter, "Institutions and Economic Theory," 159-160.



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property rights),"[94] then relational contracts have within them both kinds of institutions; formal and informal. Parties to relational contracts will often agree to defer spelling out every element of their exchange arrangement and instead lay out procedures for the submission of future problems to a governance procedure such as an arbitrator. Under relational contracts, these procedures themselves may be spelled out in great detail or left implicit. In either case, relational contracting, despite having built in ambiguities, can actually serve to mitigate one of the most persistent problems in exchange contracting, opportunistic behavior. While relational contracts often have a range of unspecified contingencies that make them flexible to the parties, a range of informal institutions frequently develop that, while often not enforceable under law, nevertheless function within the relationship as governance structures enforceable between the parties themselves; Williamson terms this kind of contractual self-management and enforcement "private ordering."[95] The informal governance structures, or institutions, of modern relational contracting are no different than sanctions, taboos, customs, traditions, or codes of conduct referred to by North. To the degree that contracts have a high degree of investment specificity (bilateral dependence), stronger working relationships between the parties will develop, complete with their own cultures and traditions of exchange. Such informal institutions will serve to govern long-term relations between parties and tend to act as a stronger check on opportunistic behavior (see Appendix C).[96]

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[94]North, "Institutions," 97.
[95]Williamson, *The Economic Institutions of Capitalism*, 250-252.
[96]Furubotn and Richter, "Institutions and Economic Theory, 133.



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*Limits to Contracting?*

Is it appropriate to view the workings of our economic system as a complex web of overlapping contractual relationships? In the view of many institutional economists, and given the discussion above, it seems that we ought to be able to make provision within contracts for virtually any kind of exchange and, under the guise of relational contracting, be able to deal with any contingency that affects our exchange relationships. According to Herbert Simon, many institutional economists make too much out of the freedom to contract. In fact, Simon asks, if it were so easy to contract with one another to facilitate exchange, why are we not all independent contractors? How can we account for the existence of firms? How can we account for the fact that nearly everyone in our modern economy is an employee?[97]

## Institutions Versus Organizations de Nuevo

The Rules of the Game

With the three basic tenets of institutional economics in mind– transactions costs, property rights, and contracts– we have more of the tools needed to understand the importance of institutions and institutional change under the NAFTA. Let's start again with the most basic question of why institutions are necessary at all? Neoclassical economics is obsessed with the concept of choice under constraint, but too often reduces

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[97]Herbert Simon, "Organizations and Markets," *Journal of Economic Perspectives* 5 (Spring 1991): 25, 27.



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individual choice to unknowable preference curves and, in the case of firms, to the mixture of cost and demand curves and a theory based upon the optimization of pricing and input combinations.[98] Exchange takes place among firms and between individuals without any specification of the institutional setting in which exchange takes place. As should be clear by now, the particular institutional setting can have a profound impact on economic performance. The problem with the basic neoclassical model is that while choice under constraint is one of the most important parts of the model, the model does not explicitly include a discussion of the constraints themselves. We identify the sources of supply and demand (incomes, tastes, prices, expectations, population, technology, the number of suppliers, even the weather), but spend little time examining the context in which those variables operate. If, as Douglass North argues, institutions are those humanly devised formal and informal constraints that structure political, economic, and social interaction, then in the neoclassical model we are left with "consumers without humanity, firms without organization, and even exchange without markets."[99]

Take, for example, Gregory Mankiw's widely used macroeconomics textbook.[100] In his multi-chapter discussion of economic growth, Mankiw, like most other economists, identifies key factors stimulating economic growth such as capital accumulation, population growth, and technological change. Yet, assumed through out his discussion of economic growth, but never mentioned, are some of the unseen and necessary institutions, such as property rights, the rule of law, a price system, or the freedom to

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[98]Coase, *The Firm, The Market, and The Law*, 3.
[99]Ibid.
[100]N. Gregory Mankiw, *Macroeconomics*, 4th ed., (New York: Worth Publishers, 2000).



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contract, that both facilitate and structure economic decision making leading to capital accumulation, population growth, or technological change. In my own hypothetical story of 19th Century Alberta farmers, I too assumed a base level of institutional development in property rights whereby ownership was defined by possession, and along with it the right to buy, sell, or exploit what one possessed. Think of institutions as a football game without the players. When the teams take the field, they will each exploit their strengths and opponent's weaknesses by employing different strategies on the field. However, both will play within the bounds of a set of agreed rules that constrain the nature of the strategies employed, but do not deterministically influence the outcome of the game itself. Sports analysts will be able to identify individual factors that could lead to victory, things such as speed, size, skill, home field advantage, even weather conditions, but will seldom ever comment on how the rules of the game itself could shape and constrain each team's strategy. Identifying the factors that might lead a team to victory is to overlook the rules by which the teams played. Likewise, in economics, identifying the determinants of supply and demand, factors of production, and elements of economic growth is to ignore the institutional context, the rules of the game, in which those factors operate.

In property rights, the competitive price system, and the contracts under which much economic exchange is conducted, we have similar set of rules of the game that both structure the way the game is played and the strategies to be employed within the rules. Economic actors generally go through life without explicitly thinking about many of the most basic institutions, such as the regime of property rights or the price system, unless there has been a violation or the institutions have broken down.



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Theory of the Firm and the Rise of Organizations

Surely our economic system is more complicated than this? If the football analogy is so great, what exactly is the team? In short, the team is an organization that comes together to take advantage of the rules of the game. Each team organizes itself differently, has different strengths and weaknesses, and employs widely divergent strategies for taking advantage of the rules. In economics, the team is actually the firm or organization that congeals around an institutional structure to take advantage of the rules. Like a football team that employs different strategies and organizing principles to maximize their potential to win each game, the firm does likewise to maximize profits. If the rules of the game were unimportant, then the various organizational approaches and strategies employed by each of the teams would be irrelevant to the game's outcome.

But why do firms come into existence at all? Is it not possible that, like our 19th Century farmers, we could all just live within a given set of institutions and repeatedly contract with others for those things we need? In fact, such an economic system is possible, although not especially practical or efficient. As Ronald Coase has argued, production could be carried out in a highly decentralized fashion such as this, except that even with institutions, like property rights or the price system, undergirding and facilitating the process of exchange, there are costs to entering into each transaction.[101] There are a whole range of transactions costs that are incurred through using the price system; price discovery, negotiation or information costs, and of course the opportunity costs incurred in the process. The presence of transactions costs means that firms may

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[101]Coase, *The Firm, The Market, and The Law*, 7.



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emerge to effectively internalize what would otherwise be market transactions costs; make what was exogenous, endogenous to the firm. But doesn't this suggest firms will simply continue to grow, endlessly trying to make endogenous those costs that were once exogenous? Is there a limit to how large a firm might become? According to the Coase Theorem, firm size is limited where its internal costs of organizing an extra transaction are equal to that of conducting it outside the firm.[102] From this premise, we can begin to reason through the rationale for both mergers and acquisitions as well as the more recent practice of out-sourcing.[103]

We have begun to answer some of Simon's questions about why there are firms and why most of us are employees of firms rather than independent contractors. However, according to Simon, there is a second line of enquiry that touches once again on the efficiency (or lack thereof) of institutions and the organizations that form around them. Economics, Simon asserts, focuses too little on the actual parties to transactions and too much on factors of production as though they were easily inter-changeable. If most of us are employees of firms, what factors cause us to work hard for the maximization of firm activities? Why do employees stay with some firms and not others? In short, what's in it for them?[104]

> The simple (neoclassical) answer to the motivational question derives from the employment contract, under which workers maximize their utility by accepting the authority of the firm; that is, by agreeing to accept orders from the profit

[102]Ronald Coase, "The Nature of the Firm," *Economica*, 16 (November 1937), 394-95.
[103]See Bolton and Scharfstein, "Corporate Finance, the Theory of the Firm, and Organizations," 95-114; Hart and Moore, "Property Rights and the Nature of the Firm," 1119-1158; Bengt Holmstrom and John Roberts, "The Boundaries of the Firm Revisited," *The Journal of Economic Perspectives* 12 (4) (Autumn 1998): 73–94. See also,"The Great Hollowing-out Myth," *The Economist*, Feburary 19, 2004.
[104]Simon, "Organizations and Markets," 26.



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> maximizers in charge. But this answer leads to the new question of how the employment contract is enforced by the employer. In particular, how are employees induced to work more than minimally, and perhaps even with initiative and enthusiasm?[105]

Simon argues that the neoclassical model also needs to look at the many organizational dynamics themselves, all of which affect economic outcomes as much as the more basic interaction of institutions and organizational structures. Simon argues that organizational phenomenon such as *authority dynamics, rewards, identification*, and *coordination* all play key roles in firm performance.[106] The role of *authority* in employee relations, for example, extends beyond the explicit terms of an employment contract and often includes the consideration of organizational goals that are worked out and managed within firms by the employees themselves. The precise role for individual employees within hierarchies of authority within a firm are seldom spelled out within employment contracts and are instead considered in the context of broad firm goals that are then worked out as a part of internal organizational dynamics. Conferring *rewards* on employees through high salaries or other incentives is an obvious means of obtaining employee loyalty and effort. Yet, creating incentives in this way is only effective to the degree individual achievement can be identified and rewarded. Firms often respond to this by organizing themselves in ways that provide a range of non-monetary incentives for employee loyalty. For instance, firms may offer high quality working environments, complete with flexible working hours, child care, or well-funded work resources. Large

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[105]Ibid.
[106]Ibid., 25-44.



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firms may be sub-divided into semi-autonomous units that confer a measure of control and job satisfaction on employees.[107] Firm structure may also be centered around a set of principles or objectives with which employees *identify* on an altruistic level. In other words, employees may stay with firms, in part, because of the goals of the firm and not necessarily because of the monetary compensation being extended to them, all of which has important implications for opportunistic behavior. Finally, Simon argues that organizations like firms also provide a *coordinative* function for groups of individuals that is not always easily achieved through market mechanisms like the price system. Since so much of our economic decision making is dependent on what others are doing, organizations such as firms can also be the source of signaling.[108]

According to Simon, these subtle, but important issues are cause to revisit the Coase theorem regarding the role of transactions costs in dictating firm size.[109] At a minimum, the firm remains a comparatively poorly understood part of our economic system, but a ubiquitous one that needs a more sophisticated view than that put forward by most economic models of the firm as a set of inputs, outputs, and simple profit maximization.[110]

## Cognition, Mental Models, and Bounded Rationality

Through Hayek's discussion of the workings of the price system, we are reminded

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[107]See Carlos and Nicholas, "Agency Problems in Early Chartered Companies," 853-875.

[108]Simon, "Organizations and Markets," 25-44.

[109]Ibid., 41-42.

[110]See Williamson, "The Modern Corporation," 1537-1568; Bolton and Scharfstein, "Corporate Finance, The Theory of the Firm, and Organizations," 95-114.



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of the important role information plays in structuring economic activity under the neoclassical model. The primary issue raised by Hayek is how best to organize economic activity when the information and knowledge needed to do so is dispersed among many people and is incomplete. Unfortunately, the need for simplicity of explanation within the basic neoclassical model has resulted in numerous elements in the human decision-making process being assumed away by the model. For example, rational consumer choice theory usually begins with the assumption that consumers enter the marketplace with well-defined preference sets that make the optimization of scarce resources easier to determine.[111] However, individual preference sets are subject to the availability of information upon which to base them, information which is inherently incomplete. Seldom discussed in standard economic text books are the challenges of processing disparate information into a usable form. How can information that we know is incomplete be used as the basis of rational decisions? The task of processing information is normally the purview of psychologists and cognitive scientists. However, economists studying the impact of institutions on economic decision-making have made increasing use of these fields to help understand the way we process and use information to make economic decisions.

### A Normative View of Rationality

What exactly is rational thought? In economics, the concept is thrown around

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[111]See, Herbert Simon, *Models of Bounded Rationality, Vol. 3, Empirically Grounded Economic Reason*, (Cambridge: The MIT Press, 1997), 291.



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liberally, without ever really being defined. We intuitively understand that economic decision-makers are confronted with a range of choices and have preference sets through which those choices are filtered and maximized for their benefit. However, can we actually say that the decision-maker's actions were rational or even that their actions maximized anything? Psychologists and cognitive scientists are increasingly loathe to label decision making as rational or irrational. Instead, they have begun to adopt the concept of good or bad thinking. The best kind of thinking, which we most often refer to as rational thinking, is whatever kind of thinking best helps people achieve their goals.[112] Rational thought concerns the methods of thinking employed to make decisions, not the various conclusions of that process. We often say that someone is "irrational" if we observe that the decision they have made conflicts with what we would have done. However, what we are really doing is voicing an opinion about the individual's conclusions, ones we might not have made ourselves. Rationality is not the same as accuracy, and irrationality is not the same as error.[113] A good decision is one that makes effective (rational) use of the information available to the decision-maker. A good outcome is one that the decision-maker likes. Such *satisficing* behavior occurs because whereas standard economic theory posits that rational choices can be made through simple maximization formulas even in the presence of constraints, such optima are simply not possible to compute within practical, feasible limits of effort.[114] As a result,

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[112]Jonathan Baron, *Thinking and Deciding*, 3rd ed., (New York: Cambridge University Press, 2000), 53.

[113]Baron, *Thinking and Deciding*, 55.

[114]Herbert Simon, *Models of Bounded Rationality,* 295-298.



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good decision making simply entails having people make the best possible decisions with the information they have; a kind of rationality subject to constraints. In economics, the concept of bounded rationality, or rationality subject to constraints was first introduced by Herbert Simon in 1956.[115] The introduction of subjective concepts in human decision-making as satisficing behavior may frustrate quantitative analysis to some degree, but more accurately represents the humanly devised world in which we live.

## Mental Models

The point here is to highlight a larger issue regarding the role of imperfect information in the way we think cognitively about our choices. The problem is that we not only have incomplete information, but that many of our most important decisions are also based upon faulty or inaccurate information. In addition to the obvious opportunity costs that gathering information entails, there are additional costs in time and effort to evaluate the information that has been gathered. The process of gathering and evaluating imperfect, perhaps false information, cannot be prolonged indefinitely. The sheer volume of information that we process each day requires some kind of mechanism to assist us in ordering it. One way we process and filter information is through the use of beliefs, many of which are formed as a result of good thinking processes that lead to outcomes which satisfy our preference sets. Beliefs are reaffirmed as they are reinforced by favorable

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[115]Herbert Simon, "Rational Choice and the Structure of the Environment," *The Psychological Review* 63 (1956): 129-138.



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outcomes.[116]

Yet another means by which we order and process the masses of information which we receive every day and, in turn, try and make decisions that satisfy our preferences, is through the use of mental models. As practical experience suggests to many, and psychologists have demonstrated in fact, the use of models is of vital importance for ordering our increasingly complex world. The danger, of course, in using models to help us in our decision-making is the possibility that we will only selectively choose information that supports our model, exclude that which contradicts it, and descend into a form of self-deception (irrationality). The danger is not that we spend too little time in thinking about our choice set, because the purpose of using models is to help us quickly sift through the choices that confront us. The real danger is in behaving as though we have great confidence in conclusions that were reached having gone through very little thought.[117] In other words, the danger is that we rely too heavily on our working models and do not adjust them as disconfirming evidence becomes available. Just so the importance of rationality and mental models to institutions in economic policy is not lost, we need to remember that

> to understand economic decision-making under conditions of uncertainty we must also understand the relationship between the mental models that individuals construct to make sense of the world around them, the ideologies that evolve from

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[116]See Baron, *Thinking and Deciding*, 62-65 ; see also Douglass C. North, "Structure and Performance: The Task of Economic History," *Journal of Economic Literature* 16 (September 1978): 792-93. North uses the term ideology in place of beliefs and makes a case for ideology being as influential on the way we think about economics as changes in technology or tastes.

[117]See Tversky and Kahneman, "Judgement Under Uncertainty,"1124-1131; Tversky and Kahneman, "The Framing of Decisions and the Psychology of Choice," 453-458. This is precisely the point made by Tversky and Kahneman. Models of how the world works, like institutions, help structure our decision-making, but tend to heavily, and perhaps incorrectly, bias it at the same time.



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such constructions, and the institutions that develop in a society to order interpersonal relationships.[118]

In order to make sense of the workings of the international economy, in addition to everything else in our complex world, everyone needs a basic working model of how the economic system works. Those models may vary considerably depending on whether we are concerned with the individual, the firm, or the nation state, but in all cases they help decision-makers process information and make decisions more quickly than they would otherwise be able to under conditions of autarky. Mental models of economic activity help us with decision-making by reducing the range of transactions costs we would normally incur to be certain that our economic decision making is sound. Simon is worth quoting at some length because of the emphasis he places on the linkages between the way we process information cognitively and the workings of our economic system. He writes,

> We know today that human reasoning, the product of bounded rationality, can be characterized as selective search through large spaces of possibilities. The selectivity of the search, hence its feasibility, is obtained by applying rules of thumb, or heuristics, to determine what paths should be traced and what ones can be ignored. The search halts when a satisfactory solution has been found, almost always long before all alternatives have been examined.
>
> Economic actors are among the experts whose behavior has been simulated: the choice of stocks and bonds for trust portfolios, determination of credit-worthiness of borrowers, design of products to customer specifications, policies for determining levels of inventory and factory schedules, and many others. At the micro level, we already have most of the components we need to substitute a realistic theory of the firm for the fictitious theory that now occupies the

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[118]A.T. Denzau and Douglass North, "Shared Mental Models: Ideologies and Institutions," *Kyklos* 47 (1994): 3-31; see also J. Conlisk, "Why Bounded Rationality?," *Journal of Economic Literature* 34 (1966): 669-700.



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textbooks....

Our new understanding of how people solve problems and make decisions is bringing within the scope of economic analysis phenomena of great importance that previously had lain outside it. Neoclassical economic theory assumes that the problem agenda, the way in which problems are represented, the values to be achieved (utility function), and the alternatives available for choice have all been given in advance. It has no systematic way of explaining how problems get on the agenda, what it is that people value and how values change, or how action alternatives are created (e.g. new products, new marketing or manufacturing methods, new public policies like the negative income tax). Hence it is incapable of creating a genuine economic dynamics....

A theory that deals with problem formation and with the design of solution alternatives can provide the basis for a theory of economic change and development.[119]

**Is It Theory That We Are After?**

One of the most basic objections put forward by critics of institutional approaches to economic activity is that these approaches constitute a kind of untestable and unfalsifiable theory. As the discussion above suggests, institutional approaches to economic theory maintain the basic tenets of the neoclassical model; markets, scarcity, choice under constraint. But in taking an institutional approach to economic activity, we are asking the neoclassical model to accommodate theories of transactions costs, property rights, and contracting, much of which the neoclassical model assumes away. In a sense, institutional approaches criticize the overly simplistic nature of the neoclassical model while possibly making the analysis of economic activity more complex by adding a series

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[119]Herbert Simon, *Economics, Bounded Rationality, and the Cognitive Revolution*, (Hants, England: Edward Elgar Publishing, 1992), 4-5.



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of variables arising out of discussions of transactions costs, property rights, and contracting.[120] In trying to develop a theory of institutions and institutional change, scholars must overcome the criticism that such a theory is unfalsifiable and therefore unviable as a theory of the broader economic system. If some market failure or unexplained aberration within the neoclassical model can too readily be explained away as the product of some friction, such as a transaction cost, improperly specified property rights, or a poorly conceived contractual relationship that permits opportunism, we are left with a weak theoretical paradigm for explaining how our economy works. While neoclassical economic theory makes numerous assumptions in order for it to act as an explanatory tool, institutional approaches lack some of the parsimony of reliable and testable theory necessary for social science research. By studying economic activity from the point of view of institutions, do we risk trying to generate a theory that includes everything but the kitchen sink?

The development of a new grand theory of economics is not the point of institutional economics, nor of this thesis. Instead, the objective is to extend the neoclassical model into areas of analysis not explicitly considered by it, but which nevertheless have a significant impact on economic activity. The study of institutions extends the neoclassical model. It neither undermines nor revises it. In fact, the neoclassical model remains the core starting point for any examination of institutions. If the neoclassical model is emphatically about scarcity and choice under constraint, then the study of institutions can be said to be all about the constraints and incentive structures

[120]Simon, "Organizations and Markets," 27.



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found within transactions costs, property rights, and contractual relationships that help shape those choices.

The pages that follow will be an examination of those constraints in the North American context since the advent of free trade, first between Canada and the United States, and then amongst all three North American states under the North American Free Trade Agreement. The NAFTA famously reduced a range of barriers and constraints to North American economic activity, but also generated numerous other incentives through the changes to North American economic institutions that the NAFTA ushered in. The standard neoclassical model helped economists make educated guesses as to the effects of the NAFTA before it was implemented, and has afterward given them the tools to try and contrast the operation of the Agreement with the theory. The relationship between the core elements of the NAFTA, the reduction of border measures, and economic activity is pretty simple; as border measures come down, trade flows and economic activity more generally should go up. Yet the NAFTA did more than reduce border measures to trade. It also brought about a new set of institutions that have shaped economic choice sets in North America. With some of the tools suggested by institutional economics and their focus on transactions costs, property rights, and contractual relationships, the aim will be to look at the NAFTA's institutions in the same way the neoclassical model allows us to understand the impact of reduced border measures.



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## CHAPTER III
## INSTITUTIONAL ECONOMICS AND THE NAFTA

Now that we have a sense for what institutions are, are not, their pervasiveness, necessity, and impact on economic performance, we can begin the effort to more explicitly link the study of institutions to changing patterns of North American economic activity arising from the North American Free Trade Agreement. Those familiar with the Agreement may have already seen numerous parallels between the NAFTA's various provisions and the discussion of transactions costs, property rights, and contracts. This mini-chapter is designed as a first cut at drawing out those parallels in preparation for the more detailed analysis in subsequent chapters. However, we first need to refresh ourselves as to the main purpose of this study and its central hypotheses.

Robert Pastor's recent book on the NAFTA is in many ways a comparison of the shortcomings of two different approaches to economic and political integration; the European Union and the emerging North American community anchored by the NAFTA.[121] Pastor concludes, in part, that whereas the European Union is paralyzed by too many institutions, the North American community faces a different set of problems because it has too few. Pastor's conception of institutions differs significantly from that posited here and more closely resembles organizations. However, Pastor correctly notes the absence of formal, permanent organizational structures in the NAFTA. The NAFTA

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[121]Robert A. Pastor, *Toward a North American Community: Lessons From the Old World for the New,* (Washington, D.C.: Institute for International Economics, 2001).



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contains no permanent secretariate within which administrative staff from all three countries help manage disputes, run the dispute settlement mechanisms, or act as a clearing house for NAFTA-related documents or information. The NAFTA is "run"out of each nation's existing trade policy bureaucracies, disputes are handled on an ad-hoc basis, and there are few mechanisms of enforcement other than the threat of retaliation. The point is that while the NAFTA lacks formal institutions, in the sense the term is used by Pastor (ie. an institution = an organization), even a cursory reading of the Agreement makes clear that *the NAFTA is emphatically, and almost purely, a set of institutions in the sense they are being used here.*

The literature on recent North American economic development is full of narratives about the politics of integration, as well as economic analysis of integration's effects. There are countless glib references in the academic and public policy literature, as well as the popular press, about how the NAFTA has reshaped the way in which we think about economic activity in North America, how the NAFTA has restructured commercial activity, and how the Agreement fostered drives toward increased efficiency and productivity. In our public discourse on economic performance and economic policy, we regularly hear references to the NAFTA as though the Agreement forms the core of all commercial activities on the continent. We regularly hear a wide range of pronouncements about the impact of the NAFTA on a variety of non-economic issues ranging from social policy to sovereignty. In short, we can find numerous anecdotal examples of how the NAFTA has supposedly reshaped the way we conceive of North American relations in both economics and a range of other policy areas. Yet, while many



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of us would concede that the NAFTA has been profoundly important in shaping the way we think about North American economic issues, there has been virtually nothing scholarly written about how the NAFTA, as a set of institutions, has actually been responsible for it.

From this hole in the research on the NAFTA stems a general research question driving this investigation: *Can the explicit consideration of institutions (in the sense of formal and informal rules and norms) explain and help us understand the recent history of North American economic development?* Let's first take a stab at a few parts of the Agreement itself to see what kinds of institutional change it promised to facilitate.

## The Rules of the NAFTA Game

The institutional matrix introduced by the NAFTA in 1994 begins importantly with the oft-ignored Preamble. Right from the beginning, Canada, the United States, and Mexico resolve, through the Agreement to strengthen the special bonds of friendship and cooperation between them. While not a key substantive clause of the Agreement, the implications of a stronger relationship between states for economic activity are profound. To the extent that the Agreement actually strengthens bonds between NAFTA partners, it promised to reduce elements of uncertainty regarding their broader relationship by extending the shadow of the future in terms of a commitment to cooperation among them. While such commitments can, on paper, always prove less effectual than advertised, and as our discussion of contracts from the previous chapter highlighted, one of the most important issues facing economic actors is dealing with the inter-temporal nature of most



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forms of exchange. Extending the shadow of the future among governments through an agreement such as the NAFTA potentially eliminates one element of the uncertainty surrounding inter-temporal exchange across international borders; the governments agree to work more closely together through the Agreement.

All three countries further agree that the NAFTA will serve to reduce distortions to trade, establish clear and mutually advantageous rules governing their trade, and ensure a predictable commercial framework for business planning and investment. The first of these, reductions in distortions to trade, can be analyzed with the standard tools of the neoclassical model for obvious benefits. Yet, while it makes intuitive sense to have clear and mutually advantageous rules, as well as a predictable commercial framework, each of these principles as enshrined in the NAFTA is not so easily understood through the neoclassical model, yet is an explicit alteration of the institutional structure economic decision-makers face in NAFTA economies. The new rules of North American commercial activity as structured by the NAFTA affect everything from transactions costs, to the distribution of property rights, to the conclusion of exchange contracts. A more predictable institutional structure (set of rules) as rooted in the NAFTA promised to make the process of reducing transactions costs, maximizing the benefits of ownership of property, and concluding contracts more predictable.

The broad outlines of a new institutional structure continues with Chapter One and the statement of objectives in Article 102. At the outset, the principles of *national treatment*, *most favored nation treatment*, and *transparency* are enshrined in the agreement. All three of these concepts rank among those that regularly litter the pages of



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scholarly literature and the popular press, but often taken for granted as underlying principles supporting institutions. *National treatment* has been especially controversial for some, but profoundly important for institutional stability facilitating economic activity in North America. Applied throughout the agreement, national treatment ensures that the goods, services, and investments of firms from a NAFTA Party will be "treated no less favorably" than "the most favorable treatment" accorded to the goods, services, and investments of domestic firms. In other words, discrimination directed against goods, services, and investments of NAFTA Parties *cannot* be based on the national origin of the product. The related principle of *most favored nation treatment* required that each NAFTA Party extend to each other the most favorable treatment each gives to non-NAFTA countries. Combined with a commitment to *transparency*, these three principles alone contribute to the reduction of uncertainty and transactions costs, and enhanced the stability of property rights and the ease of contracting across national borders.

To be sure, the economies of Canada, the United States, and Mexico were all linked to one another before the NAFTA, but in the aftermath, the boundedly rational choice set confronting economic decision makers in North America had changed. Instead of relying on a range of import substitution policies such as tariffs or other behind-the-border measures to augment competitiveness, the commitment to reduce barriers to trilateral commercial activity dramatically alters the choice set of economic decision makers. We hear again and again in the scholarly and popular press that tariff reductions under NAFTA exposed inefficient firms to foreign competition and rationalized production in North America, forcing many firms and individuals into an oft-painful



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process of adjustment. However, the most popular conception of this process targets the reduction of tariffs as being responsible. Indeed, simple trade theory readily depicts the impact of reduced tariffs on the price of goods. But what about the basic changes to the way we think about economic relations in North America that were ushered in by the NAFTA? Tariff reductions were an important part of the NAFTA, but by no means the only institutional change to have altered the choice sets of economic decision makers. Lower tariffs obviously translate into access to lower cost inputs, less expensive production costs, and increased access to a range of inexpensive consumer products. But the NAFTA also brought greater certainty to the management of property rights (both intellectual and physical), the increasingly lucrative services sector, introduced dispute settlement mechanisms in two key areas (trade remedy– Chapter 19– and investment- Chapter 11) and a more broadly applicable dispute settlement procedure at the political level (Chapter 20) that further enhanced the probability of more stable and irritant-free trading relations among all three countries. So where exactly did the NAFTA bring about institutional change?

Chapter Three-- Trade in Goods: This chapter provided for the phased elimination of tariffs on virtually all products over fifteen years and established rules for the reduction of non-tariff measures and for trade in sensitive or protected sectors. Transactions costs related to tariff levies were obviously reduced, but this chapter also altered the institutional structure (the rules) through which NAFTA Parties could impose further restrictions or make use of export taxes. Uncertainty is normally the bane of the market.



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Economic decision makers hate uncertainty. The NAFTA enhanced the predictability in the North American market place and where there is predictability, there often follows reduced risk, lower transactions costs, and, in most instances, more efficient and productive economic activity.

Chapter Four- Rules of Origin: As the subject line suggests, chapter four of the NAFTA set up rules for establishing the criteria by which North American production would qualify for tariff free treatment under the Agreement, particularly for the auto sector which established a threshold of 65% North American content to qualify for duty free treatment. In addition, Chapter Four established other criteria for determining the degree of product transformation required for imported components to then be considered of NAFTA origin. Institutions are fundamentally about shaping the choice sets confronting economic decision makers, but within those choice sets are an array of incentives. Like all other chapters of the NAFTA, changing choice sets also translate themselves into changing incentive structures. Rules of origin under the NAFTA altered the productive choice set of decision makers by providing a range of incentives for restructuring production to take advantage of tariff free treatment by using larger proportions of local inputs or enhancing levels of local value-added transformation so that they qualify for duty free treatment.

Chapter Five- Customs Procedures: It seems obvious that the trilateral standardization of accepted customs procedures, including the use of certificates of origin to establish that



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products qualify for duty free treatment, could significantly reduce transactions costs associated with cross border trade, but it is a point well worth re-emphasizing. That an entire chapter is devoted to addressing an issue that essentially involves differentials in accepted protocols and inspections procedures is testament to the potential impact of transactions costs on the movement of goods and services across jurisdictional lines. Although Chapter Five did not completely standardize all elements of the border inspection and customs processes in each country, this chapter began the process and established a consultative mechanism for working toward greater harmony on these matters.

Chapter Seven- Agriculture and Sanitary and Phytosanitary Measures: This chapter dealt with a range of topics related to market access for each country's agricultural sectors, each of which is among the most protected and politically sensitive of all sectors in each country. The Agreement tried to deal with a range of market-distorting domestic support issues and export subsidies, but most importantly, attempted to deal with important sanitary and phytosanitary measures used by each country, most often as a means of excluding each other's products from their markets. By addressing the conditions under which these measures could be used to deny entry of certain produce to one market or the other, the NAFTA re-set the institutional structure by which trade in agriculture was to be conducted. Agricultural producers could be assured of a more predictable, transparent process of securing market access. While each country could maintain its own standards of food health and safety, much of the arbitrary character by which such standards could



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be applied as naked protectionist measures was eliminated. The reduced threat of arbitrary delays due to the imposition of such measures undoubtedly altered the incentive structures facing producers in terms of their end markets. Greater assurances that broader access to the North American market would not be hindered by arbitrary sanitary and phytosanitary measures offers producers a range of changed incentives for production timing, quantities, and transportation of their products, not unlike that for manufactured goods.

The point here is not to go through each of the NAFTA's chapters in detail to describe how each of them may have altered North America's institutional incentive structure, but rather to suggest that all of them did. In every area covered by the NAFTA– everything from telecommunications, services, financial services, competition policy, intellectual property, temporary entry for business people, investment, the review of national trade remedy laws, and, of course, the dispute settlement mechanisms– the NAFTA not only reshaped the way we think about economics in North America, but also the way in which we assess our economic choice sets and the incentives that arise from them. The Agreement did so by restructuring some of the most basic the institutions– in terms of transactions costs, property rights, and contracts– affecting the choice sets that structure North American commercial activity.

If it is true that the study of institutions intuitively facilitates a greater understanding of the recent history of North American economic development, then we ought to be able to test the three hypotheses posed at the outset of this study. What follows is both a reiteration of, and first cut at, those three hypotheses, each of which will



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be explored in more detail in the coming chapters.

### A First Cut at Hypotheses

**Re: Hypothesis I:** *That changes to the institutional matrix in North American economic relations have resulted in economic outcomes that are as much a result of the institutional matrix itself as they are the result of predictions made by neoclassical economic models demonstrating the gains from liberalization.*

The case for maintaining an open, liberal economic regime is as compelling today as it was when first put forward by the likes of Adam Smith and David Ricardo more than two centuries ago. The impact of the intuitive simplicity of their arguments is one reason these basic propositions still form the backbone of mainstream economics. Yet, while elegant in its simplicity and power, the neoclassical argument in favor of liberalized trade and capital markets is only part of the explanation of divergent macro-economic performance among countries. The neoclassical model, as taught in textbooks, mainly treats only the most circumscribed cases. For example, students are taught how to analyze the likely effects on price, quantity, supply, and demand of an import tariff or quota, or the impact of sustained budget deficits on the balance of payments. However, even where the lessons of the neoclassical model are most evidently realized in advanced industrial countries, significant differences in economic performance remain. A number of developmental differences can certainly be explained by reasoning through the basic neoclassical trade model, examining the differences in factor endowments, or considering the determinants of supply and demand such as preferences, expectations, technological



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changes, or the prices of compliments and substitutes, yet something seems to be missing from our basic analytical tool box that would enable us to more adequately explain some of these divergences.

The Developing Country Case

Institutional economists argue that this approach is only part of a much larger neoclassical story; a story that should explicitly include institutions as part of the mix. Evidence abounds that trade and investment flows into North America and between NAFTA partners have risen dramatically since 1994, much of which can be explained with standard neoclassical reasoning. However, we have here already begun to understand how important a range of oft-ignored institutions– as rooted in transactions costs economics, property rights, and contracts– can be for economic development. For example, many scholars have seen the NAFTA as a mechanism for "locking-in" certain reforms that made each country, especially Mexico, more attractive as a destination for flows of foreign investment. In fact, many scholars routinely credit the NAFTA for helping Mexico weather the 1994 Peso Crisis even though the ink on the NAFTA had hardly dried when the crisis began. If those who emphasize the importance of institutions for economic performance are correct, Mexican economic reforms were "locked-in" because the NAFTA helped to re-write many of Mexico's trade and investment policies in ways that altered the choice set facing foreign actors, even in the face of a severe economic crisis.

In most industrialized countries, domestic firms have access to a long history of



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domestic laws protecting the owners of private property from unreasonable seizure by the state without some form of compensation. In the United States, that principle is enshrined in the Fifth Amendment of the Constitution. However, the only actors with standing in international law are states. Prior to the NAFTA, foreign firms had few international legal mechanisms through which to seek due process or compensation from the state for seizure of private property. Until the investment provisions of the NAFTA, foreign firms whose property had been seized by the state could do little more than make diplomatic representations and hope that their home and host governments could resolve the issue. The NAFTA now guarantees that foreign firms will be accorded treatment no less favorable than that given to domestic firms and provides a mechanism for resolving disputes over these issues between foreign firms and host governments.

If the NAFTA's institutional matrix (the rules of the game) was instrumental in helping Mexico weather the 1994 Peso Crisis, there should be evidence beyond the basic statistics on investment flows. That evidence should suggest that Mexico's institutional matrix, including the provisions of the NAFTA itself, assured economic decision makers that the risks of investing in Mexico were low in spite of the Peso Crisis, that the cost of transacting business in Mexico would continue to decline as a result of the NAFTA, and, most importantly of all, that economic agents were convinced of Mexico's commitment to a stable investment regime anchored by the security of property rights.

Developed Country Case

The Mexican case may represent something of an extreme in that the institutional



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matrix in Mexico after 1994 was radically different than it had been a decade earlier thanks to many unilateral Mexican economic reforms. However, the evidence in support of institutions being key to altering the choice set through which economic actors make decisions should be more widely applicable and include not only developing economies, such as Mexico, with a history of expropriation of private property. Again, the evidence should support the thesis that institutional change in the CUFTA altered the choice set facing decision-makers and made Canada and the United States more attractive destination for flows of foreign direct and portfolio investment. Investment flows to Canada, for example, rose in the 1980s and 1990s, but exactly why they did so has been a matter of some debate, much of it centered on the positive impact of falling federal budget deficits, but less focused on the solidification of property rights as a result of investment provisions in the CUFTA and the NAFTA. Canada's own period of economic nationalism as embodied by the National Energy Policy and the Foreign Investment Review Act gave way to a surge of liberalization under the CUFTA and NAFTA that effectively ensured the end of those programs and generated an institutional choice set for prospective investors in Canada. Aggregate statistics on foreign investment suggest that after the conclusion of these agreements, a range of Canadian assets became even more attractive to investors. Why? Undoubtedly government finances or the effects of central bank policies on the value of the Canadian dollar will have an impact. But critical institutional structures affecting the choice set confronting potential investment flows to Canada might be given credit as well. The short operational history of the NAFTA's Chapter 11 provides further evidence of the importance of institutions on economic



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performance in both developed and developing countries. Of the eighteen NAFTA investor-state dispute resolution cases launched between 1994 and 2003, ten have been brought by firms operating in Canada and the United States where regimes of property rights enforcement and regulation are supposedly highly developed and favorable to commercial interests. While a number of these suits are frivolous, they nevertheless suggest that the NAFTA's investor state rules have become part of North America's property rights structure around which more and more firms are structuring their operations and, apparently, basing their expropriation claims.

**Re: Hypothesis II:** *That the institutions embodied by the FTA and the NAFTA have had a significant impact on micro-level economic performance by inducing changes to industrial organization (firms) to take advantage of new incentive structures and by shaping the way actors, such as firms, cognitively evaluate their economic choice set.*

Neoclassical microeconomic theory is full of important insights into the nature of the firm, but has virtually ignored the impact of transactions costs on production. The standard neoclassical model is essentially an abstraction that involves the technical transformation of inputs into outputs through a simple production function $Q=F(K, L)$ where the quantity of output is a function of the variable inputs capital and labor. The rationale behind the profit maximizing firm articulated by neoclassical textbook microeconomics is intuitive and straight-forward enough, but also disappointing from the point of view of institutional economics. The neoclassical model assumes a "frictionless" world in which the acquisition of key market information by firms is costless,



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instantaneous, and accurate. If such information were gathered in a frictionless world, all firms should be profitable and there would be little need to consider the impact of elements such as entrepreneurialism or organizational structure in the economic performance of the firm. However, the gathering of information is just one process through which transactions costs are incurred by firms (thereby altering their production functions), yet are inadequately considered by the neoclassical model. Realistically, a firm's organizational structure is key to understanding many of the elements that make up its production function. For example, is the business an integrated firm or a limited partnership? What are its contractual relations with suppliers and with labor? In short, the ways in which a firm organizes to take advantage of the incentive structure put before them by sets of institutions such as the NAFTA are as determinative of its production function as inputs of capital and labor.

The literature on the theory of the firm, much of which has spawned branches of economics concerned with industrial organization and institutions, suggests that firms arise as a practical means of internalizing the transactions costs imposed upon them by the market in their production processes. The source of those transactions costs could be anything ranging from government safety regulations, compliance with anti-trust or labor law, to the most basic structure and enforcement of contractual relations with suppliers. Expansion of the firm through investment, mergers, or acquisition of other firms is one means of internalizing some of the transactions costs firms face. The theory of the firm posits that firms will emerge to take advantage of the new incentives brought about by a particular institutional matrix and will continue growing in size and function until the



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transactions costs incurred inside the firm are equal to those that would be incurred through exchange in the open market.

At an intuitive level, we know that the streamlining of costs in search of profit maximization is not just about changes to the bureaucratic structure of the firm. If, as institutional economists argue, the very purpose of creating a firm is to take advantage of the institutional matrix that confronts it, existing firms must adapt to the changing institutional environment or risk being forced from the marketplace. As a result, it is reasonable to suggest that the factors inducing institutional change are not always external to the firm. The firm is not necessarily a reactive agent whereby the impetus for organizational change is always one directional, beginning with institutional change leading to organizational change. A range of exogenous variables, such as foreign and domestic competition, macro economic conditions, or health of the firm's broader industry, may induce firms to lobby for institutional changes around which a firm's structure might most profitably flourish. Any large scale commercial negotiation features competing interests, some of which the neoclassical model suggests will be hurt by trade liberalization while others benefit. This is also undoubtedly a large part of the debate over the NAFTA as large parts of the agreement were shaped by sectoral and firm level interests throughout the economy.

If institutional economists are right and firms adapt to changing institutional conditions, then a whole range of sectors and firms had their choice set altered by the NAFTA in January 1994 when the Agreement came into force. In addition, because the creation of the NAFTA was not an overnight process, firms on both sides of the question



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of institutional change should have been lobbying for particular alterations to the institutional matrix that would benefit and/or protect them. Such lobbying introduces us to the beginnings of the dynamic of institutional change by suggesting that institutional change is also a process of change that leads to both new institutions and new economic outcomes.

**Re: Hypothesis III:** *That by extending the basic neoclassical economic model to include the explicit consideration of institutions and institutional change, we can better understand how the NAFTA came into being and how it has affected North American economic development. Institutions are not created in a vacuum nor do they change in the absence of social, historical, political, and psychological influences. By incorporating these elements into a dynamic framework for understanding institutional change, we can better understand the process of institutional change in North America over the last twenty years that led to the NAFTA.*

### A Chicken or an Egg?

Thus far I have hypothesized that institutional change in the NAFTA area can be useful in explaining the economic performance of each of the three NAFTA economies. I have also posited that firms, in response to institutional change that alters their economic choice set, re-order their organizational and production structures to maximize the capture of economic rents. Yet, with all three hypotheses posed here we are confronted with a kind of chicken or egg problem. Which comes first, institutions or institutional change?



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Or better yet, what exactly drives institutional change? According to Douglass North, there are two forces shaping the path of institutional change: increasing returns to institutions, driven by relative price changes, and market imperfections characterized by high transactions costs.[122] North posits simply that when the returns to new institutions are positive in that modifications to existing institutions can reduce high transactions costs or the market uncertainty associated with ambiguous property rights, institutional change cannot be far behind. However, what can we make out of a theoretical approach that simply posits "increasing returns to institutions?" North implies that institutional change is a bottom-up, rather than top-down process; meaning that institutional change is fundamental and driven from the roots of our economic system rather than imposed by an overarching authority. If, as argued by North, institutional change is a much more broadly based and fundamental process than can be achieved through the maximization and lobbying strategies of individual firms, it is plausible to suggest that institutional change is a bottom-up process.[123] But is this always the case?

### A Final Word About the State: Top Down or Bottom Up?

Up to this point, the consideration of institutions and institutional change has focused on change within a domestic setting. There is an important difference between institutional change affecting firms in a domestic setting and that concerning entire economies in international relations. The state is the supreme authority; it can make its

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[122]North, *Institutions, Institutional Change, and Economic Performance*, 84-86, 95.
[123]North, *Institutions, Institutional Change, and Economic Performance*, 79.



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own laws. By contrast, the firm cannot; it is subject to the laws of the state to which it belongs. Whether we are assessing the performance of national economies, specific sectors, or individual companies, domestic institutional change takes place within the context of an existing set of institutions through which property rights, in the form of contracts, are written and enforced, and lend themselves to a kind of bottom-up causation. Broadly based domestic interests could conceivably clamor for change and ultimately get it. Whereas the domestic legal systems of industrial economies institutionalize protections and enforcement mechanisms for a range of property rights, including the freedom to contract, the international system is characterized by fewer such legal mechanisms. If a theory of institutions and institutional change is going to be useful in understanding the evolution of a set of institutions like the NAFTA, it needs to shed light on how sovereign states conclude there are increasing returns to institutional change internationally as well. All of this begs the question: Is institutional change internationally more of a top-down process?

If the argument regarding institutions is that they form a kind of matrix that shapes the choice sets confronting firms and individuals, we have strongly implied that changes to these rules are driven by firms and individuals to then be enforced by the state. Looking at the NAFTA as a set of institutions that structure the choice sets of economic decision makers that in turn facilitated economic development also leads to the consideration of governance itself. While the NAFTA may provide the institutional structures that govern domestic economic activity through the reduction of transactions costs, the structuring of property rights, or the ordering of contracts for firms and



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individuals, the NAFTA does much the same regarding the relationship between states. In short, if the NAFTA is about the structure of governance for firms and individuals, it is much the same thing for each of the three NAFTA Parties. Since states remain the most important actors in international affairs, in spite of the emergence of a plethora of non-state actors, who can be driving institutional change internationally if not the states themselves? This chicken or egg-like question with respect to the direction of institutional change (top-down or bottom-up) will arise repeatedly throughout this study. This study does not aim to resolve this issue definitively, nor will it treat the matter specifically. However, by returning to it periodically, this study does aim to highlight a few possible clues to resolving this puzzle.



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# CHAPTER IV
# THE EVOLUTION OF NAFTA CHAPTER 11
## (Test of Hypothesis I)

Institutions are the humanly designed, formal and informal, constraints that structure economic, political, and social activity. In formal terms, institutions consist of a range of written constitutions, laws, rules, and conventions that constrain our behavior, help us organize disparate information, and provide guidelines for decision-making. Informal institutions, such as taboos, customs, cultural idiosyncracies, and, most importantly, family ties, help structure our activities in exactly the same way, but do so through a range of unwritten media such as oral traditions or learned cultural norms. Together, these two categories of institutions structure the economic, political, and social choice set that we all confront each day. In economics, the basis of the familiar neoclassical model is that limited resources necessarily constrain the range of choices available for economic decision-makers. Hence, when we study the neoclassical model we are actually studying the economics of 'choice under constraint.' While the neoclassical model focuses on the implementation and maximization of finite resources, there is little attention paid to the role of institutions in shaping the choice set we confront. Yet, who would deny that institutions, as defined above, both constrain and provide incentives for economic decision makers?

We have become conditioned to thinking of institutions in terms of organizations like the United Nations, the World Bank, International Monetary Fund, or the European



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Union. Yet the distinction between institutions and organizations is extremely important, particularly as we begin the discussion of the North American Free Trade Agreement. Each of the organizations just mentioned organizes itself around a set of principles or a charter mandate, much the way a nation organizes itself around its constitution. Institutions are analogous to the rules of a football game around which teams organize to play. Each team employs different strategies for winning the game, but adheres to, is constrained by, and takes advantage of the set of institutions embodied by the rules of the game. Yet, periodically, the rules of the game change thereby also altering the choice set confronting each team. To remain competitive, teams may alter the composition of their organization be shedding or adding players, altering strategy, or most radically, reconstituting the entire team. The argument being made here is that the NAFTA is a set of institutions, or rules of the game, that help shape the choice set facing economic decision makers. The rules of North American economic activity, like the rules of a football game, are not static and have actually evolved over time to become what they are. Just as the rules of a football game, in and of themselves, can often affect the outcome of a game, the institutions of the NAFTA have also affected economic performance.

As a test of the hypothesis *that changes to the institutional matrix in North American economic relations have resulted in economic outcomes that are as much a result of the institutional matrix itself as they are the result of predictions made by neoclassical economic models demonstrating the gains from liberalization,* this chapter will focus on changes to North American institutions affecting foreign direct investment leading to NAFTA's controversial Chapter 11.



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**Impressive Numbers, But What's Behind Them?**

By any measure, global foreign investment statistics paint a staggering picture. According to the United Nations, the inward stock of foreign direct investment, that is the sum total of all investment held in host countries, in 1982 was valued at US$734 billion. In 1990, that same figure more than doubled to US$1,874 billion. Yet in 2001, it had reached a staggering US$6,846 billion.[124] In 2001 alone, global inward FDI flows amounted to US$735 billion while outflows totaled US$635 billion. While impressive, figures for 2001 actually represent a sharp decline in FDI of more than 50% for both inward (down 51%) and outward (down 55%) flows owning largely to the slowing of industrial economies and sharp decreases in both stock market activity and a reduction in global mergers and acquisitions.[125] The decline in FDI flows has been most acute in developed countries as inward flows fell by half from US$1 trillion in 2000 to just over US$500 billion in 2001. Flows of FDI out of developed countries have also fallen in the past few years from US$1.4 trillion in 2000 to US$600 billion in 2001.

Yet, activity in developed country FDI is only part of the story, albeit a disproportionately large one. To understand why, consider the disparity in FDI flows to and from developing countries over the same period. Between 2000 and 2001, inward FDI flows to developing countries fell from US$238 billion to US$205 billion, a drop of only 14%. Likewise, developing country outflows of FDI in the same period declined from just over US$10 billion in 2000 to just under US$4 billion in 2001.[126] What is

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[124]United Nations Conference on Trade and Development, *World Investment Report, 2001*, 4.
[125]Ibid.
[126]Ibid., Annex table B.2.



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striking about these numbers is that given the importance of FDI to development in some of the world's poorest regions, developed countries are both the overwhelming targets and sources of FDI flows. Despite the downturn in the global economy during 2000 and 2001, developed countries were, perhaps not surprisingly, the source of 92.2% and 93.5% of all FDI outflows in those two years. However, what is most striking is developed economies were also the recipients of 82.3% and 68.4% of all those flows in each respective year. What accounts for such disparities in being able to attract valuable foreign investment capital? Why are developing countries the targets of such a small proportion of an ever growing FDI pie?

A rich and extensive literature has sought answers to the many puzzles and challenges of development. Yet, in one of the most powerful studies in development economics to come along in years, Peruvian economist Hernando de Soto has argued that one of the principal failures of capitalism in most regions of the world outside the developed West is the inability to raise the capital so key to development. For many in the west who have become accustomed to understanding *how* our economic system functions while forgetting *why* it functions, solutions to
the challenges of development amount to simplistically trying to replicate western modes of law and organization in developing countries. When such methods fail, explanations often include spurious references to cultural or religious differences rather than challenging the policy prescriptions themselves.[127] One of the great mysteries of development is the divergence in economic performance among countries with ostensibly

[127]de Soto, *The Mystery of Capital*, 3-4.



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similar legal and political structures. As de Soto vividly demonstrates, one of the central problems facing developing countries is the failure of their institutional structures to provide the basis for shifting the substantial capital that exists in the extra-legal economies of developing countries into the legal economy. One cannot easily buy, sell, or improve that which he or she does not own. Yet it is private property that underlies the creation of additional capital and the improvement of living standards. Unlike the West, where over time sophisticated institutions have evolved that support private property, property rights in large swaths of the developing world remain poorly specified. As de Soto recounts, in the developing world,

> houses are built on land whose ownership rights are not adequately recorded, unincorporated businesses [have] undefined liability, industries [are] located where financiers cannot see them. Because the rights to these possessions are not adequately documented, these assets cannot readily be turned into capital, cannot be traded outside of narrow local circles where people know and trust each other, cannot be used as collateral for a loan, and cannot be used as a share against an investment.
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> In the West, by contrast, every parcel of land, every building, every piece of equipment, or store of inventories is represented in a property document that is the visible sign of a vast hidden process that connects all these assets to the rest of the economy. Thanks to this representational process, assets can lead to an invisible, parallel life alongside their material existence.[128]

The representational process for property in the West referred to by de Soto represents part of an elaborate institutional web of constraints and incentives that help condition economic activity generally, and the exchange and augmentation of property more specifically. While de Soto's tale is one of unlocking localized sources of capital

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[128]de Soto, *The Mystery of Capital*, 6.



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through institutional change, the lessons here can readily be applied internationally to the institutions that govern, or fail to govern, flows of foreign direct investment. When we talk about the divergence in FDI flows between developed and developing economies, our focus is on both the domestic institutions of host states and the international institutions that structure the relationship between host states and the foreign investors they ostensibly wish to attract.

## Antecedents of NAFTA Chapter 11

The public debate over the NAFTA's Chapter 11 has raged over the chapter's so-called investor-state provisions which, critics allege, have established a whole new set of rights for private investors that have eviscerated the power of the state to legislate in the public interest.[129] The sometimes arcane and narrowly defined debate between supporters of Chapter 11 and its critics is outside the scope of this chapter. The debate over Chapter 11 may properly be one over whether the Agreement serves private versus public interests. However, a key element often missing from that debate is an understanding of how the institution of property has evolved over time, contributed to economic growth, and strengthened the linkages between economic and political freedoms.

The debate over the role of private property in our society is as old as recorded history. The larger historical debate over property has taken place against the backdrop of the myth of a "Golden Age" in which property as an institution was thought not to exist.

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[129]See Public Citizen, Global Trade Watch, Chapter 11 at http://www.citizen.org/trade. See also Stephen Clarkson, *Uncle Sam and Us: Globalization, Neoconservatism, and the Canadian State*, (Toronto: University of Toronto Press, 2002), Chapter 12.



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All property was held in common and the words "mine" and "thine" were unknown.[130] The earliest known defense of the "Golden Age" is found in the work of Hesiod from the seventh century B.C.E.. Yet, the first known theoretical debate over the role of property in society is represented by works by Plato and Aristotle dealing with the Peloponnesian War. Plato's *Republic* outlined a kind of utopian communism as it existed in ancient Sparta that contributed to its victory over Athens; one characterized by the almost complete absence of private property with all resources pooled for use by the state. For Plato, the greed and inequality of Athens was as a result of its highly developed system of private property and was the city's ultimate source of demise. Unlike Sparta which was organized collectively and for common purpose, Athens was organized based on the defense of individualism and the selfish pursuit of wealth that prevented it from mounting an effective defense against Sparta. However, Aristotle, Plato's pupil, took a very different view of the role of property in social structures. While he shared Plato's weariness for the social strife bred by inequality, Aristotle nevertheless saw property as an indestructible and, ultimately, positive social force.[131] Aristotle rejected Plato's contention that communal ownership (or non-ownership) of property alleviates social discord and adopted an essentially utilitarian view of property which argued for private ownership of property because of the incentives for improvement and generosity Aristotle saw private property bringing to social organization.[132]

In the 2,500 years since Plato and Aristotle, the debate over the role of property in

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[130]Pipes, *Property and Freedom*, 5.
[131]Ibid., 5-7.
[132]Ibid., 8.



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our society has, more or less, revolved around the differences between the ethical idealism of Plato and the utilitarian realism of Aristotle.[133] In the thousands of years since, the institution of property itself has ebbed and flowed from one defined by the control over physical assets,[134] such as land, to a kind of labor theory of property in which ownership is tied to improvements brought about through one's labor,[135] and grown to include a range of inalienable rights to life and liberty emerging from the enlightenment era.[136] Yet there was a profound shift in thinking about the concept of property and property rights with the urbanization of Europe and the expansion of commercial activity in the 14th and 15th Centuries.[137] Economists and economic historians have examined the merits of this debate over private ownership vs. communal or common property rights and discovered time and again that the most efficient use of scarce resources (choice under constraint) flows from private property in physical objects such as land. By contrast, un-priced entry into areas where economic activity is dominated by common property rights leads to the inefficient, even destructive, use of scarce resources, now

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[133]Ibid.

[134]Ibid., 25, 88-92; See also Daniel J. Boorstin, *The Americans: The National Experience*, (New York: Vintage Books, 1965), 72-81; de Soto, *The Mystery of Capital*, 119-20. Both Boorstin and de Soto chronicle the search for legal mechanisms in early U.S. history to transfer *de facto* occupation of land by settlers into *de jure* holding or compensation for physical improvements.

[135]Pipes, *Property and Freedom*, 34; Some of the earliest writings suggesting a labor theory of property are found in John Locke's famous *Two Treatises of Government*, written 1679-80. Although intended as a defense of private property and the role of government in securing it, according to Pipes, Locke's ideas were later used by 19th century socialists to assail private property as denying workers access to the fruits of their labor.

[136]Pipes, *Property and Freedom*, 30-38; Pipes attributes the earliest articulation of an expanded definition of property to include inalienable rights such as life, body, freedom, and honor to the writings of Grotius somewhere between 1618-1621.

[137]Pipes, *Property and Freedom*, 25.



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widely known as the tragedy of the commons.[138] Along side the powerful arguments in favor of private property have been persistent, sometimes withering, critiques of property by the likes of Jean Jacques Rousseau in his *Discourse on Inequality* (1755) and, most famously, Karl Marx and Friedrich Engles' *Communist Manifesto* (1848). The debate over property rights is really one about how best to organize a society to employ scarce resources. Although, conclusions on this point are admittedly full of value judgements about efficiency and socially desirable outcomes.

Yet, the expansion of economic activity and urbanization of European life in the late Middle Ages required a set of institutions that would facilitate the growth of impersonal exchange. As autarkic self-sufficiency in agriculture gave way to simple exchange, specialization, the emergence of long-distance trade, and eventually industrialization, more and more complex institutions were required. Private property gains importance in a commercial economy, because while it is possible exploit land without ownership, it is impossible to develop an urban and commercial economy in the absence of a more diversified definition of property that also includes outright ownership.[139] However,

> The crucial point to understand is that property is not a physical thing that can be photographed or mapped. Property is not a primary quality of assets but the legal expression of an economically meaningful consensus about assets. Law is the instrument that fixes and realizes capital.... Property is not the assets themselves, but a consensus between people as to how those assets should be held, used, and

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[138]See for example Dennen, "Cattlemen's Associations and Property Rights in Land in the American West," 423-36; Kantor, "Razorbacks, Ticky Cows and the Closing of the Georgia Open Range," 861-886; Umbeck, "The California Gold Rush: A Study of Emerging Property Rights,"197-226; Ommer, "All the Fish of the Post," 107-123.

[139]Pipes, *Property and Freedom*, 107.



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exchanged.[140]

A key issue for economic historians and anthropologists regarding the emergence of property is the relationship between it and the rise of political organization along side it. De Soto argues that if a legal system is to be effective, it must largely reflect the de facto system of emergent property rights that already exists among the holders of property (or among squatters); in essence, the law is discovered not created.[141] Historical evidence suggests that the concept of property has nearly always preceded the rise of political organization in defense of those rights.[142] In virtually all cases in which property rights are ill-defined or non-existent, legal mechanisms emerge among rights holders followed by political organization designed to defend and preserve those nascent rights.

However, as de Soto's masterful work on legal systems and economic development demonstrates throughout, the process of specifying and then organizing a political system around property rights is anything but smooth. While we in the West seldom think about the way in which the legal system supports and shapes the choice set related to property rights, the formalization of those rights is critical to the success of economic activity. We think of large parts of the developing world as lacking legal systems that adequately defend institutions like property, but the contemporary story of the developing world is in many ways a reflection of the early histories of many parts of

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[140]de Soto, *The Mystery of Capital*, 157.

[141]Ibid., 172-82.

[142]See Pipes, *Property and Freedom*, 95; Boorstin, *The Americans*, 72-89; Dennen, "Cattlemen's Associations and Property Rights in Land in the American West," 423-36; Kantor, "Razorbacks, Ticky Cows and the Closing of the Georgia Open Range," 861-886; Umbeck, "The California Gold Rush: A Study of Emerging Property Rights,"197-226; Ommer, "All the Fish of the Post," 107-123.



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the world, including the United States. In a formal sense, the completion of the U.S. Constitution in 1789 codified many of the concepts that would enshrine property rights in the American legal system, most explicitly in the Fifth Amendment's defense of life, liberty, and property without due process of law or just compensation. Yet, the system of property rights in early U.S. history was at best a confusing, often imprecise, patchwork of federal and state statutes and programs that resembled many of those currently found in underdeveloped nations.[143]

The Link to the NAFTA

What rationalized America's inefficient and imprecise system of property rights? In 1642, Virginia introduced the concept of "preemption" whereby squatters with no legal title to the land they had inhabited, could obtain compensation from the legal rights holder for improvements they had made to the land as squatters. This principle was later enshrined in many other state and federal statutes (federally under the Preemption Act of 1841) governing property rights that, along with other statutory incentives such as fee-simple land ownership under federal programs, began to rationalize what had hitherto been a confused and ineffective system of property rights.[144] Fast forward to the late 20th and early 21st Centuries and the United States appears to have a highly developed system of property rights. However, such an advanced system did not materialize overnight but instead evolves, often in fits and starts and certainly not always toward greater efficiency.

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[143]See de Soto, *The Mystery of Capital,* Chapter 5; Boorstin, *The Americans*, 72-89, 223-41; North, *Institutions, Institutional Change, and Economic Performance*, 96-98.

[144]de Soto, *The Mystery of Capital*, 119-120; Boorstin, *The Americans*, 72-81.



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A Chicken or an Egg?

Institutional change is an incremental process, one based partly on precedent, much as modern English common law has been built. One could argue that institutional change comes about in a practical, yet piecemeal way, in which holes in institutional structures are, over time, filled, patched, or revised. Even if institutional change is seldom characterized by rapid, wholesale structural changes, except perhaps in the case of exogenous events like wars or other catastrophes, what drives such incremental change? According to Douglass North, such change comes as a result of changes in relative prices that alter the incentive structure of economic activity.[145] Those price changes– to relative factor prices, information costs, and technological changes, among others– then generate the potential for greater returns to institutions and or institutional change.[146] In a domestic setting, a case could be made that either endogenous or exogenous changes to factor prices, technological changes, or even tastes could raise the transactions costs associated with economic exchange under the current institutional structure which then induce changes to, say, the nation's legal structure. Much as the confused set of property rights in the early American west contributed to higher transactions costs due to uncertainty over who owned what spawned legal innovations designed to mitigate those costs, price changes within a domestic economy could induce institutional innovation in a whole range of areas.

However, there is still an important chicken or egg problem with this line of

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[145]North, *Institutions, Institutional Change, and Economic Performance*, 84.
[146]Ibid.



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reasoning. North argues that price changes induce incremental, marginal, and non-wholesale changes to institutions.[147] Institutional change comes about as a result of the widespread impact of price changes on overall economic performance. It is a kind of bottom-up process in that wide cross-sections of economic activity are affected. In other words, institutional change seldom comes about because of focused rent-seeking activities, unless efforts are broadly organized, as they often are with trade or industry associations.[148] The historical evidence seems to offer support for this kind of bottom-up clamoring for institutional change. Whether it is miners organizing themselves to protect their claims in regions where state-enforced legal systems are non-existent, the emerging property rights among squatters in the American west, or the evolution of complex exchange, as in our Alberta family farm circa 1870, all have one thing in common: institutional change appears driven by a need to formalize or rationalize what already exists on the ground, a process of institutional change that is driven from the bottom-up.

Yet, can this view of institutional change be applied to international affairs where states are the primary actors? Was the NAFTA, and more narrowly, the NAFTA's Chapter 11 the product of a bottom-up process that began with relative price changes leading to the creation of a new set of investment rules for all three NAFTA countries? Or could it be that institutional change is actually a more complex process than is suggested by North's factor price changes that is at least partly driven from above? Could institutional change within the NAFTA area also include a kind of top-down quality in

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[147]Ibid., 83, 87, 89.
[148]Ibid., 87.



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which institutional change alters the choice set of economic actors as readily as changing economic conditions generate the conditions for institutional change? The genesis of Chapter 11 suggests the answer could be yes.

## The Hole in International Law

International flows of private foreign investment have grown remarkably in the past two decades, and foreign investment flows have long been recognized as a source of economic growth and development.[149] In fact, the management of capital flows between countries was an integral part of the rationale behind the creation of the International Monetary Fund (IMF), the World Bank (IBRD), and the abortive International Trade Organization (ITO).[150] Yet, in the midst of the increase in private capital flows, international law governing relations between private capital and its foreign destinations has struggled to keep up with these changes. The weakness of international law governing foreign investment has left states and private investors to sort out the conditions of their

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[149]See Michael Brandon, "The Encouragement and Protection of Investment in Developing Countries, A Survey of Current Approaches to the Problem," *International and Comparative Law Quarterly* 3( 1962): 1-17.

[150]Maryse Robert and Theresa Wetter, "Toward an Investment Agreement in the Americas: Building on the Existing Consensus," in Miguel Rodriguez Mendoza, Patrick Low, and Barbara Kotschwar, eds., *Trade Rules in the Making*, (Washington, D.C.: Brookings Institution/Organization of American States, 1999), 391. See also Fred Block, *The Origins of International Economic Disorder: A Study of United States International Monetary Policy from World War II to the Present*, (Berkeley: University of California Press, 1977), 32-69; See also, Memorandum by the Economic Adviser, Office of International Trade Policy (Coppock) to the Acting Director of the Office of International Trade Policy (Brown), 30 December 1947, *Foreign Relations of the United States*, 1948, (Washington, D.C.: Government Printing Office) 1: 825-6; See Final Act of The United Nations Conference on Trade and Employment, Havana Charter for an International Trade Organization, March 24, 1948, chapters 20-24.



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relationship largely by themselves.[151] While such relations can be mutually harmonious and advantageous, the absence of international rules and conventions has generally left investors vulnerable to the whims of states who, as sovereigns, have the power to nationalize industries, expropriate property, and impose discriminatory regulations. The 1960s and 1970s were a particularly bad period for relations between foreign investors and host states, which according to the United Nations, peaked between 1970 and 1974 at more than 45 yearly acts of governmental taking of foreign property.[152] One of the central issues plaguing private investors when entering a foreign country is that they have traditionally lacked any "personality" (standing) within the system of state-centered customary international law.[153] The 1900 *Paquete Habana* case before the U.S. Supreme Court established an early precedent for the right of individuals to sue states under international law and many elements of international human rights law have established the role of individuals as subjects in international law.[154] However, international law has

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[151]For example, the Iran-United States Claims Tribunal has contributed a significant body of precedent to private international property rights litigation, but the basis for the legal proceedings has been the terms of the Algiers Declarations of January 1981 which resolved the hostage crisis between Iran and the United States. Arbitration of foreign investor claims was a key ingredient of the Declarations. See George H. Aldrich, "What Constitutes a Compensable Taking of Property? The Decisions of the Iran-United States Claims Tribunal," *The American Journal of International Law* 88 (October 1994): 585-610.

[152]United Nations Conference on Trade and Development, *World Investment Report: Transnational Corporations and Integrated International Production*, (1993): 17.

[153]See *Vienna Convention on the Law of Treaties*, May 23, 1969, U.N. Doc. A/CONF. 39/27, esp. Part III, Section I on the Observance of Treaties; Mark Janis, *An Introduction to International Law 3rd ed.*, (New York: Aspen Law & Business, 1999). In addition to the Law of Treaties by which states implicitly agree to respect treaties (*pacta sunt servanda*), the wide ranging body of international law can be grouped more specifically into customary international law (generally accepted practices), general principles of law, natural law, *jus cogens* (does it make sense), and equity, all of which have less precision than domestic legal systems.

[154]See *The Paquete Habana*, United States Supreme Court, 175 U.S. 677 (1900); Janis, *Introduction to International Law*, 249-280; See also *Rome Statute of the International Criminal Court*, Article 1 at http://www.un.org/law/icc/.



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nevertheless been overwhelmingly about relationships between states.[155] States, particularly where human rights law has developed, have typically tried to insert themselves on behalf of individuals. A similar pattern has developed in the area of private international finance. Without international standing, foreign investors have historically had little recourse outside the domestic court systems of host countries to seek compensation for the nationalization or expropriation of private property. The absence of international institutions for capital flows has been a problem for international finance and development that drew calls by the United Nations as early as 1954 for the creation of a satisfactory climate for international investment.[156] As late as 1970, the International Court of Justice, in its well-known *Barcelona Traction* case was surprised by the absence of international law governing foreign investment saying,

> Considering the important developments of the last half-century, the growth of foreign investments and the expansion of international activities of corporations, in particular of holding companies, which are often multinational, and considering the way in which the economic interests of states have proliferated, it may at first sight appear surprising that the evolution of law has not gone further and that no generally accepted rules in the matter have crystalized on the international plane.[157]

The result of this ambiguity has been a conflict between developed and developing states (the traditional sources and targets respectively of FDI flows) over the

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[155]See *Statute of the International Court of Justice*, Article 34 which limits litigation to that between states. See http://www.icj-cij.org/.; see also the *Charter of the United Nations*, especially Article 4(1).

[156]U.N. General Assembly resolution 824 (IX) December 11, 1954; U.N. General Assembly resolution 1318 (XIII) December 12, 1958.

[157]*Barcelona Traction Company* (Bel. v. Spain), 1970 I.C.J. 3, 46-47, quoted in Jeswald Salacuse, "Toward a Global Treaty on Foreign Investment: The Search for a Grand Bargain," unpublished manuscript, 2002.



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nature of customary international law governing foreign investment. Aside from the insertion of much needed capital into the economy, one of the chief benefits of FDI is the associated skill-enhancing technology transfer. Many of the most prolific multinational firms are also among the most technologically driven and perform a large share of the world's research and development. Many of the skills and techniques developed by these firms are then disseminated through their offshore production often allowing these firms to offer wage rates higher than competing local firms. Highly efficient FDI also introduces new competitive pressures to local markets that either induce productivity enhancing changes to inefficient firms or forces them to exit the market place. Finally, the introduction of competitive pressures typically favors local consumers through increased product quality and reductions in price.[158] Yet, critics of FDI argue that too few of the supposed spin offs from FDI actually reach the local community, that the price paid by less-efficient firms is too high, and that unfettered FDI results in a general loss of policy sovereignty. As a result, efforts to fill the hole in international law governing foreign direct investment have had to deal with divergent sets of interests. On the one hand, developed countries, from whom most FDI originates, seek rules that favor the protection and liberalization of favorable investment climates, meaning ease of entry and exit, and few restrictions on activities once investments are established. On the other hand, because of fears that the supposed benefits to the local economy from FDI are few and that with FDI comes an attendant loss of sovereignty, many developing nations have sought to

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[158]See Edward M. Graham, *Fighting the Wrong Enemy: Anti-Global Activists and Multinational Enterprises*, (Washington, D.C.: Institute for International Economics, 2000), 3-7.



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impose conditions on inward investments, including local content requirements, capital controls, or other restrictive measures.[159]

Bilateral treaties have been a large part of the search for ways to fill the void in international law governing commercial activity. For the United States, these usually took the form of treaties of friendship, commerce, and navigation, which governed trade in goods, not investment. However, with the expansion of international capital flows following World War I, the United States began expanding the use of these treaties to deal with the treatment of U.S. nationals investing in foreign countries.[160] However, it was the aftermath of World War II that impressed upon many the need for a new international financial architecture.[161] The same impetus for rebuilding economies wrecked by warfare and stimulating international trade and capital flows which led to the creation of the IMF, World Bank, and the General Agreement on Tariffs and Trade (GATT) also stimulated thinking about capital flows more specifically. The United States undertook to incorporate investment provisions into some twenty-two bilateral commercial treaties concluded between 1946 and 1966,[162] but it was Europe that spearheaded the development of precedents in international law governing foreign direct investment, starting with Germany's bilateral investment treaty (BIT) with Pakistan in

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[159]See Jeswald Salacuse, "BIT by BIT: The Growth of Bilateral Investment Treaties and Their Impact on Foreign Investment in Developing Countries," *International Lawyer* 24 (1990):664 -673; Salacuse, "Toward A Global Treaty on Foreign Investment," 11-14; see also, Graham, *Fighting the Wrong Enemy*, 7-10.

[160]Salacuse, "BIT by BIT," 656; see also United Nations Conference on Trade and Development, *Bilateral Investment Treaties in the Mid-1990s*, (New York: United Nations, 1998), Chapter I.

[161]See Block, *The Origins of International Economic Disorder*, 32-69; UNCTAD, *Bilateral Investment Treaties in the Mid-1990s*, 8-10.

[162]Salacuse, "BIT by BIT," 656.



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1959.[163]

Since then, numerous proposals for regional or multilateral investment rules or conventions, as well as schemes for investment security funds to guard against nationalization or expropriation of private capital have been hatched,[164] among them the failed Havana Charter of 1948 that would have created the International Trade Organization (ITO) and the disastrous Multilateral Agreement on Investment in 1998. Among the most successful mechanisms to emerge from the struggle to find international investment rules was the creation of centers for arbitration of disputes between consenting parties (states and private investors). In 1965, the International Centre for the Settlement of Investment Disputes (ICSID) was created as part of the World Bank, followed a year later by the United Nations Commission on International Trade Law (UNCITRAL).[165] Through ICSID and UNCITRAL, injured foreign investors unable to negotiate a satisfactory settlement with a host government could try and secure agreement from the host country to submit the dispute to arbitration within one of these facilities. However, up to 1970, few states had been willing to submit to the jurisdiction of these bodies and the first ICSID arbitration case was not filed until 1972.

While ICSID and UNCITRAL have provided important mechanisms for the resolution of investment disputes generally, the use of their mechanisms requires the acquiescence of both parties to a dispute– something many nations are still reluctant to

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[163]Salacuse, "BIT by BIT," 657; UNCTAD, *Bilateral Investment Treaties in the Mid-1990s*, 8.

[164]See, Michael Brandon, "The Encouragement and Protection of Investment in Developing Countries," 1-15.

[165]See Aron Broches, *Selected Essays, World Bank, ICSID, and other Subjects of Public and Private International Law*, (London: Kluwer Academic Publishers, 1995), especially chapters 5-8.



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do. More effective in creating a network of conventions and rules (institutions) governing foreign direct investment have been the many bilateral investment treaties. By the end of 2001, the United Nations Conference on Trade and Development (UNCTAD) had recorded nearly 2,100 BITs, the overwhelming majority of which continue to be concluded between developed and developing countries.[166] The dramatic rise in BIT activity since World War II (158 BITs involving 97 countries in 2001 alone) has reflected the desire on the part of capital exporting countries, and more specifically the private investors within them, to bring additional certainty to the process of investing in foreign countries with weak legal protections or a history of expropriation.[167] For developing countries in need of development capital, particularly in the wake of the 1980's debt crisis, BITs have become an attractive way to solidify confidence in potential foreign investors regarding nationalization, expropriation, creeping confiscation through regulatory changes, or performance requirements like local content rules.[168]

A key point to emphasize is that the large number of BITs have not, in and of themselves, generated a new body of international law where once there was none. The various BITs and other commercial agreements which feature dispute settlement

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[166]In fact, in 2001 only 8% of all BITs concluded were between developing countries, reflecting the relative lack of FDI flowing between them; Unite Nations Conference on Trade and Development. *World Investment Report: Transnational Corporations and Export Competitiveness*, (2002), 8. ICSID has recorded more than 800 BITs that have entered into force since 1987.

[167]In September 1978, The Additional Facility Rules were approved by the ICSID Administrative Council which defined additional rules by which ICSID could administer proceedings outside its original jurisdiction. In most cases, this means that either the State party or the State whose national is a party to the dispute is not an ICSID Contracting State, or that the dispute itself did not arise as a direct result of an investment. Because neither Canada nor Mexico are Contracting States (ICSID Members), Chapter 11 of the NAFTA enshrines the use of Additional Facility Rules as part of its dispute settlement provisions. See Broches, *Selected Essays*, 249-56.

[168]Brandon, "The Encouragement and Protection of Investment in Developing Countries," 1-2; Salacuse, "BIT by BIT," 659; UNCTAD, *Bilateral Investment Treaties in the Mid-1990s*, 6-7.



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mechanisms have resulted in important precedents being set over concepts like compensable expropriation, regulatory takings, or nationalization.[169] However, because international law is so heavily state-centered, many argue that deference to sovereignty has resulted in private investors being required reach a much higher standard of proof in their claims against states than is common in domestic systems.[170] Customary international law is still primarily the law of customary state practice, with states as sovereign entities able to exercise power and authority within their jurisdictions. For example, the United Nations has repeatedly recognized the authority of the state over its territory, and did so explicitly with respect to the rights and duties of states in economic relations in 1974. Article 2(c) of the United Nations Charter of Economic Rights and Duties of States explicitly acknowledges the rights of states to "nationalize, expropriate or transfer ownership of foreign property..."[171] Instead, BITs do not change customary international law, but are functional in the same way as other international treaties in invoking the principle of *pacta sunt servanda*; that agreements ought to be respected.[172]

In most established democracies, the circumstances under which tangible property can be seized are normally precisely defined and also entail obligations on the part of the government for reasonable compensation. Although there is considerable variance across countries, in general seizure must be for a public purpose, be conducted under due

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[169]See Jon A. Stanley, "Keeping Big Brother Out of Our Backyard: Regulatory Takings as Defined in International Law and Compared to American Fifth Amendment Jurisprudence," *Emory International Law Review* 15 (2001): 349-89.

[170]Stanley, "Keeping Big Brother Out," 385-87.

[171]United Nations, *Charter of Economic Rights and Duties of States*, GA Res. 3281(xxix), UN GAOR, 29th Sess., Supp. No. 31 (1974) 50.

[172]*Vienna Convention on the Law of Treaties*, May 23, 1969, U.N. Doc. A/CONF. 39/27, Article 24.



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process of law, be nondiscriminatory and be followed by prompt, adequate, and effective compensation of the property owner. In the United States, this principle is embodied within the 5th Amendment to the Constitution. While recourse to compensation for government takings is available in most domestic systems, what are private investors to do then they go abroad and have no international personality under international law? This is the role filled by BITs.

U.S.-Style BITs

In comparison with European countries, the United States was slow to adopt a formal BIT program, doing so only in 1981 and completing only 46 BITs by the end of 2000.[173] One reason for the lower number of U.S. BITs, apart from the program's short history, is that U.S.-style BITs tend to be much more rigorous in spelling out the terms of the treaty, and they are more demanding of host country investment protections than are those concluded by Europe.[174] Nevertheless, in general, BITs have three basic objectives (investment protection, promotion, and liberalization) within which there are eight basic content areas; 1) the scope of the agreement, 2) the conditions for the entry of FDI, 3) the general standards of treatment of foreign investment by host countries, 4) monetary transfers, or the repatriation of profits from host country investments, 5) prohibitions on performance requirements, 6) protection from expropriation or nationalization, 7) compensation for losses from expropriation, and 8) dispute settlement mechanisms.

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[173]See U.S. Department of State, Bureau of Economic and Business Affairs, for a listing of current U.S. BITs at www.state.gov.

[174]Salacuse, "BIT by BIT," 657; Salacuse, "Toward a Global Treaty on Foreign Investment," 8.



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These same eight content areas also form the backbone of Chapter 11 of the NAFTA.[175]

BITs, Institutional Change, Chickens, and Eggs

By looking at the development of international law governing foreign investment over the past half century, we can see that institutional change is slow, incremental, and therefore similar to other historical examples of institutional change such as early mining claims law in the American west or grazing rights on the open range. Instead of a purely bottom-up process where institutions arise in response to specific problems and tend to reflect and support conditions on the ground, we see with foreign direct investment a half-century long process driven by a mixture of macro- and microeconomic interests in developed and developing countries, but also by the intricacies of an international system featuring states as the primary actors.

Thus far, all of this fits well with North's conception of institutional change as an incremental process that takes place at the margins of economic activity. Wholesale changes to international law and institutions structuring foreign investment flows have been hard to come by and efforts to make such rapid changes have been epitomized by the failed Havana Charter (ITO) in 1948 and the MAI in 1998. Such failures suggest that institutional change on a global scale in the area of foreign investment is not easily driven from above (top-down). Yet, foreign investment is unusual in that because of the nature

[175]Ibid. See also NAFTA Chapter 11. 1) Scope and Coverage, Article 1101, 2) Conditions of Entry for FDI, Articles 1102, 1103, 1104, 3) General standards of treatment by host, Articles 1103, 1104, 1105, 4) Monetary transfers, repatriation of profits, Article 1109, 5) Prohibitions on performance requirements, Article 1106, 6) Protection against expropriation or nationalization, Article 1110, 7) Compensation for loses, Article 1110, 8) Dispute settlement mechanisms, Articles 1115 thru 1138.



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of the state-centric international system, little institutional change can take place without the involving states in the process. Foreign investment therefore seems to represent a slightly different case from the standard bottom-up process in other historical, and largely domestic, instances. In no way does this suggest that institutions precede markets, even in foreign investment. Whether we are talking about emergent systems of property rights during the California Gold Rush, grazing rights in the prairie west, or the 17$^{th}$ century Newfoundland fishery, markets develop the moment economic development shifts from autarkic self-sufficiency to modes of simple exchange followed afterward by property rights.[176] The same has been true of institutions, or the lack there of, governing foreign investment for the past half-century. Despite the lack of institutional development that could help reduce uncertainty, risk, and a range of transactions costs, as well as secure the property rights of foreign investors, FDI did nevertheless flow; markets first, then institutions. However, as the evidence surrounding the development of new rules under the NAFTA will suggest below, institutional change with respect to foreign direct investment has become a highly state driven process.

But what can be said in the context of foreign direct investment about Douglass North's proposition that institutional change is primarily the result of relative price changes? In the rarefied world of zero transactions costs, changes to relative factor prices, preferences, or technological changes would instantly generate a market clearing

[176]See Dennen, "Cattlemen's Associations and Property Rights in Land in the American West," 423-36; Kantor, "Razorbacks, Ticky Cows and the Closing of the Georgia Open Range," 861-886; Umbeck, "The California Gold Rush: A Study of Emerging Property Rights," 197-226; Ommer, "All the Fish of the Post," 107-123.



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price and quantity at a new equilibrium supply and demand. Yet, as the long search to fill the void in international law governing foreign investment demonstrates, we do not live in such a world and the high transactions costs associated with developing a body of international law covering foreign investment have, thus far, not outweighed the transactions costs flows of foreign direct investment currently face and made such institutional change possible. Does this simply mean that changes in factor prices, preferences, and technology have not been dramatic or widespread enough to induce institutional change internationally? Does the development and heavy use of BITs in the absence of broadly accepted multilateral rules for investment suggest that relative factor prices have shifted sufficiently on a bilateral basis to warrant institutional change in investment? What are we to make of the fact that factor prices affecting foreign investment (political risk, creeping regulatory risk, or other discriminatory measures) have apparently induced institutional change bilaterally, through BITs, in over 2,100 instances, but are as yet insufficient to induce institutional change on a multilateral basis?

## The Complexities of Institutional Change

Part of the reason for the existence of more than 2,100 BITs, but the abject failure of multilateral efforts to reach similar institutional arrangements is suggested to us by scholars of conflict management who point out that finding common bargaining space between parties to a negotiation becomes more and more difficult and complex with each additional party.[177] Furthermore, reaching agreement on foreign investment rules, whether

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[177]See Hoppmann, *The Negotiation and the Resolution of International Conflicts*, chapter 13.



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in a bilateral or multilateral context, involves a negotiation process that generates a set of dynamics all their own including personal relationships, the give and take of a negotiation, and a range of internal and external factors which often influence the outcome.[178] In fact, the analysis of negotiating dynamics forms the backbone of a recent study by Maxwell Cameron and Brian Tomlin in which they argue that the negotiating dynamics themselves were critical to the outcome of the NAFTA negotiations.[179] Among the most important dynamics identified were the asymmetries of power between the three NAFTA parties which led each country to seek slightly different objectives and required them to adopt different strategies to get there. Clearly, the more complex the negotiations are, the more difficult it will be to reach agreement. An exchange contract between a plumber and home owner to repair a sink will always be simpler and easier to reach because there are only two parties to the exchange and a narrower set of issues than are present in, say, a multilateral negotiation to draw up new investment rules. Asymmetries of power within a negotiation dynamic may be extremely important in the case of the U.S.-BIT program which has, since 1981, established a template for BITs which it has used repeatedly and, in effect, presented to developing countries for ratification, rather than the basis for negotiation.[180] In short, the process of institutional change internationally is not only incremental and slow, but also more complicated than relative price, taste, or technological changes can adequately explain.

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[178] Hoppmann, *The Negotiation and the Resolution of International Conflicts*, Chapter 10.

[179] See Maxwell A. Cameron and Brian W. Tomlin, *The Making of the NAFTA: How the Deal Was Done*, (Ithaca: Cornell University Press, 2000); See also Michael Hart, *Decision at Midnight: Inside the Canada-U.S. Free Trade Negotiations*, (Vancouver: University of British Columbia Press, 1994).

[180] Salacuse, "BIT by BIT," 657-58, 662.



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Further complicating the task of sorting out the impact of institutional change on FDI flows are the changes to domestic political dynamics that the growth in global investment capital flows have brought to decision making processes. For instance, when domestic protectionist interests lobby for tariff or quota restrictions to provide relief from foreign competitors, they indirectly create incentives for foreign firms to invest directly in the domestic market, thereby possibly setting the stage for the domestic firm's eventual demise. The protection afforded domestic firms by tariffs and quotas can be temporary because foreign direct investment is often accompanied by newer technologies and techniques that provide competitive advantages within the domestic market. The political impact of this serves to shift domestic coalitions that support or oppose new trade and investment agreements.[181] In other words, the domestic politics of FDI flows are really made up of shifting sands. If domestic coalitions in support of, or opposition to, changes to international rules governing FDI are continually fluid, how can we place this within the context of institutional change brought about by widespread factor price changes as argued by North? Does this further argue for a kind of top-down driven search for institutional change in the area of foreign investment? New rules governing the security and stability of foreign direct investment are undoubtedly in the interests of particular groups within home and host countries. But can shifting coalitions of these groups single handedly push institutional change as interest group models might suggest? Or do the shifting sands suggest that while small groups take an active interest in the outcome of

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[181]Jonathan Crystal, "A New Kind of Competition: How American Producers Respond to Incoming Foreign Direct Investment," *International Studies Quarterly* 42 (1998): 513-543.



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negotiations aimed at creating new investment rules, the character of the international system necessitates that the state be the chief architect of institutional change, and that it be motivated by a broader set of objectives and principles than narrow interest group interests might advocate?[182]

Another key problem relates to measurement of the impact of institutional changes. For example, our economic models predict that the reduction in border measures such as tariffs should stimulate additional flows of goods, services, and investment across borders. In the NAFTA area, it appears that economic theory has been proven in practice, particularly in terms of the flow of goods. For example, since 1994, the total volume of trade between the three NAFTA parties has expanded from US$297 billion to US$676 billion in 2000, an increase of 128 percent. The news for each NAFTA country is good as well. Between 1993 to 2000, the U.S. dollar value of Canada's merchandise exports to the United States and Mexico rose by 109 percent, from US$112 billion in 1993 to US$235 billion in 2000, a substantially higher growth rate than the 29 percent growth in exports to the rest of the world over the same period. In that same period, Mexico's exports to NAFTA partners exploded by 238 percent between 1993 and 2000 to more than US$150 billion, while U.S. export growth to NAFTA partners in the same period more than

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[182]Recall North's argument that if relative price changes are to induce institutional change, they must necessarily be wide spread enough over time to generate broad support for the changes. See also post-revisionist diplomatic historians who argue that much early post-war U.S. foreign economic policy is the story of he pursuit of broad foreign policy objectives, often at the expense of narrow domestic interests. See Thomas W. Zeiler, *Free Trade, Free World: The Advent of the GATT* (Chapel Hill: University of North Carolina Press), 1999; Robert Pollard, *Economic Security and the Origins of the Cold War, 1945-1950* (New York: Columbia University Press, 1985).



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doubled, a rate much higher than U.S. export growth to the rest of the world.[183] The NAFTA news has been equally good in terms of foreign investment flows to North America, where by 1999 the stock of FDI in the NAFTA area had reached US$1.3 trillion, or about 28 percent of the global total. Between 1993 and 1999, Canada's stock of FDI had grown by 57 percent ( to US$166 billion) while Mexico's had risen an impressive 72 percent (to US$72 billion).[184] On the negative side, critics of the NAFTA claim that the agreement turned a US$1.7 billion trade surplus with Mexico in 1993 into an annual deficit of US$25 billion while increasing America's trade deficit with Canada from US$10.8 billion to more than US$44 billion in the same period. In addition, the NAFTA, critics charge, has been directly responsible for more than half a million job losses in the United States.[185]

Although these figures seem somewhat contradictory, they are all largely in line with the effects of trade liberalization predicted by the standard neoclassical model. With liberalization we expect see growth in trade and investment flows as well as adjustment, some of it serious, as sectors hitherto protected by trade barriers are exposed to greater competition based more purely on comparative advantage. Yet, the problem for both advocates and critics alike involves tying the NAFTA directly to any of the numerical phenomenon detailed above. Few serious scholars doubt that the NAFTA has been an important component of North American economic prosperity during the life of the

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[183]Source: Canada, United States, and Mexico, *NAFTA at Seven: Building on a North American Partnership*, 2001.

[184]Ibid.

[185]Source: Public Citizen, Global Trade Watch.



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agreement. However, saying with any precision how much of that prosperity is directly attributable to the NAFTA presents investigators with considerable measurement problems. For instance, the U.S. International Trade Commission and the U.S. Trade Representative have spent considerable time on this issue in support of the effects of the NAFTA and have even gone so far as to claim that the combined effects of the NAFTA and the Uruguay Round of the GATT have been responsible for annual gains of between $1,260 and $2,040 for the average American family of four.[186] Yet, their own methodology implicitly acknowledges that many assumptions and extrapolations had to be made to arrive at these figures.[187] All of this is suggestive of the numerous problems researchers confront when doing empirical research in the social sciences.

These same kinds of problems also confront those trying to measure the precise impact of foreign investment rules or other kinds of institutions on economic performance. The theoretical case in support of creating international investment rules has always been strong and in keeping with the basic neoclassical economic model. Stable, predictable, enforceable, and presumably efficient (although not necessarily so) investment rules, should reduce much of the uncertainty that surrounds relations between private investors and sovereign states. In theory, the presence of such stable institutional structures should smooth the way for flows of foreign investment. The raw statistics

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[186]Source: United States Trade Representative.

[187]"For both Uruguay Round and NAFTA calculations: Internal USTR calculation comparing pre and post- tariff rates for Uruguay Round as reported by the World Bank in "The Uruguay Round Statistics on Tariff Concessions Given and Received," J. Michael Finger, Merlinda D. Ingco, and Ulrich Reincke. Tariff rates were applied to relevant volumes of trade in 1999. Quoted from USTR *Estimate of Income Gains from the Uruguay Round and the NAFTA*.



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about flows of FDI within the NAFTA area seem supportive of the theory. Yet, despite a half-century of effort to bring about multilateral investment rules and the implementation of thousands of BITs, there remains little evidence as to the precise impact of BITs on capital flows. In fact, as recently at 1998, the United Nations concluded that

> ...the influence of BITs on FDI is weak, especially redirecting the share of FDI flowing from or to BIT signatory countries. In other words, following the signing of a BIT, it is more likely than not that the host country will marginally increase its share of the home country; the same applies to the share of the home country in the FDI inflows of the host country. The effect, however, is usually small.[188]

However, that evidence conflicts with other studies demonstrating both that U.S.-style BITs have had a large, positive, and significant impact on a country's overall FDI flows,[189] and that political risk is a major factor contributing to developing country capital flight.[190] Since the overwhelming majority of global FDI continues to flow between developed countries between which there are few bilateral investment agreements, it is evident that a range of other factors also contribute to the incentive structure affecting investment decisions. Investment institutions, such as BITs, that help stabilize property relations between private investors and states are important, but so too are a range of other, more traditional, factors such as proximity to markets, market size, tastes, technological factors, the skill sets of local workers, and the broader policy setting of

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[188]United Nations Conference on Trade and Development, *Bilateral Investment Treaties in the Mid-1990s* 122 (Geneva: United Nations, 1998): 122.

[189]Nicholas P. Sullivan, *Bilateral Investment Treaties as a Determinant of U.S. Foreign Direct Investment in Developing Countries* (unpublished M.A. thesis, The Fletcher School of Law and Diplomacy, Tufts University, April 2003).

[190]Robert Lensink, Niels Hermes, and Victor Murinde, *Capital Flight and Political Risk*, unpublished working paper, Department of Economics, University of Groningen Birmingham Business School, University of Birmingham, August 1998.



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particular countries.

As de Soto's *The Mystery of Capital* repeatedly demonstrates, it is the matrix of institutions, not necessarily particular ones, within and between countries, as well as their function, that are responsible for economic performance. It is important to re-emphasize that institutional change is incremental, slow, and generally takes place at the margins. The emergence of Chapter 11 of the NAFTA is no different. The controversial investor state provisions of the Agreement did not materialize overnight, nor did they radically restructure the way we think about property rights in North America. Set within the context of the half-century of searching for agreed upon mechanisms for dealing with the hole in international law, the NAFTA's provisions affected change at the margins and were not nearly as radical a shift in investor-state relations as the NAFTA's critics suggest.

## From Antecedents to the NAFTA

A brief look at the provisions of Chapter 11 of the NAFTA reveals that they owe much to the development of international law over the past fifty years designed to cover investment, and especially the U.S.-style BIT model that emerged in 1981. All three of the broad objectives of both the U.S. BIT program (investment protection, promotion, and liberalization), as well as the eight core issues (listed above) covered by the U.S. BIT framework are central to Chapter 11. In fact, taken by itself, Chapter 11 could actually be thought of as a kind of trilateral investment treaty. A reading of the text suggests Chapter 11 has many functions, but as a whole it governs the property relations between private



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investors and states by reducing the uncertainties and political risk premiums that raise transactions costs on investment capital. Prior to the NAFTA, many observers would have looked at North America's economies and concluded that the only country that would have required the application of these new rules was Mexico. Given Mexico's history of comparative political instability/corruption and the uneven domestic application of the rule of law, it is unsurprising that Mexico has had to litigate the largest number of Chapter 11 claims from private investors under the Agreement. However, more surprising is that of the eighteen total cases that have arisen under the NAFTA to date (July 2003), ten of them have been directed at Canada and the United States, the two developed NAFTA countries whose legal systems are ostensibly among the most protective of the rights of private property holders.

Recall that in addition to the basic absence of international law covering relations between private investors and states, the United Nations Charter of Economic Rights and Duties of States explicitly articulates the right of sovereign states to expropriate property, nationalize industries, or otherwise engage in the discriminatory treatment of foreign companies or investments.[191] In the early nineteenth century, many Latin American states began challenging the impunity of foreign interests within their countries with the assertion of the so-called Calvo Doctrine. Under the Calvo Doctrine, the interests of

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[191]See United Nations, *Charter of Economic Rights and Duties of States*, GA Res. 3281(xxix), UN GAOR, 29th Sess., Supp. No. 31 (1974) 50; *Vienna Convention on the Law of Treaties*, May 23, 1969, U.N. Doc. A/CONF. 39/27, Article 24. See also *1917 Constitution of Mexico*, Article 27 (I) which reads: Only Mexicans by birth or naturalization and Mexican companies have the right to acquire ownership of lands, waters, and their appurtenances, or to obtain concessions for the exploitation of mines or of waters. The State may grant the same right to foreigners, provided they agree before the Ministry of Foreign Relations to consider themselves as nationals in respect to such property, and bind themselves not to invoke the protection of their governments in matters relating thereto.



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foreign nationals could only be pursued within the domestic court systems of host countries and were not entitled to protection from their home state, even if under customary international law there were precedents for doing so.[192]

Sovereign states, developed or undeveloped, are never without the power to seize private property. The issue is over how well defined and enforced the rules of compensation for "takings" by the state actually are. In the United States, for instance, the 5th Amendment of the Constitution provides that seizures must be for a public purpose, be conducted under due process of law, be nondiscriminatory and be followed by prompt, adequate, and effective compensation. There have been two competing views in the compensation debate. On one side is the so-called Hull Rule (prompt, adequate, and effective compensation) favored by most capital exporting states. On the other is a somewhat more fluid view espoused by capital importing states.[193] None of these problems is supposed to be at issue between developed countries between whom most foreign direct investment flows. Yet, as the distribution of the Chapter 11 case load suggests, the problems of foreign investors are not restricted to developing countries.

Canada

The general outline of the origins of Canada's march toward its historic free trade

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[192]Robert and Wetter, "Toward an Investment Agreement in the Americas," 390-91; See also R. Doak Bishop and James E. Etri, "International Commercial Arbitration in Latin America," (Washington, D.C.: King & Spalding LLP), 2-7, June 2001 available at www.kslaw.com.

[193]See *Agreement Concerning the Encouragement and Reciprocal Protection of Investment*, August 27, 1988, Japan-China. According to Jeswald Salacuse, The Japan-China BIT contained vague language regarding the precise formula to be used to calculate compensation.



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agreement with the United States are well known and well documented.[194] Canada's small market, tremendous resource wealth, and enormous geographical area have been critical to the nation's economic and political development. Canada has historically managed its economy in the service of political unity behind a range of protectionist, sometimes nationalist, economic policies dating back to the late 19th Century and the National Policy.[195] The National Policy combined protective tariff barriers with the construction of the Canadian Pacific Railroad and preferential freight rates to establish an east-west economy that would foster western settlement and the extraction of natural resources for processing in central Canada. However, the development of an extensive raw materials processing and manufacturing base has always necessitated access to significant pools of capital of which Canada has few domestic sources. Again, from Canada's earliest years, tariff structures were traditionally set to discourage the importation of value-added manufactures that would, in turn, encourage inflows of investment capital for plant construction to serve the Canadian market.[196] These policies, aided by the rapid expansion of production capacity brought on by two world wars, helped Canada become one of the world's premier industrial powers by the 1940s and 1950s.

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[194]See Hart, *"Decision At Midnight"*; Gordon Ritchie, *Wrestling with the Elephant: The Inside Story of the Canada-U.S. Trade Wars*, (Toronto: Macfarlane, Walter & Ross, 1997).

[195]See Stephen Clarkson, *Uncle Sam and Us: Globalization, Neoconservatism, and the Canadian State*, (Toronto: University of Toronto Press, 2002) 207-08; Kenneth Norrie, Douglass Orwam, and J.C. Herbert Emery, *A History of the Canadian Economy*, 3rd ed., (Scarborough, ON: Nelson Thompson Learning, 2002). Considerable debate exists over the effectiveness of the National Policy as a nation building tool. See papers by Phillips, Norrie, and Dales, *Journal of Canadian Studies* 14 (Fall 1979).

[196]See, D.F. Barnett, "The Galt Tariff: Incidental or Effective Protection," *Canadian Journal of Economics* 3 (August 1979): 389-407. Note too that these policies, in many respects, are institutional changes, of the variety we are talking about here, that shift incentive structures to which economic decision makers respond.



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Yet, into the 1960s and 1970s, many Canadians began to question the range of industrial policies that encouraged so much foreign investment in Canada. Concerns were raised in several quarters over the implications of foreign ownership of Canadian-based enterprises and also because so much of Canada's manufacturing sector was of a branch-plant variety that conferred few spill-overs into the broader economy.[197] Indeed, by the late 1970s, several economic studies suggested that subsidiaries of foreign-controlled firms (most of which were American) were spending very little on research and development and that Canada ranked far behind other major OECD nations in expenditures on research and development as a percentage of GDP.[198] In the late 1960s, the government of Pierre Trudeau began the push for what would later be referred to more colloquially as "the third option." The third option itself intended to reduce Canada's large and growing dependence on the U.S. market for its economic prosperity through trade policies directed at solidifying ties to other trading partners, notably Japan and the European Community. More generally, however, the 1970s were a period in which Canada adopted a series of other policies supported by economic and political nationalists who worried about the influence of foreigners (namely Americans) on the Canadian economy. In addition to trade diversification, the Trudeau government, in 1980, campaigned on a platform that included the "Canadianization" of the economy with a policy mix that included a more overt industrial policy, greater control in the energy sector, and government review of incoming foreign investment.[199]

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[197]See Clarkson, *Uncle Sam and Us*, 207-08.
[198]Earl Fry, *The Politics of International Investment*, (New York: McGraw-Hill, Inc. 1983), 80.
[199]See Hart, *Decision at Midnight*, 16; Fry, *Politics of Foreign Investment*, 82.



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Of particular concern to American (as well as many Canadian) business interests were policy changes to energy and investment embodied by the creation of the National Energy Program (NEP) and the Foreign Investment Review Agency (FIRA). According to Earl Fry, in 1980 when the NEP was created, foreign investors controlled nearly 70 percent of all Canadian oil and gas production, and assets valued at over US$25 billion.[200] Supporters of the NEP argued that no other industrial country permitted such overwhelming foreign investor control over such key economic sectors. In several respects, the policy dilemmas the Trudeau government faced were similar to those currently faced by many developing countries and involved the apparent trade off between attracting the FDI and spin-off technology transfer that were so important to Canada's standard of living and exercising greater national control over its own economic affairs. Through FIRA and the NEP, Canadian policy sent a chill wind of uncertainty through existing foreign held operations and any future investment flows in Canada.

The stated goals of the NEP were three fold; Canadian energy self-sufficiency and Canadian ownership of 50 percent of the oil and gas sector by 1990, the redistribution of revenue within Canada, and the Canadianization of the oil and gas sector.[201] The NEP was not designed as an explicitly confiscatory program to transfer foreign owned assets to Canadian ownership, but rather as an incentive program for Canadian owned operations. However, the differential in the incentives offered to Canadian firms in new and existing

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[200]Fry, *Politics of Foreign Investment*, 86.

[201]Carman Neustaedter, "The National Energy Program: Canada and the United States," Unpublished manuscript, March 2001, 3. Accessed via Internet at http://pages.cpsc.ucalgary.ca/~carman/courses/nep.html March 8, 2004; see also, Stephen Clarkson, *Canada and the Reagan Challenge: Crisis in the Canadian-American Relationship*, (Toronto: James Lorimer & Company, Publishers, 1982), 60-69.



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oil exploration put foreign held operations at a significant disadvantage, weakening foreign-held asset values, and paving the way for Canadian firms to acquire ownership stakes in them.[202] American officials complained that Canadian policies were a form of "creeping expropriation" of private property. At a minimum, American officials charged that the NEP was a denial of national treatment and that the incentives offered Canadian firms also had the effect of being equivalent to expropriation in instances where U.S.-owned asset values fell, thereby facilitating the Canadian acquisition of them.[203]

In essence, the Canadian government changed the rules governing economic activity in the oil and gas sector starting in 1980. The government had altered the incentive structure for firms, placing foreign-controlled firms at a disadvantage. The changed rules affected asset values which altered the choice set under which domestic and foreign firms exchanged property. The rule changes did not themselves make a new market for exchange, but they did dramatically alter the incentives for entry and exit from the Canadian market. While the climate for foreign investment in Canadian oil and gas remained much more favorable than in other parts of the world, there were several prominent sales of American assets to Canadians as well as several instances of American firms simply leaving the Canadian market.[204]

Likewise, Canada's Foreign Investment Review Agency, launched in 1974, also shifted the incentive structure facing potential foreign investors in many other sectors of

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[202]Fry, *Politics of Foreign Investment*, 86-87; Neustaedter, "The National Energy Program," 3.

[203]Neustaedter, "The National Energy Program," 3-4; Clarkson, *Canada and the Reagan Challenge*, 71-78.

[204]Fry, *Politics of Foreign Investment*, 87.



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the Canadian economy. FIRA's mandate was to screen both new foreign investment and expansions of existing foreign-controlled firms within the Canadian economy. The purpose of FIRA was to ensure that foreign activities in Canada were of significant benefit to Canada including considerations of employment effects, potential for productivity enhancement, technological transfer to Canadians, the impact on competition domestically, and the compatibility of provincial policies.[205] Although FIRA approved virtually all investment proposals that it reviewed,[206] the policy structure had the effect of also reshaping the institutions governing the acquisition and exchange of private property in Canada. In a sense, Canada's nationalist economic policies were moving the goal posts. Lengthy and time-consuming application procedures coupled with the absence of transparency in the review process and the arbitrary quality of many decisions contributed to the addition of significant uncertainty regarding potential investments– a risk premium on foreign-controlled Canadian assets. The imposition, or threatened imposition, of "undertakings" by Ottawa on new investments– essentially performance requirements as a condition of approval– added an additional set of constraints to the choice set facing foreign as well as domestic firms, many of which could then enjoy protection in the domestic economy afforded them by Canadian policies.

Canadian nationalists complained that the real impact of the NEP and FIRA was much less than promised by the rhetoric of the day.[207] Yet, foreign discontent over

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[205]Ibid., 89; see also Clarkson, *Uncle Sam and Us*, 204-210.

[206]Fry, *Politics of Foreign Investment*, 89; Clarkson, *Canada and the Reagan Challenge*, 83-113.

[207]Clarkson, in particular, laments the Canadian Government's weakness (bowing of course to American pressure) in backing off proposals to strengthen FIRA in ways that would have increased Canadian ownership more broadly throughout the domestic economy by using policies and targets similar to those employed under the NEP. See Clarkson, *Canada and the Reagan Challenge*, 83. See also, Mel



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policies that discouraged the very foreign investment that Canada needed to continue the development of its resource and manufacturing base grew in the mid-1980s. In 1979 alone, US$1.7 billion in FDI left Canada for the United States while Canada took in only US$675 million. In 1981, capital outflows from Canada reached a record US$10 billion. In addition, the overall net outflow of capital from Canada, which averaged US$2 billion dollars annually during the 1970s jumped to US$10 billion during the early 1980s.[208] In 1980, Canada's share of all North American inward FDI was over 38 percent. By 1985, that share had fallen to just over 23 percent.[209] On the other side, Canada's share of all North American FDI outflows rose from just over 9 percent in 1980 to over 15 percent toward the end of the 1990s.[210] In short, Canada had become a less attractive investment climate for private capital. According to Michael Hart,

> the early 1980s had witnessed a switch in the traditional roles of Canada and the United States as importer and exporter of capital, respectively. Both countries retained their traditional host and home positions toward foreign direct investment, but their ratio of assets held abroad to domestic assets held by foreigners had changed significantly ( from 4.5 to 1.5 in the case of the United States, and from 0.28 to 0.50 in the case of Canada over the 1975-84 period).[211]

The speed with which the United States had become a comparatively attractive destination for FDI was, in part, due to the policies of the U.S. Reagan Administration favoring deregulation and low taxes. Because of the policy divergence in Canada and the

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Hurtig, *At Twilight in the Country: Memoirs of a Canadian Nationalist*, (Toronto: Stoddard, 1996), 109-117.

[208]Fry, *Politics of Foreign Investment*, 101.

[209]Source: Cemile Sancak and Someshwar Rao, *Trends in Canada's Inward FDI*, Strategic Investment Analysis Directorate, Micro-economic Analysis Branch, Industry Canada, October 18, 2000.

[210]Ibid.

[211]Hart, *Decision at Midnight*, 222.



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United States, as well as the growing competition for capital flows, in 1984, the Canadian government initiated a review of FIRA's mandate that resulted in a name change, Investment Canada, and a dramatic reversal of its function from one of screening FDI to one of promoting Canada as a destination for FDI.[212] Much the same happened with the NEP, which was abandoned in 1984.

These specific Canadian policy reforms were part of a much broader opening of the Canadian economy brought about in the early years of Brian Mulroney's tenure as Canada's new prime minister that included a 1985 proposal for a free trade agreement with the United States. U.S. interest in such an agreement was driven, in part, by a desire to deal with specific Canadian policies, such as investment, that were hindering American interests and contributing to a generalized perception of Canada as hostile to foreign, and particularly American, capital.[213] As an important exporter of capital itself, Canada had the interests of its own multinational corporations in mind in the pursuit of stronger investment provisions on a bilateral, regional, and multilateral basis.[214] The Canada-U.S. Free Trade Agreement (CUFTA) dealt directly with investment issues, and in many ways reversed the just-described domestic institutional changes to property rights in Canada by internationalizing them in a formal agreement. By itself, Chapter 16 of the CUFTA is essentially a BIT, one of the first ever concluded between two developed countries, and

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[212]Ibid.

[213]Ibid., 222-24; In fact, in 1982, the United States challenged Canada over FIRA's performance requirements at the GATT. The GATT later ruled that FIRA's performance requirements violated the national treatment provisions of GATT Article III(4), but lent support to both FIRA's export performance regulations and some local content rules. See Robert and Wetter, "Toward an Investment Agreement in the Americas," 391.

[214]Clarkson, *Uncle Sam and Us*, 219-220.



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essentially follows the model developed under the U.S.-bit program which began in 1981.[215]

Chapter 16 of the CUFTA guaranteed that investments made in the host country by each other's nationals would be accorded treatment no less favorable than that accorded to firms in the domestic market (national treatment). Such treatment included securing rights of establishment, acquisition, sale, and conduct of enterprises in each other's territory.[216] In addition, the threat of the imposition of performance requirements, such as minimum export levels or local content rules, as a condition of investment, as proposed under FIRA, would no longer be permitted under the Agreement.[217] And, of course, both parties agreed to a prohibition on measures that directly or indirectly nationalized or expropriated FDI of the other party in its territory, and would not impose any measures that would be tantamount to expropriation, such as those that depressed foreign asset prices under the NEP.[218]

Several important points about this episode merit elaboration. Canada and the United States have long been each other's most important trade and investment partners.[219] Yet, the institutional ambiguity in international law governing investment between the two countries allowed frictions to develop during the 1970s and early 1980s when policy changes in Canada generated significant uncertainty and raised transactions costs on new investment. The rules of the game had changed the incentive structure

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[215]Salacuse, "Toward a Global Treaty on Foreign Investment," 10.
[216]CUFTA, Article 1602.
[217]CUFTA, Article 1603.
[218]CUFTA, Article 1605.
[219]In 2000, Canada ranked second only to Great Britain as the target of U.S. FDI while Canada was the fifth largest source of FDI in the United States. Source: Statistics Canada.



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governing the exchange of private property in Canada, and with few options available to American firms disadvantaged by Canada's policy changes, there was little that could be done other than have government representatives complain on their behalf to Canadian authorities. Here we can again consider Douglass North's assertion that relative price changes are an important source of institutional change in the market. We could argue that the original shifts in policy that induced relative price changes in the Canadian market were driven from above, as in governmental authority. Thereafter, widespread dissatisfaction with those relative factor price changes on both sides of the Canada-U.S. border (as in complaints from businesses and, in the case of the NEP, Western Canadian provinces), induced a second series of autonomous domestic changes by Canada that were capped off by the conclusion of a BIT with the U.S. (Chapter 16 of the CUFTA). Yet, even the original policy changes in Canada can be cast in the light of institutional change driven from below, or from the bottom up, for while the NEP and FIRA did not please everyone in Canada, there was enough broad-based domestic concern over the role of foreign enterprises in Canada that the role of tastes (as in preferences) could be said to have helped induce institutional change.[220]

Finally, Chapter 16 was an incremental, and not fundamental, change to institutions governing the distribution of property in North America. Both Canada and the United States have strong domestic legal systems that have well-established procedures covering private property. Many U.S. and Canadian subsidiaries in each other's countries

[220]North, *Institutions, Institutional Change, and Economic Performance*, 84-86; For Canadian nationalist concerns regarding inflows of FDI, see Clarkson, Uncle Sam and Us, 204-208; Mel Hurtig, *The Vanishing Country: Is it Too Late to Save Canada?*," (Toronto: M&S, 2002), 11-52.



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have successfully used domestic legal systems to pursue their rights. As such, the real need for a BIT-like investment chapter within a free trade agreement is doubtful. However, Chapter 16 came about within the context of a broader reconsideration of economic openness by both countries and the legal and regulatory institutions that had been governing their national economies and structuring their economic relations. So, are we left with an institutional chicken or egg?

Mexico

The basic story Mexico's entry into the NAFTA negotiations is also well known and needs no recounting here.[221] However, a few elements related to foreign investment merit repeating because the evolution of Mexican institutions affecting investment flows, eventually leading to the NAFTA Chapter 11, were as equally incremental and slow as in the Canadian case. The need for foreign investment capital in Mexico has been as pressing an issue historically as it has for Canada. However, in the Mexican case, access to international capital flows was made even more difficult as the country struggled to emerge from the crushing debt crises, soaring interest rates, and falling oil prices of the early 1980s. As part of Mexico's effort to put its economic house in order, the administration of Miguel de la Madrid began a long process of domestic economic reforms in 1985 that included privatization, deregulation, and the start of a broad shift

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[221]See Carlos Salinas de Gortari, *Mexico: The Policy and Politics of Modernization* (Barcelona: Plaza & Janes Editores, 2002); Maxwell Cameron and Brian W. Tomlin, *The Making of the NAFTA: How the Deal was Done* (Ithaca: Cornell University Press, 2000).



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away from years of industrial import substitution.[222] This general trend in Mexican economic openness was broadened and deepened under the administration of Carlos Salinas de Gortari in his efforts to bring greater privatization, to state enterprises and banks, liberalize prices and wages, and to stimulate additional trade and investment.[223] These reforms not only began to reverse Mexico's economic fortunes, but also won them formal memberships in both the GATT in 1986 and the Organization for Economic Cooperation and Development (OECD) in 1994. However, the improvement in Mexican economic performance that went along with the reforms contributed to the appreciation of the Mexican peso and a rising current account deficit.[224] In fact, between 1987 and 1994, the year the NAFTA was implemented, Mexico watched its $8.8 billion trade surplus evaporate into deficit of $18.5 billion.[225] The lingering effects of the debt crisis resulted in Mexico's leaders casting around for ways to finance its mounting current account deficit as well.

Part of the solution was the revision of Mexico's investment statutes that had, much like Canada, turned what was an inward looking, defensive investment climate into a more open and favorable climate for development capital to flow into Mexico. In 1989, for example, Mexico revised its 1973 *Act to Promote Mexican Investment and Regulate Foreign Investment*, even the title of which sent the contradictory message of both

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[222]Salinasi, *Mexico: The Policy and Politics of Modernization*, 394-491.

[223]Manuel Pastor Jr. and Carol Wise, "Mexican-Style Neoliberalism: State Policy and Distributional Stress," in Carol Wise ed., *The Post-NAFTA Political Economy: Mexico and the Western Hemisphere*, (University Park, PA: The Pennsylvania State University Press, 1998), 41-44. See also, Salinas, *Mexico*, 9-36.

[224]Salinas, *Mexico*, 27.

[225]Pastor Jr. and Wise, "Mexican-Style Neoliberalism," 46.



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promoting and discouraging FDI, with new regulations that sought mainly to promote rather than discourage investment. In 1993, Mexico went even further, partly in anticipation of the conclusion of the NAFTA's investment provisions, by replacing the 1973 law with the *Foreign Investment Law* which substantially liberalized Mexico's investment regime.[226] Most famously, in 1989, the *Decree for Development and Operation of the Maquiladora Industry* greatly enhanced Mexico's export driven production by allowing foreigners 100 percent ownership and preferential customs treatment provided that all production was exported.[227]

However, as President Carlos Salinas discovered when he traveled to Europe in early February 1990 to attend the World Economic Forum meetings in Davos, Switzerland, the competition for investment capital had become even more intense with the entry of many former Soviet republics as competitors for scarce resources. European capital was not interested in Mexico.[228] During the late 1980s, the United States and Mexico engaged in several discussions on economic issues, and much like Canada prior to the CUFTA in 1987, had considered pursuing several sectoral trade and investment arrangements with the United States. In fact, in 1987, the two countries concluded the *Framework Understanding on Trade and Investment* which set the agenda for such negotiations.[229] However, following the cool reception Mexico received in Davos, Salinas wasted little time in proposing a comprehensive free trade deal with the United States,

[226]Jorge A. Vargas, *Mexican Law : A Treatise for Legal Practitioners and International Investors*, (St. Paul, MN: West Group, Inc, 2001), vol. 3, chapter 1; Cameron and Tomlin, *The Making of the NAFTA*, 59.

[227]See, Salinas, *Mexico*, 37-47.

[228]Cameron and Tomlin, *The Making of the NAFTA*, 1-3, 62-63.

[229]Cameron and Tomlin, *The Making of the NAFTA*, 59.



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formally doing so in early February 1990.[230]

But why did Mexico need a comprehensive agreement with the United States that covered investment when it had already liberalized its rules governing investment? Many scholars immediately suggest that Mexico concluded it needed an agreement with the United States in order to bring credibility to the reforms it had already put in place; a kind of policy lock-in that would ensure Mexico would remain a stable, predictable destination for investment. Given Mexico's historical record of economic instability and lax enforcement of the rule of law and a history of expropriation of foreign property symbolized by the 1938 nationalization of the Mexican oil sector and the 1982 nationalization of the banking sector, it is easy to understand why these policies needed to be locked-in. Carlos Salinas himself suggests as much, writing that the

> flow of foreign investment did not increase with the speed or in the volume that Mexico required. Both domestic and foreign investors argued that the rules in Mexico changed with each administration: one nationalized, the next privatized. It was essential to provide internal stability, convince investors that our policies would have continuity and long-term validity, and that they would not depend on the discretionary powers of the administration in office.[231]

It might seem obvious that Mexican, or even Canadian, laws governing foreign investment did not materialize overnight or that some ground work needed to be laid domestically in order for Chapter 11's provisions to take root. From the point of view of neoclassical trade theory, we could say that Chapter 11 "removed barriers" to investment

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[230]Salinas, *Mexico*, 48. Salinas recounts that the first proposal for a free trade agreement between the United States and Mexico came from President Bush on November 22, 1988 and was rejected. Mexico's own proposal came on February 1, 1990 in a meeting between Commerce Secretary, Jaime Serra Pucha and Carla Hills, United States Trade Representative.

[231]Salinas, *Mexico*, 42.



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in Mexico and Canada by locking-in a process and set of rules that would be followed by all. Yet, leaving the discussion there, as is done so often in the public policy literature, misses the importance of institutions in structuring so much of our economic, social, and political lives. Changes to investment rules are not typically about the addition or removal of barriers to a market that then miraculously greases the skids for additional investment flows. Rather, changes to investment rules are changes to an economic road map, full of incentives and hazards that structure the choice sets available to investors in the countries affected by them. New investment institutions means a different set of incentives through which everyone must navigate and to which everyone will respond.

## The United States

Lest the discussion leave the reader with the impression that within North America, only Canada and Mexico have had changing institutional structures with respect to FDI, or that the United States merely imposed its particular brand of BIT on its two smaller partners with few implications for itself, let's briefly enquire into America's own institutional changes. Canada and Mexico are not the only two NAFTA Parties that have gone down the road toward review of incoming investment flows. During the 1970s, many Americans were alarmed at the rapid changes in the global economy brought about by rising oil prices and a stagnant American economy. As oil prices rose, spending by Americans on oil from Organization of Petroleum Exporting Countries (OPEC) began to find its way back into the United States in the form of foreign direct investment. Acquisition and control of American companies by wealthy individuals from OPEC



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countries fueled a kind of xenophobia in many quarters that, in turn, generated a response from the U.S. Congress.[232] One of the most important measures to arise out of Congressional activism on foreign investment was the creation in 1975 of the Committee on Foreign Investment in the United States (CFIUS). Nominally, CFIUS had an impressive membership and mandate to review incoming FDI, yet the committee served a largely political purpose by allowing American political leaders to claim action even while the Committee's real impact was muted.[233] While the Committee's activities were largely muted during the remainder of the 1970s and early 1980s, the recovery of the global economy in the mid- to late- 1980s, coupled with growing U.S. budget and trade deficits, generated higher levels of FDI inflows, especially from Japan, which in turn contributed to renewed interest in regulating FDI. Higher flows of Japanese foreign investment in the United States were more a matter of perception than reality, but these concerns spawned several legislative efforts to revive U.S. reviews of foreign investment. The most successful of these was the so-called Exon-Florio amendment to the 1988 Omnibus Trade and Competitiveness Act which reinvigorated the CFIUS and directed its efforts primarily at investments affecting national security. While other proposed measures would have required that all foreign investment be reviewed, the Exon-Florio amendment placed the discretionary responsibility for reviewing investment with the White House, and therefor allowed the President to maintain some control and hence

[232]C.S. Eliot Kang, "U.S. Politics and Greater Regulation of Inward Foreign Direct Investment," *International Organization* 51 (Spring 1997): 310-14.

[233]Kang, "U.S. Politics and Regulation of Foreign Direct Investment," 315. Note the similarities in effect between CFIUS and FIRA where more than 90 percent of all applications for direct investment in Canada were approved.



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preserve America's historically liberal outlook to economic policy. Nevertheless the vagueness of the law cast a shadow of uncertainty over potential FDI.[234] As Eliot Kang writes,

> If the parties to a transaction that might be deemed subject to review under the Exon-Florio amendment failed to notify CFIUS, and if the transaction then escaped review, CFIUS– on its own initiative or pressured by Congress– could review the transaction at virtually any time it chose. If CFIUS then recommended action to which the President agreed, divestment could be forced retroactively– a costly consequence for any investor.[235]

In addition to reviewing and blocking new FDI in "sensitive" industries, CFIUS could impose performance requirements on new investments. But more importantly, CFIUS was given no specific rules or tests for what products, services, or technologies were "sensitive" to national security interests; precisely the kind of uncertainty economic decision-makers loathe. No activity or industry was excluded from review. While no specific instance of forced divestment has yet occurred, the presence of CFIUS has had a significant impact on potential investments, often without even bringing them under review. In 1991, for instance, the Taiwan Aerospace Corporation dropped its bid for a 40 percent stake in U.S. aerospace giant McDonnell Douglas after Congressional demands that CFIUS review the transaction generated uncertainty that contributed to the demise of the deal.[236]

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[234]Kang, "U.S. Politics and Regulation of Foreign Direct Investment," 326; See also John B. Goodman, Debora Spar, and David B. Yoffie, "Foreign Direct Investment and the Demand for Protection in the United States," *International Organization* 50 (Autumn 1996): 565-91.

[235]Kang, "U.S. Politics and Regulation of Foreign Direct Investment," 327; See also Goodman, Spar, and Yoffie, "Foreign Direct Investment," 565-91.

[236]Kang, "U.S. Politics and Regulation of Foreign Direct Investment," 329.



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## Sources of Institutional Change

Many scholars and commentators, including Kang, have viewed episodes like this, or those often transpiring over trade policy more generally, as being driven by ideology, interest group, bureaucratic or inter-branch politics.[237] They argue that trade and investment policy seldom attract a wide public following and that because the benefits of liberalized trade and investment are spread throughout the economy while downside adjustment is often localized and acute, even small, concentrated interests can often have disproportionate influence over policy change. In many areas, as the discussion of investment in all three NAFTA countries suggests, such policy change can often have an important impact on economic institutions such as private property rights.

However, as scholars of trade, and increasingly foreign investment, well know, trade and foreign investment flows tend to alter the domestic politics of economic policy such that dramatic national policy reversals are rare.[238] Nevertheless, the returns to institutional change for particular interests to lobby government provides incentives for them to organize into associations such as trade groups or unions who then concentrate their efforts. As North argues, "[t]he larger the percentage of a society's resources

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[237]One of the most famous studies of interest group lobbying affecting trade policy is E.E. Schattschneider's famous study of the origins of the Smoot-Hawley Tariff. E.E. Schattschneider, *Politics, Pressures, and the Tariff: A Study of Free Enterprise in Pressure Politics, as Shown in the 1929-30 Revision of the Tariff,* (New York: Prentice-Hall, 1935); see also Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (Cambridge: Harvard University Press, 1971); Judith Goldstein, "Ideas, Institutions, and American Trade Policy," *International Organization* 42 (Winter 1988): 179-217; Robert Pastor, *The Politics of U.S. Foreign Economic Policy*, (Berkeley: University of California Press, 1980); Richard E. Caves, "Economic Models of Political Choice," *Canadian Journal of Economics* 2 (May 1976) 278-300; G.K. Helleiner, "The Political Economic of Canada's Tariff Structure: An Alternative Model," *Canadian Journal of Economics* 2 (May 1977):318-326.

[238]See Goodman, Spar, and Yoffie, "Foreign Direct Investment and the Demand for Protection in the United States,"565-91; Crystal, "A New Kind of Competition,: 513-43.



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influenced by government decisions (directly or via regulation), the more resources will be devoted to such offensive and defensive (to prevent being adversely affected) organizations."[239] As Kang points out in his piece on the development of CFIUS, in spite of public nerves regarding OPEC, then Japanese, FDI into the United States, there was little broad-based public input, either for or against, into the process of formulating a public policy response.[240]

It is worth reemphasizing that viewing economic change through the lense of institutions is no substitute for the neoclassical model's focus on resource endowments, prices, tastes, or technological change. However, looking at change through the neoclassical model assumes a frictionless marketplace in which changes to such factors instantly ripple through the market via the incentives they provide to economic decision makers. Yet, that rarified air does not exist, particularly in the modern world of trade and investment policy which, since at least the Tokyo Round of the GATT in the 1970s, has been increasingly grappling with issues unrelated to border measures such as tariffs. Investment is just one of these issues, and the NAFTA's Chapter 11 is just one way in which institutions and institutional change are shaping the incentive structure for foreign investors.

Were relative price changes the main driving factor behind institutional change surrounding foreign investment in North America? Investment was only one of many controversial issues being addressed during the NAFTA negotiations, so how is it that

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[239]North, *Institutions, Institutional Change, and Economic Performance*, 87.
[240]Kang, "U.S. Politics and Regulation of Foreign Direct Investment," 325.



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relative price changes by themselves could have done the job? However, Canada and Mexico sought stronger investment rules as a way to remove negative perceptions regarding the investment climates in each country, suggesting that internal policies were having an impact in terms of risk premiums. But were these concerns with shifting patterns of transactions costs on investment enough to radically alter North America's institutional structure governing investment? No. Part of the story of institutions is that understanding economic change requires an appreciation of the incremental, path-dependent nature of that change over time. As the long history of the search for international law (rules and norms, a.k.a. institutions) suggests, Chapter 11 of the NAFTA is not a radical departure from practices that had emerged to bring more certainty to relations between states and private investors. Concepts like national treatment, most favored nation treatment, and minimum standards of treatment have long been enshrined in the thousands of BITs that have been concluded world-wide, and have been a part of the global trading system as applied to goods and services dating to the inception of the GATT. Chapter 11 of the NAFTA was simply not that radical. In fact, the only innovations within Chapter 11 that can be said to have been dramatic were dispute settlement mechanisms which effectively compelled state Parties to the Agreement to submit themselves to binding arbitration.[241] Here, the NAFTA makes use of ICSID's Additional Facility Rules for arbitral proceedings because neither Canada nor Mexico is a

[241]Note that the WTO contains no such compulsory provisions, either for trade in goods and services or investment (TRIMs).



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member of ICSID.[242] Yet, even here, the shift from voluntary to compulsory arbitration for states in litigation with private parties has precedents prior to the NAFTA in many BITs.[243]

## Incentives, Institutional Change, and The NAFTA

The process of institutional change may be incremental, but what can we say about how the NAFTA has reshaped the incentive structures regarding foreign investment in North America? What incremental changes did the NAFTA actually make? The limitations of social science methodologies preclude us from definitively separating the effects of Chapter 11, or more broadly the NAFTA, on economic activity. Without the benefit of a laboratory-like control group against which to compare economic growth during the life of the NAFTA with what growth would have been like without it, all we can do is venture into a kind of ahistorical, educated guess. However, mounting anecdotal evidence on FDI flows in response to the NAFTA generally, not just the provisions of Chapter 11, suggests that there has been a significant response to the changed incentive structures the NAFTA put in place. For instance, while Canada's overall stock of both inward and outward FDI continues to rise, its share of both inward and outward flows in North America has fallen in recent years. Between 1980 and 1998, Canada's share of all inward North American FDI fell from 38 percent to 13 percent while Canada's share of

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[242]See Broches, *Selected Essays*, 249-56; See also International Centre for the Settlement of Investment Disputes, List of Contracting States at http://www.worldbank.org/icsid/constate/constate.htm.

[243]Salacuse, "BIT by BIT,"672; Salacuse, "Toward a Global Treaty on Foreign Investment," 25.



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outward FDI in North America fell by nearly 3 percent between 1990 and 1998.[244] One explanation for this general decline in outward investment flows is that Canadian firms wishing to serve the North American market may no longer be as concerned with the location of their operations. In other words, because of the NAFTA, why not serve the North American market from where you are?[245] At the same time, several large Canadian acquisitions of American assets and an increased presence in the U.S. market by several large Canadian firms such as Bombardier, Magna, Nortel, and Canadian National, suggest this might not work for all firms. However, coupled with the statistics showing the United States as the principle target of foreign investment in the NAFTA area during the 1990s there are growing concerns regarding the alleged "hollowing out" of Canadian business as growing proportions of their operations are relocated in the American market.[246] But of course, the governance of FDI flows represent only one element of the NAFTA and the NAFTA itself only a part of the broader structure of incentives and institutions now shaping trade and investment flows in an increasingly integrated North American economy. As the largest, broadest, deepest, and most competitive of the three national economies in North America, the United States already presents an attractive location for

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[244]Source: Sancak and Rao, *Trends in Canada's Inward FDI*, 2000.

[245]Daniel Schwanen, "Trading Up: The Impact of Increased Continental Integration on Trade, Investment, and Jobs in Canada," C.D. Howe *Commentary* No. 89. March, 1997, 16. See also the work of Paul Krugman on relationship between trade and location economics and that by Roger Porter on business clustering. Paul Krugman, "On the Relationship Between Trade Theory and Location Theory," *Review of International Economics* 1(2) (1993): 110-122; Michael E. Porter, *The Competitive Advantage of Nations*, (New York: Free Press, 1990); see also Ho Yeon Kim, "Impact of Trade Liberalization on the Location of Firms: NAFTA and the Automobile Industry," *The Annals of Regional Science* 37 (2003): 149-173.

[246]See Richard G. Harris, *North American Economic Integration: Issues and Research Agenda*, Ottawa: Industry Canada Discussion Paper Number 10. April, 2001; Clarkson, *Uncle Sam and Us*, 203-229; Isaiah A. Litvak, "The Marginalization of Corporate Canada," *Behind the Headlines* 58 (Winter 2000-01): 1-24.



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many kinds of new investment. With the incentives provided by the NAFTA in terms of the freedom of goods and services to flow across borders to Canada and Mexico, firms may simply elect to locate in the largest of the three markets and service the other two from the United States. This may account for some of the disappointment among some in Canada over the country's inability to attract significantly more investment capital under either the CUFTA or NAFTA.[247]

A more telling portrait of the incentive structure the NAFTA's Chapter 11 brought to the exchange of property in North America are the Chapter 11 arbitration cases themselves. Although few in number, the cases offer a glimpse into just how Chapter 11 has altered the property rights structure in North America by creating new legal ground on which states and private investors can settle disputes and set out a new set of rules for adjudicating the exchange of property. Many of the cases allege discrimination against foreign firms by governments, in other words, a denial of national treatment (NAFTA Article 1102).[248] Critics have alleged that the application of national treatment within the NAFTA has conferred legal rights to foreign companies that are not accorded to domestic companies.[249] While many North American firms have legal presences, in terms of operations and representation, in each of the countries in which they operate and could

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[247]See Clarkson, *Uncle Sam and Us*, 210-211; Sancak and Rao, *Trends in Canada's Inward FDI*, 2000. Work by Sancak and Rao at Industry Canada has demonstrated that Canada's share of World inward FDI declined from 10.7% in 1980 to 3.5% in 1998, while its share of North American inward FDI has also experienced a sharp decline from 37.3% in 1980 to 13.2% in 1998, a drop of 24.1%.

[248]For instance see www.state.gov. *Methanex vs. United States*, *Canfor Corporation vs. United States*, *Ethyl Corporation vs. Government of Canada*, *United Parcel Service vs. Government of Canada*, *Fireman's Fund vs. United Mexican States*, or *Metalclad Corp. vs. United Mexican States.*

[249]See Public Citizen, Global Trade Watch, at www.publiccitizen.org.; see also, Clarkson, *Uncle Sam and Us*, 228, 249-50.



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pursue their property claims through respective domestic court systems, Chapter 11 establishes a legal process (culminating in arbitration) that fills a hole in customary international law between states and private interests. Whereas domestic court systems could conceivably discriminate against a foreign entity, under the NAFTA's rules, such discrimination on the basis of nationality is prohibited. Unlike domestic legal procedures which are established, and provide domestic firms with predictable access to due process in the event of a dispute, foreign firms have had fewer such options when operating in the same environment. Even with Chapter 11's procedures, the arbitration process provides essentially a "one-shot" opportunity to seek redress under arbitration rules with limited scope for appeal.[250] In essence, the national treatment provisions of the NAFTA did not intend to confer any greater legal rights to foreign investors than already afforded to domestic investors making investments "in like circumstances."[251] The Agreement merely levels the playing field. In other investor-state arbitration cases, parties claim to have been denied the minimum standard, or a fair and equitable standard of treatment (Article 1105) as required under customary international law (ie. customary state practice).[252] Others have claimed that the state has imposed forms of performance requirements

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[250]See NAFTA Article 1136 (b) and ICSID Additional Facility Rules, Article 57. In October 2000, *Metalclad vs. United Mexican States*, Metalclad petitioned the Supreme Court of British Columbia to have the arbitration decision against it overturned on the grounds that the tribunal had exceeded its jurisdiction under the Convention and that enforcing the award would be a violation of public policy. On February 8, 2001 Canada made a similar claim before a federal court in Ottawa over an arbitral award in its case with S.D. Myers Inc.

[251]See Free Trade Commission Clarifications Related to Chapter 11, July 31, 2001.

[252]*ADF Group vs. United States*, *Methanex Corp. vs. United States*, *S.D. Meyers vs. Government of Canada*, *Waste Management vs. United Mexican States*, *Metalclad vs. United Mexican States*.



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(Article 1106) on their investments as a condition of their investment.[253] And, of course, the cases of many investors have claimed that the intervention of the state has been tantamount to expropriation (Article 1110).[254]

What is interesting about these cases is that virtually none of them allege that there was an outright nationalization or expropriation of property as we think about it historically. Instead, most suits allege forms of discriminatory treatment in the application of regulatory measures imposed by states that have the effect of expropriating (taking) private property.[255] It is remarkable that in the ten years of the NAFTA there have only been eighteen Chapter 11 suits. More remarkable still is how few of them have resulted in arbitral awards,[256] and how many tribunals have ruled in favor of the state.[257] In a purely domestic setting, such private interests would have recourse to the domestic legal system. Under the rules of the NAFTA, investors have access to a set of international rules through which to seek adjudication and due process that otherwise might be denied them because of the weakness of customary international law. The eighteen Chapter 11 cases represent responses to a changed set of incentives brought about by institutional change to

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[253]*ADF Group vs. United States*, *Ethyl Corp vs. Government of Canada*, *S.D. Meyers vs. Government of Canada*, *Metalclad vs. United Mexican States*.

[254]*Methanex Corp. vs. United States*, *Ethyl Corp. vs. Government of Canada*, *S.D. Meyers vs. Government of Canada*, *Waste Management vs. United Mexican States*, *Metalclad vs. United Mexican States*.

[255]One possible exception to this is *Metalclad vs. United Mexican States* in which Metalclad was forced to abandon an investment to operate a hazardous waste facility in Mexico. The divestiture of the facility was largely the result of a bureaucratic dispute between Mexican local and federal officials over permits for operation that the tribunal ruled was tantamount to expropriation. The tribunal awarded Metalclad $16.7 million on August 30, 2000 only to have the award set aside by a British Columbia court.

[256]*Pope & Talbot Inc. vs Government of Canada*, *S.D. Myers vs. Government of Canada*, *Ethyl Corp. vs. Government of Canada* (settled outside arbitration), *Metalclad vs. United Mexican States*.

[257]*ADF Group vs. United States*, *Loewen Group Inc. vs. United States*, *Mondev International Ltd. vs. United States*, *Azinian et al. vs. United Mexican States*, *Marvin Roy Feldman Karper (CEMSA) vs United Mexican States* (partial dismissal).



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investment rules in the NAFTA area.

By the late 1990s, several public interest and environmental groups were growing increasingly concerned with the potential for the provisions of Chapter 11 to be used to challenge state regulatory control over safety and the environment, in spite of explicit language within the Agreement to the contrary (Articles 1101 and 1114). Several cases have become lightning rods for such criticism as private investors take advantage of the choice set presented them by Chapter 11's institutional changes to test the limits of new rules governing private property rights. Cases such as *Ethyl vs. Government of Canada*, *S.D. Myers vs Government of Canada*, or *Metalclad vs. United Mexican States* are all derided by environmentalists and others as a subversion of the state's ability to regulate in the public interest, yet all of them represent responses to new institutions by firms engaged in foreign direct investment. The most watched of these cases, *Methanex Corp. vs. United States*, is a case in point. Methanex Corporation, a Canadian marketer and distributor of methanol, has claimed damages of $1 billion for alleged injuries resulting from a California ban on the use or sale of the gasoline additive MTBE which contains methanol as a key ingredient. Methanex contends that a California Executive Order and the regulations banning MTBE expropriated parts of its investments in the United States in violation of Article 1110, denied it fair and equitable treatment in accordance with international law in violation of Article 1105, and denied it national treatment in violation of Article 1102.

NAFTA vs. Domestic Law



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In the absence of Chapter 11, Methanex would have little recourse but to pursue its claim through the U.S. court system. The key question is why Methanex has chosen to pursue its Article 1110, 1105, and 1102 claims through the Chapter 11 rather than the domestic courts? The answer, it turns out, rests in the differences in each of the NAFTA Party's legal systems in defining terms like property and expropriation, and in the absence of a precise definition of these and others such as "tantamount to expropriation" within the NAFTA itself.[258] United States jurisprudence on expropriation rests primarily on a body of case law derived from interpretations of the Fifth Amendment of the U.S. Constitution and the eminent domain clause, therein.[259] Until the early twentieth century, the Fifth Amendment's protection against direct takings (outright expropriation) was understood to apply only to circumstances of outright expropriation of property (ie. the government acquired title to the land). However, starting with the 1922 *Pennsylvania Coal Co. v. Mahon* case, the Supreme Court introduced the idea of a form of taking that was more regulatory in nature.[260] Eventually, U.S. courts arrived at a kind of three-pronged test to determine whether regulatory changes rose to the level of expropriation as protected by the Fifth Amendment: 1) what was the government's intent in setting the regulation 2) what was the extent of the economic impact and 3) was the investor's expectation for his/her investment reasonable given the nature of the property. In practice,

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[258]See NAFTA, Article 1110.

[259]Stanley, "Keeping Big Brother Out," 353-54; See also the Fifth Amendment to the U.S. Constitution which states that "property shall not be taken for public use without just compensation." Note also that the concept of eminent domain is actually derived from sovereignty itself (ie. sovereign state) and requires no real constitutional recognition.

[260]Pennsylvania Coal Co. v. Mahon, 260 U.S. 393 1922. Prior to this, the U.S. Supreme Court had taken a *de jure* approach to the definition of takings (see *Mulger v Kansas*, 123 U.S. 623, 1887). With *Pennsylvania Coal v. Mahon*, the Court introduced the concept of *de facto,* or regulatory takings.



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then, U.S. domestic standards regarding regulatory expropriation have held that regulatory taking in the public interest does not rise to the level of compensable expropriation, that the impact of a regulatory change needs to be substantial, and that the mere loss of opportunity by an investor because of a regulatory change can and should often be anticipated and therefore does not amount to regulatory expropriation.[261]

In Canada, the Constitution Act 1982 (which includes the Canadian Charter of Rights and Freedoms) explicitly excludes the safeguard of property rights and instead guarantees only "the right to life, liberty and security of the person and the right not to be deprived thereof except in accordance with the principles of fundamental justice."[262] Canada's provinces also have the power to enact laws affecting "property and civil rights" within their jurisdictions, or, in other words, a general power to expropriate property within their jurisdictions.[263] In addition, as a general rule, Canadian law on takings has held that no compensation is payable for loss caused by a statute or regulation.[264]

Unfortunately, Chapter 11 of the NAFTA has no clear definitions or criteria for determining which measures rise to the level of expropriation, no deep body of jurisprudence through which definitions have emerged, and a clause in the Agreement (Article 1136 (1)) explicitly separating the cases from one another limiting the scope for the creation of precedent. Some of the only international case law providing guidance on these issues has emerged out of the Iran-United States Claims Tribunal, which adopted a

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[261]Jon A. Stanley, "Keeping Big Brother Out of Our Backyard,"365-370.

[262]Canada, *Constitution Act 1982*, pt. I (Canadian Charter of Rights and Freedoms), 7.

[263]Canada, *Constitution Act 1867*, 92 (13).

[264]Peter W. Hogg, *Constitutional Law of Canada*, 2nd ed. (Toronto: Carswell Publishers, 2002), 703.



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fairly liberal approach to the meaning of takings, including regulations. For instance, the Tribunal has generally ruled that "liability exists whenever acts attributable to a state have deprived an alien owner of property rights of value to him, regardless of whether the state has thereby obtained anything of value to it."[265] In addition, the Tribunal has ruled, "liability is not affected by the fact that the state has acted for legitimate economic or social reasons and in accordance with its law."[266] Yet, while tribunals such as this have developed a set of liberal standards for expropriation, most of which go beyond U.S. domestic law, international law continues to be broadly biased in favor of the state rather than private investors.[267] Critics of the NAFTA worry that within Chapter 11 proceedings, a similarly liberal definition of takings is emerging that threatens to go beyond domestic law in all three NAFTA countries. Should the NAFTA push North America's legal structure governing property rights beyond that which exists in any of the three NAFTA countries, it would be an important institutional change affecting the incentive structure surrounding foreign investment.

Two Chapter 11 cases, *Pope & Talbot v. Government of Canada* and *Metalclad v. United Mexican States*, offer some sense of where jurisprudence on Chapter 11 is heading that is suggestive of the nervousness regarding the *Methanex* case. The *Pope & Talbot* decision acknowledged that "the exercise of police power needed to be analyzed with special care," and it also concluded that "regulations can indeed be exercised in a way

[265]Aldrich, "What Constitutes a Compensable Taking of Property?," 609.

[266]Aldrich, "What Constitutes a Compensable Taking of Property?," 609.

[267]Stanley, "Keeping Big Brother Out," 385-89. Chapter 11 jurisprudence has followed this same pattern to now with numerous tribunals ruling in favor of governments.



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that would constitute creeping expropriation."[268] Further, the tribunal argued that "much creeping expropriation could be done by regulation, and a blanket exception for regulatory measures would create a gaping hole in international protections against expropriation."[269] Although the panel went on to reject Pope & Talbot's claim because the regulatory change imposed upon it was not substantial enough, the decision inserted the notion of creeping expropriation due to regulatory changes squarely into Chapter 11's body of jurisprudence, thus placing the standards for expropriation under the NAFTA well above those of Canada and near those of the United States.[270]

In *Metalclad vs. United Mexican States*, the Chapter 11 tribunal went even further in expanding the definition of expropriation under Article 1110 saying that

> Expropriation under NAFTA includes not only open, deliberate and acknowledged takings of property, such as outright seizure of formal or obligatory transfer of title in favor of the host State, but also covert or incidental interference with the use of property which has the effect of depriving the owner, in whole or in significant part, of the use or reasonably-to-be-expected economic benefit of property even if not necessarily to the obvious benefit of the host State.[271]

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[268]See *Interim Award by Arbitral Tribunal in the Matter of an Arbitration Under Chapter Eleven of the North American Free Trade Agreement Between Pope & Talbot and the Government of Canada,* June 26, 2000, 35. Available at http://www.dfait-maeci.gc.ca/tna-nac/documents/pubdoc7.pdf.

[269]*Interim Award, Pope & Talbot v. Government of Canada*, 34.

[270]This ruling also raised the bar should it be applied to Mexico. See Article 27 of the 1917 Constitution of Mexico which reads:

Ownership of the Lands and waters within the boundaries of the national territory is vested originally in the Nation, which has had, and has, the right to transmit title thereof to private persons, thereby constituting private property.

Private property shall not be expropriated except for reasons of public use and subject to payment of indemnity.

The Nation shall at all times have the right to impose on private property rights the limitations dictated by the public interest, as well as to regulate, for the collective good, the use of natural resources susceptible to appropriation, to ensure a more equitable distribution of public wealth, to conserve them, to achieve the well-balanced development of the country and the improvement of the living conditions of the rural population.

[271]*Award Between Metalclad Corporation and The United Mexican States*, ICSID Additional Facility, Case No. ARB(AF)/97/1 (August 30, 2000). Available at http://www.worldbank.org/icsid/cases/awards.htm.



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By using the phrase "in whole or significant part" the Metalclad tribunal seems to have gone one step beyond the "substantial" economic test put forward in *Pope & Talbot* and introduced a more expansive and subjective standard for expropriation, thus opening the door for a range of regulatory measures that even slightly infringe upon investment performance to be considered a form of expropriation, including the possibility of lost opportunity. This definition clearly reaches beyond the standards for takings in any of the three NAFTA Party's domestic legal systems. If the *Methanex* tribunal were to adopt this kind of expansive definition of expropriation, it would have the practical effect of extending the protection from expropriation afforded to foreign investors beyond that offered to domestic investors by the U.S. legal system, which currently offers the strongest private property protections of the three NAFTA Parties. The Methanex case is being closely watched because of the impact a win for Methanex could have on the NAFTA, in international law, and on domestic legal systems should foreign investors be accorded greater protection than that currently provided domestically. Methanex appears to be taking advantage of the relative lack of definition in NAFTA jurisprudence to push its claim that California should be liable for opportunity costs due to regulatory changes; a claim which, if pursued through the U.S. court system, seems likely to fail.

Here we see some of the strongest evidence that institutional change in the NAFTA area has brought about outcomes that are as much a product of the institutions themselves as they are about the predictions made by neoclassical economic theory. In fact, neoclassical economics might never have predicted that with the liberalization under



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the NAFTA, firms like Methanex could pursue claims such as this and yet, we see cases being filed in which economic decision makers, in this case firms, are responding to the opportunity set that the institutional structures within the NAFTA have created. Neither our economic modeling nor our sophisticated statistical analyses on FDI flows begins to measure the impact of this kind of institutional change as a result of Chapter 11. Yet, the impact is profound.

In partial response to critics, and in light of several worrisome cases such as *Metalclad* and *Methanex*, in July 2001, as provided for under Article 1131, the NAFTA Commission issued an interpretation of Article 1105 (minimum standard and fair an equitable treatment). The Commission's interpretation said that the terms "fair and equitable" and "full protection and security" were only applicable to private litigants to the extent that those terms were recognized under customary international law.[272] Further, the concept of a minimum standard of treatment was only to rise to the level accorded under international law and, as written in the NAFTA, did not constitute a newly created standard to which foreign investors could appeal in Chapter 11 cases.[273] Although the interpretation by the Commission was arcane for many, it did lay down a marker for future arbitral panels regarding the standard by which private foreign investment was to be judged as having been accorded minimum standards of treatment and fair and equitable protection in a domestic setting.

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[272]Recall that Customary International Law, like international law generally is difficult to define since it all it really refers to is the ever changing customary practice of states.

[273]See NAFTA Free Trade Commission Clarifications Related to NAFTA Chapter 11, July 31, 2001 at www.ustr.gov.



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The NAFTA Commission's interpretation has since been incorporated into U.S. negotiating positions in other free trade agreements, notably those with Chile, Singapore, and five Central American states (Costa Rica, Honduras, Nicaragua, Guatemala, and El Salvador). The investment chapters of each of these agreements go to great lengths, much further than the NAFTA, to more precisely define terms such as "fair and equitable" and "full protection and security."[274] Yet, unlike the July 2001 NAFTA Commission interpretation which could come to no agreement among all three Parties on an interpretation of expropriation, each of these new U.S. investment agreements also goes to some length to bring extra precision here as well.

As has been argued here, and as many civil society groups have claimed, the lack of a precise definition of expropriation has left NAFTA Chapter 11 Tribunals with little guidance as to how to adjudicate cases like Metalclad and Methanex, and left "expropriation" and "tantamount to nationalization or expropriation" (NAFTA Article 1110) ill-defined. In the absence of these definitions, economic decision makers have explored the limits of the incentives provided by the NAFTA's Chapter 11 to launch cases like Methanex by arguing that state regulations have amounted to a kind of indirect expropriation that is "tantamount to expropriation" under the NAFTA. The Chile, Singapore, and CAFTA agreements all contain the same basic language as the NAFTA with respect to expropriation, but also contain annexes detailing how that language is to

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[274]See Article 10.4 of the United States-Chile Free Trade Agreement, Article 10.5 of the U.S.-Central American FTA, and Article 15.5 of the U.S.-Singapore FTA, all available at www.ustr.gov. Each of these agreements also contains a provision regarding the Parties shared understanding regarding the definition of the "minimum standard of treatment" under customary international law which reads "...the customary international law minimum standard of treatment of aliens refers to all customary international law principles that protect the economic rights and interests of aliens."



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be interpreted. To begin with, unlike the NAFTA which leaves Customary International Law undefined, each of the new agreements does so explicitly by confirming "...their shared understanding that 'customary international law' generally and as specifically referenced...from a general and consistent practice of States that they follow from a sense of legal obligation."[275]

In a head-on challenge to the indirect expropriation arguments used in cases such as Metalclad and Methanex, annexes to the most recent U.S. agreements now contain guidelines for determining whether "an action or series of actions by a Party has an effect equivalent to direct expropriation without formal transfer of title or outright seizure." While the guidelines admit that such determinations will necessarily have to be made on a case-by-case basis, they are heavily deferential to host governments and their power to regulate in the public interest.[276] Whereas the imprecision of Chapter 11 of the NAFTA generated a particular kind of incentive structure with respect to property rights that firms have tried to assert through the Agreement's arbitration provisions, U.S. negotiators hope that the changes made to recent agreements will redress this perceived loophole in the NAFTA.

## Conclusions

The governance of the exchange of private property is one of the most

[275]See U.S.-Central American FTA, Annex 10-B and U.S.-Chile FTA, Annex 10-A.

[276]See Annex 10-C.4(b) of the U.S.-Central American FTA which says, "except in rare circumstances, nondiscriminatory regulatory actions by a Party that are designed and applied to protect legitimate public welfare objectives, such as public health, safety, and the environment, do not constitute indirect expropriations."



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fundamental determinants of economic growth. We simply cannot buy, sell, or improve what we do not own. Yet, even with ownership, the humanly devised rules and norms which we must follow in order to exchange property are still determinative of the level of economic performance.

When we talk about the liberalization of foreign investment in North America through the NAFTA, we most often quote a range of statistics on how much foreign investment flowed into, out of, and between all three countries. Yet, as this chapter has argued, such statistics are only a part of the story. In a narrow sense, Chapter 11 of the NAFTA was less of a liberalizing agreement than one which solidified what was already taking place on the ground. In all three NAFTA countries, important changes to public policy on foreign investment had taken place, all within the context of a broader search for ways in which to fill the hole in international law governing relations between sovereign states and private investors.

Yet, it is not enough for us to say that the NAFTA "locked-in" a kind of security regarding foreign investment in North America and that flows of FDI as a result were valued at *X* or *Y*. By focusing our attention so narrowly, we miss the deeper impact the NAFTA has had on the way we have come to think about economics in North America and upon the incentive structure through which economic agents make decisions. The NAFTA, in and of itself, does nothing to independently secure domestic legal reforms, except insofar as the Law of Treaties imposes a kind of moral suasion to abide by international agreements. Mexico could, as a sovereign state under international law, again revise its legal structure in ways that brought renewed uncertainty to the security of



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property rights, thereby undermining the security of contracts, and significantly raising the level of transactions costs incurred by future foreign investors. Chapter 11 of the NAFTA merely plugged a hole in international law governing relations between states and private parties by providing both guidelines and mechanisms for investor-state conduct over foreign investment. Chapter 11 brought to international investment rules a set of institutions that already exists in most national legal systems.

Equally important, the institutions of Chapter 11 cannot be considered in isolation from either the rest of the NAFTA, the other standard elements in the neoclassical model influencing economic growth, or the historical and path-dependent evolution of the institutions themselves. Chapter 11 may contain strong provisions for the protection of private property, but the acquisition of private property relies upon much more than adequate legal protections. Such legal protections evolve within an historical context that helps explain and drives institutional change. Recall North's proposition that institutions are the formal and informal, humanly devised constraints on our economic choice sets. They may be written, such as constitutions or the NAFTA, or unwritten, as in normative behavior, taboos, or customs. Where ever they appear, they structure our behavior by shaping the choice set before us. In many ways, the institutional matrix economic decision makers confront every day is infinitely complex, and in many cases so inefficient as to discourage economic development. Yet too often, the neoclassical explanation for economic performance dismisses departures from clean and efficient outcomes under the guise of market imperfections, systemic frictions, or barriers to economic activity without really delving into what those barriers are or what they entail. Looking at institutions as



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an explanation and source of economic development does not deny the importance of other approaches to explaining the evolution and impact of the NAFTA. Models of explanation emphasizing the importance of rent-seeking bureaucratic politics, interest-group politics, or international relations, are important because they detail the responses of various groups to the incentives they confront. Institutional economics merely argues for an examination of the institutional structures (such as rules of debate in the U.S. Congress ) that shape those behavioral incentives.

So what can we conclude about *Hypothesis I* posed at the outset? We can say with some certainty that institutions do affect economic performance by shaping the incentive structure through which economic decision makers make choices. The evidence of such change does not necessarily come through the weekly, monthly, or yearly raw statistics on economic activity, but rather through a deeper examination of institutions like Chapter 11, both in the context of their own development and in conjunction with others (ie. other social, economic, and political structures) all within the overarching context of the basic neoclassical model which features scarcity and choice under constraint as its principal features.

Those constraints, or institutions, have their own path-dependent histories, are always changing (as Chapter 11 subtly did in July 2001), have done so in subsequent agreements like the Chile FTA and the CAFTA, and will continue to slowly change at the margins going forward. It is worth pondering here how the terrorist attacks of September 11, 2001 may be contributing to further institutional change in the NAFTA area, even though security measures taken since the attacks are not formally part of any economic



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agreement. As the U.S.'s northern and southern borders harden because of security concerns, that political fact will increasingly play a significant role in shaping the incentive structure for economic decision makers in North America. We are already hearing about the potential for border delays and the impact it is having on supply chain management for firms engaged in cross border trade. Will these institutional changes brought about as a result of September 11 soon begin affecting investment decisions in North America as firms try to secure their positions to mitigate border uncertainty? These changes may yet prove to be among the most important determinants for investment in an institutional matrix affecting foreign investment. Yet, without an understanding of how the institutions themselves structure choice sets, we will have fewer means with which to interpret the raw numbers.



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# CHAPTER V
# FIRMS AND THE INSTITUTIONS OF THE NAFTA
## (Test of Hypothesis II)

In the ten years of economic activity in North America under the NAFTA, we have been bombarded with statistical information about the volumes of trade and investment flowing across both international borders. All three NAFTA governments regularly put out figures detailing the success of the NAFTA in freeing trade between the three countries, how it has stimulated business activity and created tens of thousands of new jobs. For example, the most recent trilateral brochure on the NAFTA claimed that between 1993 (the year preceding the start of NAFTA implementation) to 2001, trade among the NAFTA nations climbed 109 percent, from US$297 billion to US$622 billion and that daily trilateral trade has reached nearly US$2 billion.[277] The news for each country is also good. Canada's trade to its NAFTA partners rose 94 percent between 1993 and 2001 as exports to the rest of the world in the same period rose only 5 percent. For Mexico, exports to its NAFTA partners rose by a staggering 224 percent as its trade with the rest of the world rose by 94 percent. U.S. exports to its NAFTA partners, meanwhile, doubled while exports to the rest of the world increased by 44 percent.[278] The news seems equally good on the jobs front as U.S. employment supported by exports to NAFTA countries grew by nearly 1 million between 1993 and 2001. On the other hand, we

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[277]Source: United States Trade Representative, *NAFTA at Eight*, released July 31, 2001.
[278]Ibid.



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routinely hear about how lower tariff structures are providing incentives for venerable firms such as Levi Strauss or Fruit of the Loom to move virtually all of their production out of Canada and the United States or out of North America all together.[279] And of course, firm-level decisions such as these have a real impact on individuals as the number of U.S. workers claiming NAFTA trade adjustment assistance tops half a million.[280]

No matter where we look, the NAFTA provides numerous laboratories with which we can test economic theory. Simple neoclassical trade theory suggests that with the reduction of barriers, such as tariffs, an expansion in the flow of goods and services across borders will ensue as the price of imports falls and barriers to exports are removed. Neoclassical trade theory also suggests that one of the effects of free trade agreements is a kind of trade diversion in which, because of the incentives provided by reduced tariffs and other measures, goods and services that might otherwise have been exchanged elsewhere are exchanged between parties to the trade agreement instead. Finally, with the reduction in tariff rates and other barriers, we can expect the increase in foreign competition to create exit pressures for less efficient domestic industries that may ultimately create painful adjustment in the form of job losses. In all of these areas, we observe the impact of institutional change on economic activity as economic agents have responded to the new choice sets generated by the NAFTA's implementation.

The NAFTA is fundamentally a set of rules. The Agreement created no overarching regulatory bodies or administrative mechanisms, instead leaving the

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[279] *Associated Press*, September 25, 2003; *Miami Herald*, July 29, 2003.
[280] Source: Public Citizen, Global Trade Watch.



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administration of the Agreement to be run jointly by each of the national bureaucratic agencies responsible for trade policy. The Agreement's dispute settlement mechanisms are *ad hoc*, in the sense that no formal permanent adjudicatory body hears and rules on disputes.[281] The Agreement sets out schedules for the reduction of tariffs and other commercial barriers. It details the rules by which each country will accord treatment to each other's investors, service providers, agricultural products, and the application of sanitary and phyto-sanitary measures. By almost every measure, the NAFTA is a set of rules by which the trade game has been played since 1994. When we speak of economic rules, we are talking about the realm of economic institutions. Such institutions are found everywhere because they shape the way we think about and reason through the choice sets which confront us. In a world characterized by scarcity (in terms of resources, time, information, etc.), institutions help reduce the considerable transactions costs associated with mitigating the uncertainty about such choice sets. Institutions are the humanly devised, formal and informal, constraints that shape individual choice sets and direct economic activity.

The myriad statistical evidence on the impact of the NAFTA suggests that the economic response to the changed choice sets brought about by the institutional change in North America have largely been in line with the predictions of neoclassical economic theory. It seems obvious that institutional change has induced new patterns of economic

[281]Technically, the rules for forming dispute settlement bodies are entrenched and members of panels are drawn from permanent lists of potential panelists maintained by each NAFTA Party. However, in practice, rosters of panelists have in some cases been difficult to fill. Even when panelists are proposed from active lists by each of the parties to a dispute, significant wrangling often takes place between governments over whether individuals are perceived to be unbiased and therefore fit to serve on a particular panel.



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activity. With the reduction of tariff and other barriers, hitherto a significant transaction cost in exchange between Canada, the United States, and Mexico, trade flows appear to have risen dramatically. But to say that the new incentive structures within the text of the NAFTA have brought about new patterns of economic activity is, unfortunately, stating the obvious without examining how those structures are actually shaping that activity. In trotting out statistic after statistic on trade and investment patterns, we sometimes too readily look to the resulting statistics as being enough supporting evidence for these new patterns of activity without really examining the underlying incentive structure that often drives and channels that activity. Neoclassical economic theory can suggest to us that import prices may fall and that the quantities traded may rise as a result of reduced tariff barriers under the NAFTA. However, neoclassical theory, full of its assumptions about perfect competition and costless transacting, doesn't tell us much about the firm level response to changes in the economic environment in which they operate. We can diagram and understand how cost and revenue curves affect firm-level performance, and as any student of micro-economics knows well, for the profit maximizing firm, marginal revenue must equal marginal cost. But too often in economic theory, we assume away the fact that maximizing activity takes place within the context of a set of institutions that facilitates, or hinders, the entire maximization process. In fact, given the considerable uncertainty economic decision makers are confronted with every day, we might reasonably question whether profit maximizing activity is an appropriate guide for



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understanding the behavior of firms.[282] That institutions, like the NAFTA, help structure and reduce some of that uncertainty suggests that the particular kind of institutional setting in which exchange takes place has significant implications for economic activity.

The NAFTA brought about important changes to the institutional matrix that now governs and guides exchange in North America. Much of the public statistical evidence appearing in government economic reports supports this assertion. But other than the reduction of a small range of transactions costs (tariffs and other restrictions) that facilitate exchange, what can we say about the underlying institutions within the NAFTA itself? How have these actually induced changes to economic performance at the firm level as they respond to the incentive structures within? This chapter is a test of the proposition that *institutions embodied by the NAFTA have had a significant impact on micro-level economic performance by inducing changes to industrial organization (firms) to take advantage of new incentive structures and by shaping the way actors, such as firms, cognitively evaluate their economic choice set.*

## Bringing Order to a Complex World

It does not take a keen observer to note that the firm is a ubiquitous part of a modern economic system. Firms come in all shapes and sizes, have work forces large and small, and are responsible for producing just about everything we consume. Firms, like institutions, are man-made and appear to play an important function in structuring

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[282]See Armen A. Alchian, "Uncertainty, Evolution, and Economic Theory," *The Journal of Political Economy* 58 (June 1950): 211-221.



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economic activity. So, what exactly is the firm? Is it just another institution? These issues raise important considerations for the analysis of the impact of the NAFTA's institutions on firms and leads to an important distinction between the two that needs to be clarified here. Put simply, *institutions are the economic rules of the game around which organizations, such as firms, structure themselves and play the game.*

Back to Institutions

A good place to begin is to recall briefly the role institutions play in structuring economic activity. The most basic assertion being made in this study is that where economic performance is concerned, institutions matter. Consider once again the plight of a subsistence farmer in the Canadian west of the late $19^{th}$ Century. Living essentially in autarky, producing and consuming largely for himself, our farmer has little need for exchange markets outside the realm of his farm. Yet, as the farmer's production and consumption activities become more expansive and complex, the need for mechanisms of exchange, particularly modes of impersonal exchange, becomes more acute. As his activities become more complex, the farmer confronts a range of problems which make the process of exchange progressively more complicated and costly. Under autarky, exchange takes place largely within the farmer's immediate family circle where the uncertainties of exchange are mitigated by kinship as a powerful bond of insurance against opportunistic behavior. However, once the process of exchange moves beyond familial ties and becomes impersonal, the uncertainties regarding the terms of exchange rise dramatically. What the farmer needs are institutions such as a well-defined system of



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property rights, contracts backed by the rule of law, and an effective price system capable of reducing the costs of information gathering by signaling much of that information through the prices themselves.

Consider the obstacles facing a farmer in exchanging surplus production that stem from having an ill-defined set of property rights. We earlier argued that property rights in land was one of the earliest known mechanisms for efficiently exploiting and allocating scarce resources. Although property rights are not a necessary requirement for exploiting resources, some form of property rights over the factors of production is necessary for efficient exploitation of scarce resources. Property rights– both *absolute*, which are rights exercised against all others, and *relative*, which are exercised against one or more people– are critical to jump starting the price system so key to impersonal exchange because of the value that fully specified property rights can then have attached to them. If our Alberta farmer, along with everyone else with whom he/she might exchange, can attach a value to the property rights they hold, the process of exchange essentially becomes one of trading rights. As Coase reminds us,

> If rights to perform certain actions can be bought and sold, they will tend to be acquired by those for whom they are most valuable, either for production or enjoyment. In this process, rights will be acquired, subdivided, and combined, so as to allow those actions to be carried out which bring about that outcome which has the greatest value on the market.[283]

In the absence of these basic institutions through which price signals are transmitted to the farmer as to the value of certain property rights, high transactions costs and the

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[283]Coase, *The Firm, The Market, and The Law*, 12.



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uncertainties of exchange over rights that are unspecified vastly complicates the process. If a farmer exchanges some portion of his production for a piece of manufactured equipment, but neither the farmer nor the seller of the equipment has completely specified rights over what they are selling, attaching a value to those products becomes problematic since others may have a claim on the transaction. As the well-known tragedy of the commons demonstrates, the improper specification of property rights can at worst lead to the disastrous exploitation of scare resources. However, incomplete property rights specification can also raise the costs of discovery in finding a market for exchange, the ownership of the objects of exchange (who can exchange which rights), defining the precise terms of exchange, and enforcing the terms of exchange against opportunistic behavior.

Rationality, Uncertainty, and the Firm

However, even with a basic set of institutions helping to reduce the negative impact of market exchange fraught with uncertainty and high transactions costs, such problems in exchange inevitably persist even in the most advanced market economies. In the zero transactions costs world of neoclassical economics, decision makers operate under conditions of perfect competition characterized by instantaneous access to perfect information about prices, goods, preferences, and technology that permits supply and demand to instantly reach a market clearing price and quantity. In technical terms, the conditions of perfect competition reduce economic decision making to one of logically optimizing the allocation of scarce resources– essentially a mathematical problem rather



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than one involving difficult choices.[284] In such a zero transactions cost environment, economic agents could instantly and costlessly contract with one another for virtually every form of economic exchange. Yet, the simple optimization of resources is not the problem economic decision makers face. Instead, decision makers, like our family farmer, are faced with myriad uncertainties about the market conditions he or she faces that make such contracting, at best, costly, often problematic, and at worst prohibitively expensive.

Research into decision making by psychologists and cognitive scientists has provided numerous insights into human reasoning and rationality. Among the most basic of findings has been the tendency for humans to try and order their complex world through simplifying heuristics, or rules of thumb, about the world around them.[285] In economics, this function is partially served by the many institutional structures that help guide economic decision making in what would otherwise be a world characterized by pervasive uncertainty and opportunism. Institutions such as the price system, an effective system of property rights, and the rule of law provide us with rules of thumb through which we process the imperfect information around us. Under the neoclassical model, we frequently talk about the "profit maximizing" firm under conditions of perfect competition. If competition were perfect, the precise structure of economic organizations like firms would be irrelevant for economic performance. We would be back in our zero

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[284]See, F.A. Hayek, "The Use of Knowledge," 519-20. Hayek later suggests producing an optimal outcome within conditions of perfect information would be compromised by the difficulty of the task and the introduction of human imperfection to the process, 524-25; See also Herbert A. Simon, "Altruism and Economics," *The American Economic Review* 83 (May 1993), 156, who makes the same claim.

[285]See Herbert A. Simon, "Rational Decision Making in Business Organizations," *The American Economic Review*, 69 (September 1979): 506-07; Herbert A. Simon, "Theories of Decision-Making in Economics and Behavioral Science," *The American Economic Review* 49 (June 1959): 253-283. See also Baron, *Thinking and Deciding*, Chapter 3.



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transactions cost world where markets instantly established market clearing price and quantities for supply and demand and we could instantly contract with each other for virtually all forms of exchange. However, because we live in a world characterized by high transactions costs, imperfect information, and considerable uncertainty, in spite of institutions to help structure our decision making, it makes little sense to talk about the "profit maximizing" firm. One overriding assertion of this study is that institutions matter for economic performance. Yet, the same assertion can be made for the organizational forms that congeal around those institutions.

Our economic models of rational consumer choice, for example, tell us that every individual is motivated by self-interest and has known preference sets as represented by utility curves.[286] Such curves are said to be everywhere, and the assumed rationality postulate of analysis is that self-interest will drive decision makers to make choices that will allow them to reach a higher ordinal of utility. The problem is that the use of ordinal utility curves tells us very little about the actual preference sets of decision makers because they are left undefined by the model. The reality of the human condition is that individuals have limited computational capacity, and are able only to selectively search through all possible alternatives or evaluate their consequences. In addition, the search for information is incomplete, often full of inaccuracies, based upon partial ignorance (ie. the role of prior knowledge or levels of expertise), and often terminated with the discovery of

[286]A second standard of rationality often employed in economics, the so-called "present-aim" standard is more in line with the "good thinking" vs. "bad thinking" framework put forward by Baron and cited earlier. See Baron, *Thinking and Deciding*, 53-66. Good thinking is merely what ever kind of thinking best helps achieve one's goals.



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satisfactory, not necessarily optimal, courses of action.[287] Simon has argued that the self-interest assumption in human rationality breaks down amidst the range of other motives for human decision-making, including significant, even necessary, levels of altruism.[288]

Neoclassical rationality combines well-defined choice set and known preference sets which are then fed into simple optimization models. However, psychology and cognitive science have suggested that differences between reality and perception in reasoning stem from the omissions and distortions that arise in both perception and inference about the information we actually possess, much less that which we do not.

> The decision-maker's information about his environment is much less than an approximation to the real environment....The decision-maker's model of the world encompasses only a minute fraction of all the relevant characteristics of the real environment, and his inferences extract only a minute fraction of all the information that is present even in his model.[289]

Studies of human reasoning have even identified instances in which information relevant for making self-interested assessments is ignored (although not intentionally), instances in which differences in the mere presentation of information influence our decision processes. Further, under conditions of uncertainty, human decision making is strongly influenced by preconceived stereo-types, beliefs, and personal experiences into which we regularly try and place new and imperfect information. In short, the use of heuristics (rules of thumb) allows us to simplify a complex world, but the use of such heuristics can

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[287]Herbert Simon, " Human Nature in Politics: The Dialogue of Psychology with Political Science," *The American Political Science Review* 79 (June 1985): 295.

[288]Simon, "Altruism and Economics,"156-61; Simon, "Organizations and Markets,"25-44.

[289]Simon, "Theories of Decision-Making," 272.



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also lead to important errors of bias in the decision making process.[290] By themselves, the limitations of our cognitive processes suggested by psychology and cognitive science give us pause to reconsider the rationality postulate of the neoclassical model. These limits render human decision making "intendedly rational but only limitedly so."[291]

Institutions go a long way toward expanding those limits by providing additional rules of thumb by which we attempt to order the complex, and imperfect process of exchange. Such institutions help us make exchange decisions by transforming significant, although by no means all, amounts of uncertainty into much more manageable risk.[292]

## The Theory of the Firm

With some grasp of the importance of institutions in shaping our economic decision-making, we are still left with a primitive understanding of the role of the firm in all of this. If institutions are such wonderful things, why can we not all individually contract for most forms of exchange and production? In the frictionless, transactions cost-free world of the neoclassical model, such a situation might actually be possible. However, even the most efficient of institutions entail some transactions costs. Enter the role of the firm. Casual observation confirms that the overwhelming majority of us are

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[290]Tversky and Kahneman, "Judgement Under Uncertainty," 1124-1131; Tversky and Kahneman, "The Framing of Decisions and the Psychology of Choice," 453-458.

[291]Herbert Simon, *Models of Man: Social and Rational Mathematical Essays on Rational Human Behavior in a Social Setting*, ( New York: John Wiley and Sons, 1957), xxiv.

[292]We often talk about the management of risk in economics, but seldom speak of the mechanisms we use to mitigate and shift risk. Insurance (life, home, auto) is one of the most common mechanisms used to shift risk to other parties, but government regulation is a less obvious form of risk management that shifts the burden of risk from one group to another. See also *The Economist*, "Survey of Risk," January 24, 2004.



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employees, not principals and agents to individual contracts, not artisans producing and selling our products direct to market.[293] How is it that firms now account for such a significant portion of this activity? Unfortunately, neoclassical economic theory is of surprisingly little help. While the firm is obviously of central importance to our economic system, it is, as Harold Demsetz has argued, been given a kind of black box treatment in modern economic theory.[294]

Textbook treatments of the neoclassical firm typically begin with a description of the basic production function Q = F(K, L) where output (Q) is a straightforward function (F) of inputs of capital (K) and labor (L). More complicated production functions incorporate a range of other important inputs such as technology, energy, or even elusive entrpreneurial factors such that production functions look more like Q = F($x_1, x_2, x_3 \ldots$). All of this is then fed into a simple maximization calculation

$$\max \pi = p^o q - \sum_{i=1}^{n} r_i^0 x_i$$

where profit ($\pi$) is the difference between the total revenue from the sale of output ($q$) at the market price ($p^o$) and the total expenditure on all inputs ($x_i$) whose prices are $r_1^0, r_2^0, \ldots r_n^0$. The entrepreneur simply tries to maximize $\pi$ subject to the essentially

[293]Simon, "Organizations and Markets," 27; Simon, "Rational Decision Making," 502.
[294]Harold Demsetz, "The Firm in Economic Theory: A Quiet Revolution," *The American Economic Review* 87 (2) (May 1997): 426-29.



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technical conditions of the production function.

Thereafter, the basis of textbook discussions flows from this basic formula as manipulations of the production function. Fixed and variable costs, concepts like diminishing marginal returns, marginal and average product curves, long run production curves and their isoquant maps, marginal rates of technical substitution, and economies of scale are all typically considered, but only as extensions of the basic production function. Where is the firm? What is the firm? Someone or some entity is ordering the inputs, coordinating labor, employing capital, and using some ingenuity in the production process. That entity is the firm (or those within it), but it is given little explicit consideration within the neoclassical model and just assumed to exist. Some attention is paid to organization as a possible factor within the production function, but an explicit analysis of how firm structures affect economic performance of the firm is left out of the model.

Further, the market conditions in which production functions operate are carefully circumscribed by the standard neoclassical model. First and foremost are assumptions regarding rational choice and profit maximization as the central objective of a competitive firm. Then there are the assumptions about competitive market conditions that allow economists to predict how much output to expect from, say perfectly competitive, firms. The first of these is that firms sell a standardized product that is assumed to be a perfect substitute for products sold by other firms (in other words, no product differentiation). Second, firms are price takers, or have no ability to manipulate market prices regardless of how much it produces. Third, factors of production are



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perfectly mobile in the long run. And lastly, that firms and consumers are each in possession of perfect information.[295]

No matter where we look in the neoclassical model, there are important assumptions made which simplify the model and allow it to reach the strong conclusions it does about efficiency, growth, and productivity. Admittedly, the model makes no claim to reflecting all aspects of economic activity, rather its intent is to provide a simplified picture of the economic world around us.[296] Nevertheless, as we consider each of the model's assumptions, our experience suggests the world in which we live is actually more complex. Part of that complexity includes the role of the firm as an organization, operating within an economic environment characterized less by the conditions of perfect competition and more by uncertainty, high transactions costs, and opportunistic behavior, a kind of limited autarky. We are trained to think about the operation of markets under the neoclassical model without explicitly considering the role of firms, except as the technical abstraction of a production function. But the central problem for the neoclassical model is that in a world of uncertainty, positive transactions costs, and opportunism, the straightforward calculation of profit maximization becomes much more problematic. Institutions and firms are not the same, but their relationship is key to extending the neoclassical model, and our understanding of our economic system, beyond

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[295]See Robert H. Frank, *Microeconomics and Behavior*, (New York: McGraw Hill, 2000), 347-353; See also Demsetz, "The Firm in Economic Theory," 426-29.

[296]For instance, one intermediate level text book offers chapters on the "Economics of Information and Choice Under Uncertainty," the role of "Altruism and Non-Egoistic Behavior," and "Cognitive Limitations and Consumer Behavior." However, each of these are presented outside the basic model, are largely descriptive rather than integrative, and are presented with the disclaimer that they are "(Supplementary)"chapters.



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the assumptions noted above.[297] On the surface, markets, as shaped by institutions, reveal exchange opportunities while firms actually produce. The two are also essentially different forms of governance over scarce resources.[298]

### Institutions vs. Organizations

Within the market for exchange there are institutions that act like road maps, structuring and guiding economic activity through the market's various rules and norms, but the fact that most of us work for firms suggests organizations represent another set of players in the market for exchange. Although, as Demsetz argues, we cannot talk about firms apart from markets nor vice versa, there is a bright line of distinction between the two that is critical in terms of the interaction between them.[299] No one has made this distinction clearer than Ronald Coase.

Coase asserted that one of the main reasons for the rise of firms is that there are transactions costs to using the price system, among them price discovery costs or the negotiation costs associated with concluding separate contracts for each exchange transaction.[300] The firm, by organizing around the price system and a set of property rights, effectively circumvents and supercedes elements of those institutions by organizing large parts of the process of contracting, production, and exchange within the

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[297]Demsetz, "The Firm in Economic Theory," 426.
[298]Williamson, "The Modern Corporation,"1541.
[299]Demzetz, "The Firm in Economic Theory," 426.
[300]Coase, "The Nature of the Firm," 390-91.



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firm itself, thereby generating significant transactions cost savings. Included in these savings are the costs of enforcement and monitoring against opportunistic behavior in market-based contractual relations, as well as the considerable costs associated with uncertainty when exchange takes place within, rather than outside the firm.[301]

Incentives to Integration

According to Coase, the "firm becomes larger as additional transactions (which could be exchange transactions co-ordinated through the price mechanism) are organised by the entrepreneur and becomes smaller as he abandons the organisation of such transactions."[302] In other words, the firm organizes as a means of mitigating the uncertainty and considerable transactions costs associated with market exchange up to the point of diminishing returns to additional vertical integration of the firm; the firm is essentially a nexus of numerous contractual relationships organized internally rather than externally through the market. Rather than using the impersonal direction of exchange as coordinated through the signaling of the price system, firms internalize some of this activity by directing the coordination of resources within the firm. In some sense, the rise and pervasiveness of firms has created a marketplace characterized more by exchange between firms rather than individuals.[303] Why then do we not have a single monopoly

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[301]Coase, "The Nature of the Firm," 389-92. It is worth noting the Williamson has argued that the internalization of transactions costs within firms has a dramatic effect on the specification of property rights within the firm itself which in turn affects the economic performance of the firm by possibly generating new internal transactions costs. In short, the internal operation of the firm ceases to remain constant, thereby changing the incentive structure within the firm, and of the merits of internalizing transactions costs. See Williamson, *The Economic Institutions of Capitalism*, 131-135.

[302]Coase, "The Nature of the Firm," 393.

[303]Simon, "Organizations and Markets," 28.



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firm which has internalized all possible transactions costs and produces everything? Why not organize all transactions through the firm rather than the market? Coase's response is that firm size is limited by the decreasing returns to the "entrpreneurial function," or the rising cost of organizing an additional transaction within the firm structure. "Naturally," Coase argues, "a point must be reached where the costs of organising an extra transaction within the firm are equal to the costs involved in carrying out the transaction in the open market."[304] As more and more transactions are organized within the firm's structure, those costs may rise relative to those obtainable through the price system, particularly if, as is so often the case, a firm fails to efficiently coordinate resources under its control. Williamson has added another important observation regarding the growth of firms. As exchange relations become more specialized, the importance of the exchange relationship to both buyer and seller becomes more important. In the exchange of highly fungible goods, such as gasoline, the presence of many potential sources of gasoline for drivers make exchange relations between drivers and petrol vendors relatively uncomplicated. However, other kinds of exchange relations are not so straight forward and involve highly specialized parts, say in the production of a fighter jet, that are said to be highly "asset specific."[305] In other words, they are specialized to that particular exchange relationship.

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[304]Coase, "The Nature of the Firm," 394-95; It is important to note that many scholars have been interested in other factors related to the nature of the firm and its growth. Herbert Simon, for example, has focused on the role of motivation, authority, incentives, loyalty, and organizational identification (as in values or other intangibles) as factors in both firm size and longevity. Many of these might be classified as some of the informal institutions much like customs, taboos, or tastes that also tend to shape economic activity. See Simon, "Organizations and Markets," 25-44: Simon, "Altruism and Economics," 156-161; North, *Institutions, Institutional Change, and Economic Performance*, 84-88.

[305]See other examples offered by Macneil, "The Many Futures of Contracts," 720-21; Hart and Moore, "Property Rights and the Nature of the Firm,"1122-1125.



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Williamson argues that asset specificity is an important incentive for firm integration. The more specific the attributes of exchange are to a buyer and seller, the greater the incentives to bring those exchange relationships entirely within a single firm.[306]

Oliver Williamson has also argued that the economizing dynamic of the firm and vertical integration has been obscured by the anti-trust zeal with which regulators and the public at large have viewed the rise of the multinational corporation. While nefarious or predatory intent on the part of firms can never be assumed away, Williamson argues that a transactions cost approach to the study of a firm's organizational structures provides a more nuanced view of firm activities than one imbued with ill-intent as is so often the case.[307] In fact, a transactions cost approach to the study of the firm yields insights into how firm organization affects its economic performance. In particular, the rise of the American multinational corporation in the twentieth century has largely been the product of organizational changes to corporate governance structures (institutions within the firm itself) that separated firm management and strategy from operational production details.[308] This shift from a largely unitary, integrated firm to one with numerous semi-autonomous divisions under the umbrella of a single firm paved the way for the reduction of transactions costs and uncertainty within a firm's structure even as the production capabilities of a growing firm became ever more diverse.[309] Other institutional

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[306]Williamson, "The Modern Corporation," 1546-1547; Williamson, *The Economic Institutions of Capitalism*, 52-56.

[307]Williamson, "The Modern Corporation," 1539-1540, 1542, 1564.

[308]Bolton and Scharfstein, "Corporate Finance, the Theory of the Firm, and Organizations," 95-114; Holmstrom and Roberts, "The Boundaries of the Firm Revisited," 73-94; Williamson, "The Modern Corporation," 1537-1568.

[309]Williamson, "The Modern Corporation," 1555-1560; See also, Williamson, *The Economic Institutions of Capitalism*, 273-297.



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innovations within the firm, such as the separation of ownership from management and the creation of foreign subsidiaries have paved the way for both increased foreign direct investment, the technology transfer that comes from it, and the broad management of increasingly diverse, and far flung corporate operations.[310]

Harold Demsetz recently offered an important revision of Coase's firm growth theory in which he argued that rising market transactions costs will induce vertical integration of the firm, but that it could also lead to a reduction in specialization in production– a pillar of the neoclassical model– as the firm manages the production of more of what is uses (horizontal integration). According to Demzetz, as market transactions costs rise, the implication for firm growth through vertical integration under Coase is a reduction in the number of market-based exchange transactions; in other words, a reduction in neoclassical specialization within the economy, leading logically to self-sufficiency, or a form of autarky, the antithesis of the neoclassical model.[311]

The main point here is that the simplifications made to the Theory of the Firm by the neoclassical model overlook numerous complexities that shape how the operation of the firm within our economic system. Coase's emphasis on transactions cost economizing as the basis for the firm is important, and remains suggestive of how firm performance ebbs and flows. However, there are a range of other factors ranging from ownership structures, asset specificity, even altruism on the part of employees that suggest the firm

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[310]Williamson, "The Modern Corporation," 1556, 1560-1563; Bolton and Scharfstein, "Corporate Finance, the Theory of the Firm, and Organizations," 95-114; Hart and Moore, "Property Rights and the Nature of the Firm," 1119-1158; Holmstrom and Roberts, "The Boundaries of the Firm Revisited," 73-94.

[311]Demsetz, "The Firm in Economic Theory," 427.



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is more than a consequence of its production curve.[312] Yet with Coase firmly in mind, we generate an intuitive sense for how and why firms elect to incur transactions costs within the market or attempt to internalize them within the firm. As economic conditions change, so too will the merits of internalizing the costs of exchange transactions within a firm. These insights are suggestive of the incentive structures behind contemporary merger and acquisition, downsizing, or outsourcing and lead us, finally, to the important distinction between institutions and organizations.[313] Firms are essentially organizations designed to capture rents from the incentive structures provided by the institutions that structure the operation of the market place. We have already argued that the mere presence of institutions reduces the impact of, but does not eliminate, issues such as market uncertainty, imperfect information, or opportunism. Rather, institutions merely eliminate some of that uncertainty in much the same way a road map provides directions but does little to guarantee numerous other aspects of the journey.

Firms as Rational Profit-Maximizers?

Recall the weaknesses of the neoclassical model's rationality assumptions. In the context of uncertainty, human beings are at best boundedly rational in their decision

[312]Holmstrom and Roberts, "The Boundaries of the Firm Revisited," 73-94; Simon, "Altruism and Economics," 156-161.

[313]Williamson, "The Modern Corporation," 1557, details the effects of changes to corporate governance structures in the 1960s which led General Motors to "spin off" the Ethyl Corporation from its central operations, but retain a stake in the firm. Similarly, one of the key issues in contemporary labor relations with the Big Three auto makers in the United States is the outsourcing of parts manufacture to lower-cost input producers rather than production within the firm itself. In effect, this is a shift in governance structure in which transactions costs within the firm have allegedly become higher than those which can be obtained through market exchange.



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making processes. Many of the same kinds of rationality problems exist in assessing the motivations behind the decisions of firms. As with assessments of individual motivations, models of decision making in economics, as well as political science, too simplistically attribute motives to profit maximization or vague concepts of power.[314] Because the economic environment of the firm is complicated and dynamic, we might question the assumption of maximizing behavior on the part of the firm, even if such assumptions allow our standard economic models to reach compelling conclusions. In fact, with uncertainty, particular actions may have a range of outcomes, most of which cannot be determined with complete certainty. As such, there are no criteria upon which to arrive at a decision that will maximize profits.[315] Rather, uncertainty forces decision makers into boundedly rational decision making in which actions are selected on the basis of preferable, rather than purely maximizing, outcomes.[316] In other words, a kind of satisficing, rather than maximizing, behavior emerges within firms.[317] The particular organizational form through which a firm's decision-making process takes place, which in effect sets the distribution of property rights within a firm, then becomes highly significant for the performance of the firm.[318]

At any moment of time, the existing property-rights arrangements establish the

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[314]Simon, "Human Nature in Politics," 296. Williamson, "The Modern Corporation," 1539.

[315]Alchian, "Uncertainty, Evolution, and Economic Theory," 212.

[316]Alchian, "Uncertainty, Evolution, and Economic Theory," 212; See also Simon, "Rational Choice and the Structure of the Environment," 129-138; Baron, *Thinking and Deciding*, 55-56.

[317]Simon, "Theories of Decision-Making," 262-65.

[318]Hart and Moore, "Property Rights and the Nature of the Firm," 1122-1125. Hart and Moore use the example of a luxury yacht and the kitchen within it in the provision meals to those who charter the boat. Depending on whether the skipper of the boat or the chef in the kitchen is the owner of the yacht makes an enormous difference to the incentives facing each party in the provision of services as well as bargaining power in the distribution of rent from the yacht.



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> identities of those individuals who are in effective control of the organization and indicate the standpoint from which policies of the organization will be framed. The property-rights arrangements extant affect not only transactions costs and productive efficiency but also the distribution of income and power among the different factor owners associated in the coalition. Thus, any (voluntary) changes in the rights structure over time will tend to be made in such a way as to improve the welfare of those in control of policy.[319]

Perhaps the best way to characterize the difference between institutions and organizations is to use the analogy of a football game. The rules of the game structure the play by providing guidelines by which both teams compete, much the same as institutions tend to structure and guide economic activity for individuals and firms. The rules do not spell out for us the precise strategies we might employ or the way in which we approach the game, but do set guidelines and limits which condition the boundaries of the game. The rules often contain prohibitions on certain kinds of competition on the field, but at the same time provide a set of incentive structures around which teams may employ various strategies for winning the game. Likewise, firms organize themselves around the set of institutional structures that both set limits and suggest incentives for business strategies that may lay the foundation for the realization of positive profits. Depending on the particular attributes of the competition, a football team may employ slightly different strategies for winning as the competitive conditions mix with the rules of the game to provide incentives, which if properly acted upon, could lead to victory. Firms, seeking positive profits, try and do the same thing, restructuring their activities as economic conditions change within a given institutional setting. From year to year, the rules of the

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[319]Furubotn and Richter, *Institutions and Economic Theory*, 331.



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football game may change, inducing teams to acquire a different mixture of players or strategies for winning. Again, similarly, changing institutional settings will induce organizational changes within the firm. Finally, there is no necessary reason why widely differing organizational structures cannot flourish in the same institutional environment.[320] If the football team's organizational adjustments to changing rules match those needed in the competitive environment set out by new rules, the team will be successful. In the case of the firm, adaptation to the incentives or disincentives structured by institutional change will largely determine the entry or exit of firms from the marketplace.

Recall that under the rarefied neoclassical conditions of perfect information, the instantaneous flow of information about prices would permit supply and demand to instantly arrive at a market clearing price and quantity, thereby eliminating the need for a strategy for capturing rent. Uncertainty would be eliminated and the specific form of organization taken by a firm would be unimportant to firm performance.[321] In a similar way, with perfect information, there would be no need for strategy, no game plan to win the game, and perhaps no winner from the contest on the field. Why? Uncertainty is both a prerequisite for the positive profits of firms, and the reason different organizational

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[320]For example, in 16th Century British North America, the London-based Hudson's Bay Company ran its fur trading operations as a fully integrated company, complete with incentives such as efficiency wages to overcome some of the agency problems associated with long distance operations. By contrast, the Montreal-based Northwest Company, also in the fir trading business, organized itself as a limited partnership, complete with that organizational structure's incentives for productivity and profit sharing. See Carlos and Nicholas, "Agency Problems in Early Chartered Companies," 853-76; see also Williamson, "The Modern Corporation," 1555-1556; and Holmstrom and Roberts, "The Boundaries of the Firm Revisited," 73-94.

[321]Coase, "The Nature of the Firm," 392.



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structures matter for economic performance.[322]

### Entry, Exit, and Adjustment

We can find evidence of the rise and fall of firms nearly everywhere we look, much of which can be understood in terms of the standard determinants of supply and demand within the neoclassical model. Whether we agree that social science decision making models need greater subtlety to reflect important parts of the decision making process, most analysts would agree that changes in technology, tastes, input prices, demographic patterns, incomes, or expectations can have a dramatic impact on the production decisions of firms. In another critique of the rationality postulate about the activities of profit maximizing firms, Armen Alchian raised the possibility that successful firms are actually "adopted" by the market rather than being engaged in adaptive behavior as market conditions change.[323] Since under uncertainty no reliable criteria for selecting profit maximizing outcomes exists, Alchian speculated, in admittedly extremist terms, that perhaps the market itself performs a kind of selection process from among thousands of firms. Many of those that survive to realize positive profits have, in effect, randomly chosen (because the presence of uncertainty provides no basis for pursuing maximizing behavior) organizational structures well-suited to particular market conditions. Yet, how do we account for the observation that firms seem to be constantly trying to alter their organizational structures as economic conditions change in nearly every place we look.

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[322]Alchian, "Uncertainty, Evolution, and Economic Theory," 212-213.
[323]Alchian, "Uncertainty, Evolution, and Economic Theory," 211-221.



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Foresight and motivation on the part of firms under constantly changing market conditions undoubtedly play a key role in economic performance. However, Alchian suggests that observed adaptive behavior on the part of firms takes the form of copying the perceived successes of existing firms rather than through purposeful self-evaluation and adaptation. Innovation comes not from the identification of market niches, but rather as a byproduct of firm efforts to copy those that have already been successful.[324] All of this further emphasizes the difficulties confronting firms stemming from uncertainty in a changing market place.

The Chicken or the Egg?

While Alchian's argument was originally made more than a half-century ago, development economists continue to struggle with understanding of the market conditions that foster the rise and fall of the firm. One of the most interesting research threads to emerge in recent years has been work on economic clusters, most prominently associated with Harvard University's Michael Porter. Porter's work has highlighted the importance of a range of factors related to a firm's location, including competitive inputs, the proximity of support industries, and the context for firm strategy, that have been demonstrated to have a key impact on both firm and sectoral economic performance.[325] What is interesting about this recent work is that while government is seen as a key pillar in setting the context in which a firm operates, the ability of government to set tax and

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[324]Alchian, "Uncertainty, Evolution, and Economic Theory," 217-20.

[325]Michael E. Porter, "The Adam Smith Address: Location, Cluster, and the 'New' Microeconomics of Competition," *Business Economics* 33 (January 1998): 7-13.



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regulatory policies which then lend themselves to the development of successful industrial clusters has been either uneven or simply unsuccessful.[326] The point is that whether firms are "adopted" by the market, engage in copy-cat behavior, or consciously adapt to changing market conditions, the performance of firms is more complicated and nuanced than our basic microeconomic models at first suggest. Furthermore, the institutional environment, in the form of rules, regulations, business practices, or trade agreements like the NAFTA, interact with the organizational structures of firms and affect their performance.

However, we are again confronted with the central question of which comes first, organizations or institutions? We have suggested through the example of the family farmer that exchange is difficult in the absence of institutions to help us structure and simplify the choice sets we confront. At the same time, the mere presence of institutions to add further structure and predictability to an otherwise uncertain world provides no guarantees that exchange will take place, whether between firms or between individuals. In fact, we have ample evidence of the existence of institutions that, while structuring economic activity, unfortunately discourage it at the same time.[327] While institutions seem a necessary requirement for the rise of the firm, once established, firms also have an influence on the development of institutions.

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[326]Michael E. Porter, *The Competitive Advantage of Nations*, (New York: The Free Press, 1990), 4.

[327]See in particular de Soto, *The Mystery of Capital.* See also Dennen, "Cattlemen's Associations and Property Rights in Land in the American West," 423-36; Kantor, "Razorbacks, Ticky Cows and the Closing of the Georgia Open Range," 861-886; Umbeck, "The California Gold Rush," 197-226; Ommer, "All the Fish of the Post,"107-123; R. Quentin Grafton, Dan Squires, and Kevin J. Fox, "Private Property and Economic Efficiency: A Study of Common Pool Resource," *Journal of Law and Economics* 43 (October 2000): 679-713.



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For example, while firms organize around a range of institutions including property rights, the price system, and a whole range of other formal legal rules, they have frequently contributed to the establishment of industry standards.[328] Many of these standards become a kind of institution around which firms tend to structure their production. Take for example the evolution of the compact disc (CD) and the digital video disc (DVD). As technological advances allowed the development of the compact disc for storing music, video, and data, firms who for the past twenty years had made vinyl records, cassette tapes, video cassettes, or floppy disks have adapted their production as consumer and industrial demand for one kind of product rose while demand for older technologies faded.[329] Those who did not adapt to new competitive conditions were forced from the market place while those same market conditions also provided a new incentive structure for the entry of firms employing the newest techniques. This process is very much like the "creative destruction" of the marketplace first detailed by Joseph Schumpeter more than a half-century ago.[330] As organizational structures built

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[328]See David, "Clio and the Economics of QWERTY," 332-337. Consider also the competition between different gauge railway lines and why some, less common, gauge railways persist.

[329]Note the current controversy over technological changes that have made peer-to-peer file swapping software allowing individual computers to share copyrighted material, especially music. The legal institutions governing copyright and patent protection appear to be struggling to cope with technological changes that allow electronic file swapping. With changing technology, the incentive structure under current institutions has changed and may lead either to legal changes (formal institutions) or stimulate additional technological changes to secure intellectual property in electronic media. The Recording Industry Association of America alleges this technology has resulted in a 25 percent decline in CD sales since 1999 and significantly changed market conditions. See, *New York Times*, "New Parent-to-Child Chat: Do You Download Music?," September 10, 2003; *The Economist*, "Tipping Hollywood the Black Spot," August 30, 2003.

[330]See Joseph A. Schumpeter, *The Theory of Economic Development: An Inquiry into Profits, Capital, Interest, and the Business Cycle*, (Cambridge: Harvard University Press, 1934); Joseph A. Schumpeter, "The Creative Response in Economic History," *The Journal of Economic History* 7 (November 1947): 149-59.



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around institutions adapt to, or struggle with, the changing incentives for economic activity, the failure of one firm often generates incentives for others to enter the market. Likewise, the entry of new firms can generate strong competitive pressures that force existing firms from the market. The institutions of the NAFTA induced this kind of creative destruction within the market place as firms adapted to the relaxation of tariffs and other trade barriers that generated new market access opportunities for firms.

## The Link with the NAFTA

Some of the restructuring of economic activity is detailed in the changing patterns of trade within North America outlined above. However, other, more subtle, elements of firm-level changes in response to institutional change can be better understood by actually examining institutions that shape firm choice sets. It is important to emphasize again that institutions are by no means the only determinants of economic performance. An analysis of economic activity necessarily makes use of the analytical tools of the neoclassical model, but can be augmented through careful examination of institutions as well. Analysts of trade policy, whether supportive of or opposed to trade liberalization, are fond of attributing a broad range of phenomena, economic and non-economic, directly to the NAFTA. Before we can definitively suggest that the NAFTA has done one thing or another, we need a closer look at how the specific institutions of the NAFTA actually shaped firm-level decision making. What follows is an account of two different economic sectors covered by the NAFTA, Financial Services and Autos, and the starkly different impact the NAFTA's institutions covering each sector had at the level of the firm. What



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emerges is that in Financial Services, the NAFTA's firm-level impact was minimal, while in Autos institutional changes were much more pivotal.

Financial Services

The past half-century of development in global financial services, including banking, has largely mirrored the growth in international commerce. The gradual liberalization of the world's economic systems, in part facilitated by the changing rules of the GATT/WTO-based trading system, has stimulated significant growth in international trade and financial flows. Where business activity has increased, and especially where cross-border activity has grown, the financial institutions of host and home countries have not been far behind in providing investment finance, basic banking services, and deeper integration of national, regional, and global financial institutions (organizations)[331] and regulations. Like their global competitors, North American financial organizations were affected by, and drove, changes in the financial services sector. Each of the NAFTA economies' banking sectors comes from different historical and regulatory traditions, none of which were immune from broader global trends affecting financial services. The respective banking sectors, and the firms within them, were shaped by, and have made changes to their organizational and strategic operations.

However, as we will see here, when the NAFTA was concluded, the provisions of

[331]Because the common usage of institutions to describe financial firms would generate confusion with the definition of institutions developed in this study, hereafter I will refer to financial institutions as "financial services providers" of "financial organizations" so as to maintain the distinction between institutions and organizations as I have defined them.



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the Agreement dealing with financial services did little to significantly alter the institutional matrix structuring economic activity in the North American banking sector, in so far as they induced financial services firms to dramatically restructure their operations. Instead, the minor institutional changes made by the NAFTA became part of a larger set of regulatory rules (institutions) that govern the banking sectors of each country and their operations in other NAFTA countries, and to which firms have responded with strategic and organizational changes.

*The North American Banking Sector*

The North American banking sector is a somewhat complicated patchwork of activity that has been structured by labyrinth regulatory burdens and controls. In each of the NAFTA countries, these regulatory measures are largely the product of historical experience with rapid swings in economic activity that have periodically put pressure on the solvency each nation's financial services sector, and by extension, the solvency of each nation's economy. In 1994, the first year of implementation of the NAFTA, Mexico's eighteen major financial institutions were, unlike those in Canada and the United States, largely free of any restrictions on branching within Mexico. Also, unlike its NAFTA partners, Mexico had no sub-federal regulatory agencies which imposed local regulatory obligations. In spite of the lack of restrictions on branching throughout Mexico, the country is largely "underbanked" in that many of Mexico's financial organizations are concentrated in larger urban areas, especially Mexico City. In addition, whereas U.S. bank asset ownership as of 1992 was widely held, the shares of overall bank



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assets held by Mexico's and Canada's three largest banks was highly concentrated at 58 percent and 61 percent respectively. By contrast, the three largest banks in the United States held only 12 percent of total bank assets.[332] Beginning in the 1970s, Mexico's banking system underwent a series of important structural changes, including the nationalization of the whole sector in 1982 in partial response to the debt crisis. However, in 1989, the nationalization of Mexico's banking sector was reversed, and a series of reforms in 1991 abolished exchange controls, privatized and deregulated significant portions of the financial markets, and established new regulations for reserve requirements that went beyond those mandated under the Basle Accords.[333]

The Canadian financial services sector is dominated by a small number of major, Schedule A, banks which control nearly 90 percent of all Canadian bank assets. A sizable number of other financial services providers, all of them comparatively smaller in size, operate in Canada as so-called Schedule B banks and now include a range of foreign service providers. Canada maintains three levels of regulatory power over financial institutions, but financial regulation is dominated by the federal government's control over the Schedule A banks. Securities and investment service organizations are separately regulated by each of the ten provinces, and trust and insurance services are supervised by the particular layer of government granting the firm's operating charter. In response to the many technological changes driving consolidation in the industry globally, Canada began

[332]Harry M. Makler, "Regional Integration and Trends in Financial Services," in Jerry Haar and Krishnan Dandapani eds. *Banking in North America: NAFTA and Beyond* (New York: Pergamon, 1999), 13-14.

[333]Makler, "Regional Integration," 15.



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to substantially liberalize its banking sector with the passing of the Bank Act in 1980.[334] Most importantly, the Bank Act began the process of eliminating many of the "firewalls" between chartered banks, securities, trusts, and insurance companies that were thought to be at the root of Depression era financial volatility. Henceforth, financial service providers were allowed to offer a range of services that crossed these boundaries.[335] In addition, the Bank Act provided that federal regulation would take place under more unified federal authority.[336] In 1987, the Banks and Securities Act allowed Canadian financial services firms even more flexibility to offer a range of investment banking services, a flexibility still denied at the time to U.S. banks by the Glass-Steagall Act.[337]

Between 1967 and 1980, the Canadian government's regulatory preference was for widely held ownership structures that would ensure the healthy separation of banking from non-banking activities. In particular, individual ownership stakes in Canadian financial institutions were limited to 10 percent and non-resident investors were prohibited from collectively holding more than a 25 percent stake in any institution-- the so-called "10/25" rule. [338] The ownership provisions of the 1967 Bank Act prohibited foreign firms from effectively entering and competing in the Canadian market. The 1980 Bank Act changed this by allowing the entry of foreign banks to operate subsidiaries

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[334]James L. Darroch, "Canadian Banking Strategy in North America," in Jerry Haar and Krishnan Dandapani eds. *Banking in North America: NAFTA and Beyond* (New York: Pergamon, 1999), 85-86; Clarkson, *Uncle Sam and Us*, 154-55.

[335]Clarkson, *Uncle Sam and Us*, 154-55.

[336]Makler, "Regional Integration," 16.

[337]Stephen Lande, Manuel Mindreau, and Michael Lande, "NAFTA and Finanical Services: Implications for Banks," in Jerry Haar and Krishnan Dandapani eds. *Banking in North America: NAFTA and Beyond* (New York: Pergamon, 1999), 33; Darroch, "Canadian Banking Strategy in North America," 86, 88-89; Clarkson, *Uncle Sam and Us*, 154-55.

[338]Darroch, "Canadian Banking Strategy in North America," 85.



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under a special class of banks known as Schedule B banks that permitted more highly concentrated ownership structures than allowed under Schedule A, albeit with important caps on how much of the Canadian bank asset market they could control.[339] Most importantly, domestic regulatory changes (institutional change) had the effect of stimulating significant merger and acquisition activity within the domestic market allowing banks to become larger, more diverse providers of financial services domestically, while also allowing them to gain additional financial power internationally.[340]

In 1989, Canada-U.S. Free Trade Agreement (CUFTA) opened the Canadian banking sector even further by allowing American financial subsidiaries to operate like Canadian chartered banks throughout the country. By 1992, all foreign owned subsidiaries were licenced to operate throughout the country, although some provinces still maintain limited ownership restrictions on provincially chartered financial services providers.[341] U.S. firms and investors would be exempt from aspects of the federal "10/25" rule (Article 1703.1), rules capping foreign penetration of the Canadian banking sector at 16 percent (Article 1703.2), and would be allowed to open branches without

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[339]Barbara Libby, "The Impact of the North American Free Trade Agreement on Commercial Banking," *Journal of Economic Issues* 28 (2) (June 1994): 503; Darroch, "Canadian Banking Strategy in North America," 85-86; Lande et. al. "NAFTA and Financial Services," 34.

[340]Darroch, "Canadian Banking Strategy in North America," 90-91.

[341]See *Canada-U.S. Free Trade Agreement*, Article 1703.1 which exempted U.S.-based financial services providers from aspects of Canada's "10/25" rule and would treat non-residents the same as Canadian residents. The rule prevents any single non-resident from acquiring more than 10 percent of the shares, and all non-residents from acquiring 25 percent of the shares of a federally regulated, Canadian-controlled financial services provider; Makler, "Regional Integration," 17; Lande, et. al. "NAFTA and Financial Services," 34.



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having to apply to the Minister of Finance for approval.[342] However, while the Free Trade Agreement opened the Canadian market for U.S. financial services firms, it essentially confirmed the status quo for Canadian financial services providers operating in the United States. However, more than U.S. firms in the Canadian market, it has been Canadian firms in the U.S. that have been far more active. While the provisions of the CUFTA liberalized the Canadian market more than the U.S., it was Canadian banks that have, over the years, made the strongest moves into the U.S. market.[343] Yet, while the CUFTA formalized the existing financial services relationship between the two countries, the only real principle embodied by the Agreement was that of *de jure* national treatment, although there is no specific clause explicitly dealing with national treatment.[344] For instance, among the most important U.S. commitments in Chapter 17 of the CUFTA was a promise to accord Canadian firms treatment equal to that given domestic firms in the event of future changes to the 1933 Glass-Steagall Act which separated commercial from investment banking.[345] But, the CUFTA failed on several fronts to tackle important regulatory barriers to financial services in either country and did not provide a framework for encouraging future liberalizations; in essence it was a one shot deal.[346]

When compared with the banking systems of its NAFTA partners, the U.S. banking system looks like a diffuse, sometimes confused, structure of regulation that has,

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[342]*Canada-U.S. Free Trade Agreement*, Article 1703.2; Lande, et. al. "NAFTA and Financial Services," 34.

[343]Lande, et. al. "NAFTA and Financial Services," 35; Libby, "The Impact of the NAFTA," 505.

[344]Libby, "The Impact of the NAFTA," 504.

[345]The provisions of Glass-Steagall were repealed by in January 1999 by Section 101 of the Gramm-Leach-Bliley Act (PL 106-102).

[346]Lande, et. al. "NAFTA and Financial Services," 35-37.



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over time, placed severe limitations on the kinds of services banks may offer and where they can offer them.[347] In 1992, there were more than 27,000 commercial banks in the United States, giving the U.S. more per capita sources of banking services than any other country.[348] The structure of the American banking system owes much to its regulatory history, significant parts of which have come in the wake of financial crises like the stock market crash of 1929 or the savings and loan debacle of the 1980s and early 1990s in which more than 4,600 federally insured financial services providers failed.[349] Although the savings and loan debacle resulted in a flurry of new regulatory legislation, some of the most important regulatory rules in the American banking sector emerged in the years surrounding the onset of the Great Depression. Two pieces of legislation have proven particularly important, the 1927 McFadden Act which established state sovereignty on banking activities and prohibited interstate branching (hence the 27,000 commercial banks), and the 1933 Glass-Steagall Act separating commercial from investment banking. By themselves, these two pieces of legislation mark significant differences in the institutional structure governing banking in the United States compared with that in its NAFTA partners. In addition, the U.S. financial system has at least four separate regulatory authorities at the federal level, plus at least one within every state.[350] Compared with Canada and Mexico, the U.S. banking structure can only be considered

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[347]James R. Barth, Ray Chou, and John S. Jahera, Jr., "The U.S. Banking Industry in Transition," in Jerry Haar and Krishnan Dandapani eds. *Banking in North America: NAFTA and Beyond* (New York: Pergamon, 1999), 68-73.

[348]Makler, "Regional Integration," 17.

[349] On the later episode, see Barth et. al. "The U.S. Banking Industry in Transition," 54-56.

[350]Makler, "Regional Integration," 19. For instance, the Federal Reserve, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Office of Thrift Supervision.



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fragmented.[351] The International Banking Act of 1978 brought federal supervision to foreign-owned bank affiliates, but essentially confirmed that foreign-owned banks would be accorded the same privileges as domestic financial institutions.[352] There is diversity among state regulations governing ownership, taxation, and jurisdiction. Savings and loans can be owned by non-banks, but not by banks. Credit unions are often tax-exempt. In some states, banks are permitted greater leeway to offer kinds of financial services, such as securities and insurance, that federally authorized banks are not. Only in 1975 did states begin to relax restrictions on interstate banking, yet those that remain have prevented a truly nation-wide banking structure to emerge.[353] Under the terms of the CUFTA, there was no explicit agreement to further liberalize interstate banking to allow Canadian firms additional access. Instead, the United States simply reaffirmed its commitment to national treatment in the application of new federal regulations to foreign controlled banks (CUFTA Article 1702.2). Canada ensured market access for its financial services providers, but only to a fragmented U.S. market which limited Canadian entry into localized markets which were in some ways ill-suited to the kind of integrated nation-wide structures to which Canadian firms were accustomed to.

*The NAFTA*

The NAFTA essentially built upon the limited achievements of the CUFTA by trilateralizing its provisions to include Mexico, but also went beyond the provisions of the

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[351]Libby, "The Impact of the NAFTA," 502.
[352]Libby, "The Impact of the NAFTA," 502, 503.
[353]Makler, "Regional Integration,"26; Lande, et al., "NAFTA and Finanical Services," 32-33.



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CUFTA in several important, but modest areas. For instance, Article 1403 guaranteed that future changes to U.S. Glass-Steagall and McFadden restrictions would apply to Mexican as well as Canadian firms and Article 1405 explicitly introduced the concept of national treatment in financial services. In addition, Article 1406 established that each of the Parties would apply most favored nation treatment and accord NAFTA Party financial services providers treatment no less favorable to that accorded firms from any other country with respect to establishment, acquisition, expansion, management, conduct, or operation within its territory. The NAFTA also made headway, where the CUFTA did not, in having the provisions of the Agreement apply to sub-federal regulatory authorities in states and provinces (Article 1403, 1405.4), although Article 1409 effectively grand fathered existing non-conforming measures at the state and provincial levels. The NAFTA also included both consultative and dispute settlement mechanisms (Article 1412, 1413, 1414, 1415), although the provisions of Chapter 14 have yet to be invoked, whereas the CUFTA had no such mechanisms. Finally, the principle of transparency was specifically added to ensure the timely publication and notification of proposed regulatory changes and to allow interested firms the opportunity to comment and prepare for them (Article 1411). The NAFTA confirmed the right of Mexican banks (already granted under 1978 U.S. legislation covering the operation of foreign banks) to operate in the United States and extended the rights won by Canadian banks under the terms of the CUFTA to Mexico; namely the right to national treatment if McFadden and Glass-Steagall were ever



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amended.[354]

While the advances made in the NAFTA over the CUFTA were not unimportant, the more basic objective of making up for the shortcomings on substantive liberalization of barriers to financial services within the CUFTA went largely unfulfilled by the NAFTA.[355] As one might have expected, the NAFTA imposed the most changes on the newly re-privatized Mexican financial sector. Early on in the NAFTA negotiations, Mexico strenuously objected to the inclusion of financial services in the Agreement at all, never mind talks aimed at removing Mexican caps on foreign ownership-stakes.[356] However, in the end, Mexico agreed to allow Canadian and American investors 100 percent ownership in Mexican banks. However, under Article 1410, Mexico was permitted several reservations with regard to foreign investment in its financial sector, including a transition period of six years and the right to freeze U.S. and Canadian investment under certain conditions.[357] As important as the provisions of Chapter 14 were in the context of the negotiations, they have certainly not been instrumental in the integration of financial services into a single North American market.[358] In many ways, the financial services sector in North America remains a fragmented patchwork of regulations and regulatory bodies. The United States has repealed both the McFadden

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[354]The McFadden Act was effectively repealed in January 1994 by the Riegle-Neal Interstate Banking Act (PL 103-328) and the Glass Steagall Act was explicitly repealed in January 1999 by the Gramm-Leach-Bliley Act (PL 106-102).

[355]Lande et. al. "NAFTA and Financial Services," 37.

[356]See Cameron and Tomlin, *The Making of the NAFTA*, 98-99, 113-115.

[357]NAFTA Article 1410; Lande et. al. "NAFTA and Financial Services," 39; Darroch, "Canadian Banking Strategy in North America," 89.

[358]Clarkson, *Uncle Sam and Us*, 160; Lande et. al. "NAFTA and Financial Services," 37-41; Darroch, "Canadian Banking Strategy in North America," 90.



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Act (in 1994), prohibiting interstate branching, and the Glass-Steagall Act (in 1999), separating commercial from investment banking, but as Articles 1409 and 1410 make clear, each country retains the right to adopt and maintain virtually any prudential measure deemed necessary to protect investors, depositors, financial market participants, policyholders, or claimants. In addition, each NAFTA Party can impose all measures relating to the maintenance of the safety, soundness, integrity or financial responsibility of financial organizations or cross-border financial services providers, as well as all measures designed to preserve the integrity and stability of national financial systems; in effect a kind of blank check to regulate in the national interest.

### Looks Like NAFTA-driven Integration, But Is It?

Since the provisions of the NAFTA came into force in January 1994, the NAFTA has been cited as the cause of all sorts of economic change in North America, both good and bad. There is a virtual shopping list of changes that have come to the North American financial services sector in recent years, many of which, to the casual observer, could appear driven by the provisions of the NAFTA. Yet, to understand the changes to the competitive environment in North American financial services, one needs to look more closely at a range of non-NAFTA institutions that are even more important in explaining these changes. For instance, we have already mentioned the role of both the McFadden and Glass-Steagall Acts in structuring the American banking sector. With the advent of the NAFTA, some observers expected these limitations on American banks to limit the



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expansion of U.S.-owned subsidiaries into either the Canadian or Mexican markets.[359] In fact, because of the unified domestic regulatory structure in Canada and Mexico, the presence of few limitations on nation-wide branching or on the separation of commercial and investment banking services, Canadian banks, in particular, were seen as being best positioned to enter the somewhat similarly structured Mexican financial services market. At first blush, that seems to have been what happened. All of Canada's major chartered banks have had explicit North American strategies since at least the mid-1980s and have dramatically increased their financial stake in North America. Between 1983 and 1993, the Bank of Montreal raised the share of U.S. assets in its overall asset portfolio by 454 percent. Toronto Dominion raised theirs in the same period by more than 300 percent– all long before the NAFTA.[360] In 1992, Canada's Scotiabank purchased a 5 percent stake in Grupo Inverlat, then the fifth largest bank in Mexico allowing Scotiabank to expand its trade finance and corporate banking business in Mexico while also allowing it to participate in future growth in Mexican retail and small business banking sectors.[361]

Surely, the CUFTA, the NAFTA, or both must be responsible for some of this, right? Aren't these Agreements all about the seamless integration of financial services into a single North American market place? Aren't the Financial Services chapters of the CUFTA and NAFTA responsible? Were Canada's financial services providers simply thinking ahead by adopting North American strategies? What about the deepening integration of financial services in North America after the Agreements were in place?

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[359]Lande, et. al. "NAFTA and Financial Services," 41.
[360]Darroch, "Canadian Banking Strategy in North America," 85.
[361]Lande, et. al. "NAFTA and Financial Services," 41.



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This kind of activity must have taken off after the conclusion of negotiations, right? Take, for example, the recent history of the Bank of Montreal (BMO). In 1994, BMO became the first Canadian chartered bank to be listed on the New York Stock Exchange. In 1996, BMO acquired a 16 percent equity stake and 20 percent voting interest in Groupo Financiero Bancomer, parent company of Mexico's second largest bank. In its 1997 annual report, BMO proudly highlighted its North American strategy which included being able to offer a range of financial services through its subsidiaries in all three NAFTA countries. In 1990, the bank set a target for non-Canadian revenue as a share of total revenue of 50 percent by 2002. The bank achieved that mark in 1997 (of which United States and Mexico accounted for 41 and 6 percent respectively), and set a new target of 60 percent for non-Canadian revenue in the near future.[362] Yet, a slightly closer examination suggests that although firms like BMO and Scotiabank cite the deepening integration of the North American economy as part of their strategies and have acquired equity and partnerships in both the United States and Mexico, few of these are a direct result of the institutions of the Financial Services provisions of the NAFTA itself. For instance, BMO's acquisition of Chicago-based Harris Bank, one of the largest financial services firms in the U.S. mid-west and headquartered at the center of an eight-state region that accounts for nearly half of Canada's trade with the U.S., is clearly now part of BMO's North American strategy.[363] But it certainly wasn't part of BMO's response to the provisions of the NAFTA specifically since Harris Bank was acquired in back in 1984.

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[362]*Building Shareholder Value*, Bank of Montreal, 180th Annual Report, 1997, 2-3; Darroch, "Canadian Banking Strategy in North America," 92.

[363]Clarkson, *Uncle Sam and Us*, 166.



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None of this is to suggest that institutions and institutional change are having little impact on the financial services sector in North America. In fact, the opposite is true, but it was probably not the institutions of the NAFTA. Recall that the argument being advanced in this chapter is that institutions provide the incentive structures around which firms organize themselves (originally) and adapt their organizational structures to the changing institutional environment. Institutions have been critical to the evolution of financial services firms in North America, but few of the clues to changing firm behavior that institutions often suggest are found within the NAFTA. We have touched on some of the institutional changes that have affected firm behavior in financial services within each of the three domestic markets; among others, the Bank Act in Canada, the re-privatization of Mexico's banks in 1989,[364] and the lingering effects of the McFadden and Glass-Steagall Acts in the United States. In fact, an understanding of firm behavior and institutional change in the financial services sector would need to assess a broader set of exogenous factors that have, over the years, led to various forms of regulation (ie. institutions). For the United States, the Great Depression and its plethora of legal changes in response to financial collapse in the early 1930s need consideration. In Mexico, the impact of the 1994 Peso crisis along with the range of economic reforms that were instituted throughout the 1980s and 1990s and their impact on the operation of the Mexican financial sector are important considerations.[365] In recent years, four of Canada's

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[364]On this particular topic, see also Salinas, *Mexico*, chapters 15 and 16; Lande et. al. "NAFTA and Financial Services," 41-50; Ignacio Perrotini and Luis Miguel Galindo, "Internationalization of the Mexican Financial Market," in Jerry Haar and Krishnan Dandapani eds. *Banking in North America: NAFTA and Beyond*, (New York: Pergamon, 1999): 102-118.

[365]Perrotini and Galindo, "Internationalization of the Mexican Financial Market," 102-118.



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largest Schedule A chartered banks have clamored for federal approval to merge with one another, creating mega-banks that can compete with the world's largest financial firms.[366] Although Canada's federal government put a stop to the mega-mergers in Canada, all five of Canada's major banks argued at the time that the domestic and international competitive environments, which included a wide range of institutional structures, was generating incentive structures that made it essential for Canada's financial institutions to generate greater economies of scale to remain competitive. Recalling Coase and the Theory of the Firm, Canada's banks were trying to internalize within larger firms many of the transactions costs incurred by smaller institutions, among them those associated with expensive technological change.

In fact, many of the most important forces affecting change in the financial services sector have been technology driven. As the cost of information technology has fallen, new and ever more complex financial instruments, as well as the means to deliver them, have emerged within the market. The emergence of automated teller machines, telephone and Internet banking, as well as new individual service providers offering everything from loans and credit cards to insurance, often without nation-wide office branching, have all been pressuring traditional, multi-branch firms offering the full complement of services. The rise of many Asian and east European economies over the last decade, along with the series of financial crises that struck southeast Asia and Latin

[366]See BMO, *Policy Alternatives for Canadian Financial Services*, July 1997; Government of Canada, Department of Finance, *Change, Challenge, and Opportunity: Report of the Task Force on the Future of the Canadian Financial Services Sector*, September 1998. Canada's Department of Finance decided against the proposed mergers even though the *Report of the Task Force* recommended they be approved.



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America in the 1990s, have all changed the prominence of overseas capital markets, altered the competitive positions of many domestic firms, and led to concerns that financial crises in one part of the world can too easily spread to others (contagion). Amidst all of these phenomena, whether we speak of their impact domestically or internationally, we are invariably lead to a discussion of institutions, or the rules by which international and domestic finance operate. It just so happens that the rules of the NAFTA have not been as influential in directly shaping the evolution of financial services in North America as perhaps the regulatory powers of Federal Reserve or the Federal Trade Commission are in the United States, or the Bank of International Settlements and the International Monetary Fund are for international finance.

However, the Financial Services chapter of the NAFTA, nevertheless, impresses upon us the importance of examining the institutional structure around which firms organize themselves and clamor for institutional change. We can talk about the North American financial services sector in terms of a range of forces affecting business behavior that *includes* the institutions of the NAFTA's Financial Services chapter. But, we *cannot* talk about integration of North America's financial services sector as having been *substantially driven* by that chapter's institutions. The impact of the NAFTA's institutions on firm behavior varies chapter by chapter, economic sector by economic sector. The NAFTA's most important impact on financial services in North America has been that financial services firms have tended to follow business activity.[367] Where ever other kinds of firms have expanded their activities as a result of the NAFTA's

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[367]Lande et. al. "NAFTA and Financial Services," 41.



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institutions, financial services providers have not been far behind. For instance, as firms in other economic sectors consolidate, merge, and otherwise re-structure their activities in the face of competition, financial decisions may increasingly be made by head-offices and with home-country financial services providers. Such changes may be affecting the behavior of financial services providers by actually reducing market opportunities in the home market, thereby making diversification into the broader North American market place more imperative. This kind of indirect influence on financial services firm behavior in North America can still be traced to the institutions of the NAFTA, but most strongly through the activities of firms whose activities flow more directly from the incentive structure provided by the NAFTA's institutions.

In a sense, the direct impact of Financial Services chapter of the NAFTA on individual firms represents one pole on a continuum of the interaction between institutions and firm structure. The NAFTA's impact on the North American auto trade, to which we turn next, represents the opposite pole.

Autos

In sharp contrast to the institutions of the NAFTA covering financial services, which by and large confirmed the status quo rather than initiating significant changes in firm behavior, consider those institutions affecting the North American auto industry. Perhaps better than any other chapter of the NAFTA, the story of the auto sector highlights the interaction between firms, institutions, and institutional change in the evolving performance of the North American economy. Like the financial services sector,



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the North American auto sector has also been shaped by a range of global competitive challenges that preceded the NAFTA. Yet, unlike financial services, the NAFTA negotiations over autos more clearly featured provisions designed to affect patterns of firm-level activity. The vastness of the literature on the North American auto sector defies comprehensive summary, but we do need a brief, necessarily stylized, history of the auto sector to understand both the role of firms in shaping institutional change as well as the impact of those institutions on firm behavior.

*Canada*

The current state of Canada's auto sector has been shaped most profoundly by the provisions of the 1965 Auto Pact with the United States. Until 1965, Canada's auto industry was underpinned by a series of government policies, including high tariffs and local content rules, and patterns of trade based on the pre-World War II tariff preferences offered to Commonwealth countries by the United Kingdom, all of which provided incentives for the world's automakers to locate production facilities within Canada, which America's Big Three automakers did, but largely to serve only the domestic Canadian market. Yet, Canada's vast spaces and small population made serving the Canadian market, even from within, problematic for many firms. Canada's pre-Auto Pact industry tended to feature a small number of firms, offering a narrow range of products, and short production runs, which in turn hurt productivity, limited employment opportunities in the manufacturing sector, and limited the potential for up-stream industries such as parts manufacturers. Until the end of World War II, Canada was able to export significant



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portions of its auto production surplus to its Commonwealth cousins. However, post-war Europe had little need for the large vehicles produced in North America and by the 1960s, the Canadian auto sector was in trouble. The solution for Canada in the auto sector, as with many other sectors of the Canadian economy, was to try and generate economies of scale in production for the purposes of exporting the vast majority of the surplus. But Canada needed a reliable and deep enough market to take in its production. The Auto Pact would secured that access. The result in autos was the emergence of a sector of the Canadian economy that became deeply integrated with the U.S. auto sector and supported a pool of high-skill, high-wage jobs well in excess of that which Canada's domestic market could support on its own.[368]

Prior to the Auto Pact, Canada tried several unilateral measures to augment the auto sector, including import duties as high as 25 percent and duty remission schemes in an effort to bring about larger production runs and productivity enhancing competitiveness to the industry. The impetus for reaching a bilateral arrangement with the United States came after U.S. officials threatened to possibly countervail the Canadian incentives with offsetting border measures. Rather than a debilitating trade battle over an auto sector that was, in both countries, largely dominated by America's Big Three, negotiations began in the fall of 1964 on a bilateral deal that would allow the Big Three to

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[368]It is somewhat simplistic to suggest that both Canada and Mexico simply export excess production to the United States. The CUFTA and NAFTA have stimulated considerable intra-industry trade back and forth across both borders, significantly complicating the trade flow picture. Final goods also make their way back and forth across the borders as different plants specialize in specific models for export while importing a range of others. See Pradeep Kumar and John Holmes, "The Impact of NAFTA on the Auto Industry in Canada," in Sidney Wientraub and Chirstopher Sands eds., *The North American Auto Industry Under NAFTA*, (Washington, D.C.: The CSIS Press, 1998), 114.



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take maximum advantage of proximate production facilities in both countries. As signed in January 1965, the Canada-U.S. Automotive Products Agreement in which Canada agreed to make its protective measures more efficient (but largely intact) while the U.S. agreed to exempt Canadian products from its protective measures. Original equipment and parts manufactured in Canada would be granted duty free U.S. entry provided they met minimum Canadian and/or U.S. value added requirements.[369] In addition to the formal agreement, Canada sought and obtained from the Big Three automakers commitments to continually increase the Canadian value added component of their production by at least 60 percent of the value of growth in Canadian sales.[370] From a Canadian point of view, the Auto Pact was one of the most successful trade and industrial policy achievements in Canadian history. It was largely an asymmetrical agreement, supporting thousands of export jobs in Canada that would ordinarily not have existed, and the agreement facilitated the development of a well-entrenched Canadian automotive sector complete with assembly as well as a range of upstream and downstream industries, but one inextricably tied to the fortunes of the U.S. auto industry as well. Although the Auto Pact was ratified by the U.S. Senate, the terms of the agreement almost immediately became the target of criticism by American politicians, some of which persisted through the conclusion of the CUFTA in 1987.[371]

Throughout the 1985-1987 CUFTA negotiations, Canada was understandably

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[369]Michael Hart, *A Trading Nation: Canadian Trade Policy from Colonialism to Globalization*, (Vancouver: UBC Press, 2002) 244.

[370]Hart, *A Trading Nation*, 244.

[371]Congress, House, Representative Bereuter of Nebraska speech entitled "Make Haste Slowly in Canadian Free Trade Talks," 99th cong., 2nd sess., *Congressional Record* vol. 132, no. 93, (17 July 1986).



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reluctant to open the Auto Pact to renegotiation in new bilateral talks, in spite of considerable pressure from Capitol Hill and from U.S. negotiators to reopen the issue.[372] In the end, the Auto Pact remained largely intact under the CUFTA with only a few changes, including a commitment by both governments to eliminate remaining tariffs in automotive products within ten years, and a commitment by Canada to end its duty remission schemes by 1996.[373]

*United States*

In reality, the modern North American auto industry transcends borders and can hardly be thought of in separate national terms because each national industry is, and has been for many years, so deeply integrated with the others. The industry has been dominated for most of the 20th century by U.S. firms operating on both sides of the border. By the mid-1980s, both the U.S. and Canadian auto industries had come under considerable pressure from foreign competitors, many of whom offered more fuel efficient, higher quality vehicles that matched the consumer tastes of greater and greater numbers of people. In 1965, nearly all the cars sold in Canada were made by the Big Three. By 1985, about one third of all sales came from abroad.[374] A similar story of lost

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[372]For example, see two page advertisement taken out by the Canadian government on proposed free trade talks, *New York Times*, 10 December 1985, D17-20. See also *Wall Street Journal*, 23 June 1987, 30.

[373]Canada, Department of External Affairs, *Elements of a Canada-United States Free Trade Agreement, Synopsis*, 7 October 1987, (Ottawa: Department of External Affairs), 3; Canada, Department of External Affairs, *The Canada-U.S. Free Trade Agreement*, 12 October 1987, (Ottawa: Department of External Affairs), 151-59; *New York Times*, 5 October 1987, D5.

[374]Hart, *Decision at Midnight*, 203; Kumar and Holmes, "The Impact of the NAFTA on the Auto Industry in Canada," 92, 110-111.



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market share took place in the U.S. that was part of a much wider story in the United States of challenging economic conditions and increased foreign competition in a range of products that drew the ire of many American politicians. By the mid-1980s, economic disputes, particularly with Japan and the European Community, had become extremely contentious as the United States languished in one of its worst recessions in a generation and struggled to keep key industrial sectors such as automobiles and steel from disappearing. Both autos and semiconductors were especially sore points in U.S.-Japan trade relations that eventually resulted in the acceptance by Japan of Voluntary Export Restraints on luxury automobiles and Voluntary Import Expansion agreements for semiconductors.[375]

*The "Honda Problem"*

The success of the duty remission scheme under the Canada-U.S. Auto Pact led Canada to extend the scheme to attract a number of specialty vehicle manufacturers to Canada, particularly Japanese auto makers. So successful was the scheme that it was also applied in other industrial sectors. Japanese firms did not gain Auto Pact status, but the remission programs did provide Japanese producers with incentives to enter the North American market via Canada, a phenomenon not lost on U.S. negotiators and legislators who pressured Canada to open the Auto Pact to revision under the CUFTA

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[375]See Destler, *American Trade Politics*, 77-80, 112-113; Lauara D'Andrea Tyson, *Who's Bashing Whom?: Trade Conflict in High-Technology Industries,* (Washington, D.C.: Institute for International Economics, 1992), 106-110; Steve Dryden, *Trade Warriors: USTR and the American Crusade for Free Trade*, (New York: Oxford University Press, 1995), 300, 318-321.



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negotiations.[376] Thanks largely to Japanese transplants in Canada, a growing proportion of the bilateral auto trade was taking place outside the Auto Pact. What to do about non-Auto Pact trade threat became a major issue in the CUFTA talks.[377]

Throughout the negotiations, Canada resisted changes that would reduce its advantages under the Auto Pact, but was open to those that augmented industrial expansion opportunities for Canadians.[378] Market access opportunities which existed under the Auto Pact remained under the CUFTA, as did the value added commitments of the Big Three automakers. But the most important provisions of the agreement were the new rules of origin governing both Auto Pact and non-Auto Pact trade. Under the CUFTA, 50 percent of all vehicle production costs would have to be incurred in either Canada or the United States to qualify for duty free entry to either country. In essence, Canada would continue offering duty free treatment of northbound goods under the provisions of the Auto Pact, while the United States would adhere to the 50 percent rule of origin for all autos and auto parts to qualify for duty free treatment. This was one means of dealing with the Honda Problem because it would force transplant manufacturers to source more of their production from within North America to qualify for duty free treatment.

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[376]Hart, *A Trading Nation*, 245; *Wall Street Journal*, 11 September 1987, 36; Hart, *Decision at Midnight*, 202-04, 263-64, 283-84.

[377]Hart, *Decision at Midnight*, 203.

[378]Hart, *Decision at Midnight*, 290.



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*CUFTA and Institutions*

From the point of view of institutions, the rules of origin within the CUFTA represent a set of institutional structures that contribute to the structure of the North American auto industry. The provisions of the Auto Pact obviously also produced significant changes in the North American auto sector by encouraging new investment in Canadian assembly and auto parts production that could take advantage of privileged access to the U.S. market; from the point of view of the Canadian government, a domestic industrial policy that saved the Canadian industry.[379] Yet, provisions of the CUFTA, especially the 50 percent local content rule[380] and the end of Canada's duty remission program,[381] seem to have been designed both as a stimulant for investment in the industry and as a means of strengthening the market positions of the Big Three.

> By preventing Canada from further granting of Auto Pact status to new manufacturers and requiring the phasing out of the export- and production-based duty remission orders introduced during the 1980s to entice Asian investment, CUFTA eliminated an incentive for non-Auto Pact manufacturers (transplants) to expand their Canadian operations or increase their use of Canada-produced parts. CUFTA thus created two classes of vehicle manufacturers in Canada: those with Auto Pact status (GM, Ford, Chrysler, Volvo, and CAMI) and those without (Toyota, Honda, and Hyundai).[382]

Those whose production incorporated high levels of domestic content were granted preferential access under the rules of origin to a market place of some 300 million consumers. Those whose production continued to source many of its parts from outside

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[379]Hart, *A Trading Nation*, 245.
[380]*Canada-U.S. Free Trade Agreement*, Annex 301.2, Section XVII.
[381]*Canada-U.S. Free Trade Agreement*, Article 1002.3.
[382]Kumar and Holmes, "The Impact of NAFTA on the Auto Industry in Canada," 138-139.



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North America, such as Honda and other screwdriver transplants, would be subject to tariff discrimination when their products crossed the 49th parallel. For non-CUFTA trading partners, the incentive structure had shifted because of the agreement and the choice was simple: change production patterns or face competitive disadvantages vis-a-vis domestic producers in North America.

*Mexico*

The history of the Mexican automotive industry, broadly speaking, is not unlike Canada's. Mexican economic policies over the past half-century have generally been characterized by heavy bias toward import substitution as a means of boosting local employment and much needed industrialization. The auto industry has long been seen as a key industry in this effort and has been characterized by high tariff protection, local content rules including requiring the installation of locally produced engines and transmissions, as well as trade balancing provisions that linked producers' sales to their export balance (ie. for every item imported, firms needed to produce one of similar value in Mexico) thereby ensuring the development of local upstream and downstream producers. These government led efforts to support the Mexican auto industry are enshrined in the series of Auto Degrees (Decreto para el Fomento y Modernización de la Industria Automotriz), the first of which was implemented in 1962 and have been amended every few years since.[383]

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[383]Rogelio Ramirez de la O, "The Impact of NAFTA on the Auto Industry in Mexico," in Sidney Weintraub and Christopher Sands eds., *The North American Auto Industry Under NAFTA*, (Washington, D.C.: The CSIS Press, 1998), 48-53.



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The 1977 Auto Decree, for example, toughened trade balancing requirements on domestic firms to encourage a positive balance of auto exports to imports and also enshrined the distinction between domestic and foreign firms (national vs. non-national producers), offering additional protection to the former over the latter. The 1989 Decree, the last pre-NAFTA Auto Decree, confirmed many of the protective provisions of other Decrees, but added even more pressure on firms to export by requiring a zero trade balance of firms as a condition of importing. The 1989 Decree appeared to liberalize the Mexican industry by reducing the local content requirements from 50 to 32 percent, but in doing so redefined "national producer" in such a way as to make it virtually impossible for new entrants, particularly foreign firms, to meet this standard for sales in the Mexican market.[384] The impact of the Auto Decrees on the performance of the Mexican auto sector over the years has been uneven with the sector's performance being affected more by the ebb and flow of Mexico's macroeconomic performance than the Decrees themselves. By the 1990s, Mexico had substantially liberalized important parts of its economy. Yet, the cumulative impact of the Decrees continued to support an inefficient, high cost industry offering a limited range of products for sale compared to the industry's U.S. counterparts– not unlike the outcome of Canada's own early protective model.[385] However, one effect of the protection the Decrees afforded the Mexican auto sector was the creation of a vibrant auto parts manufacturing sector that arose largely as a result of Mexico's local content and trade balancing rules. When the NAFTA negotiations began,

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[384]Ramirez de la O, "The Impact of the NAFTA," 51-52.
[385]Ramirez de la O, "The Impact of the NAFTA," 57.



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the Auto Decrees and, in particular, the protection afforded to the lucrative Mexican auto parts producers, proved to be the among the biggest hurdles.[386]

*Autos, Institutions, and The NAFTA*

The North American auto sector is among the most important of all industrial sectors in each respective nation. As might be expected, the NAFTA negotiations covering the auto sector were among the Agreement's most important and, unlike the chapter on Financial Services,

dramatically altered the institutional matrix governing North American auto trade and production. It is within the Auto negotiations and their aftermath that we most clearly see some of the dynamics leading to institutional change. However, it is also where we most clearly observe both firm-level responses to institutional change and the role firms can play in bringing about institutional change. First, we need some appreciation of the institutions the NAFTA altered or put in place. Among the most important of the Auto provisions were the following:

- Elimination of tariffs on all automotive goods by 2003
- New rules of origin and a regional-content requirement of 62.5 percent for cars and specific components and 60 percent for other parts, after a 10 year phase-in that begins with 50 percent.(Article 403.5)
- The NAFTA confirmed the status of the U.S.-Canada Auto Pact and the elimination of Canada's duty remission program based on Auto Pact principles (Appendix 300-A.1).
- Initiated a graduated reduction in requirements on Mexican producers to engage in trade balancing, down to 55 percent by 2003 (Appendix 300-A.2.12).
- Began the phase-out of the 1989 Mexican Automotive Decree (Appendix 300-A.2.1) and other Mexican restrictions over 10 years up to 2003 (Appendix 300-

386Cameron and Tomlin, *The Making of the NAFTA*, 92.



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A.2.2-6).

- Treatment of Mexican-produced vehicles as "domestic" under the U.S. corporate average fuel economy (CAFÉ) (Appendix 300-A.3.1-5).
- Elimination of restrictions on the importation of used cars to Mexico after 15 years and full elimination of restrictions only after 25 years (Appendix 300-A.2.24).
- A new FDI policy in Mexico, although not a direct part of the NAFTA's provisions, that eliminates the limit of 49 percent as the maximum foreign-investment share in parts producers, but only after 5 years.
- The national-content requirement that is to continue for 10 years, until 2003, except for investments in exports. Maquiladora production can count toward national content for up to 20 percent of costs if it is not produced by a plant owned by the car assembler. (Appendix 300-A.1.4).

In each of these changes to the institutions governing North American auto trade, we see shifting incentive structures around which firms adapted their own organizational structures and altered their production patterns. It is no surprise that the reduction of entry barriers to the Mexican market imposed by the Auto Decrees had an important, and almost immediate, impact on auto trade with the United States. In 1992, the United States exported a mere $80 million worth of vehicles to Mexico. By 1994, the first year of NAFTA implementation, U.S. vehicle exports had soared to $569 million.[387] Yet, this is the easiest part of the story to explain using the standard neoclassical model. We expect that the reduction of trade barriers such as tariffs and other kinds of domestic protective measures will stimulate additional trade flows between parties to the agreement. But the neoclassical model only begins to hint at a larger tale of industry restructuring and rationalization that the incentive structure of the NAFTA's institutions created.

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[387]Johnathan Doh, "The Impact of the NAFTA on the Auto Industry in the United States," in Sidney Weintraub and Christopher Sands eds., *The North American Auto Industry Under NAFTA*, (Washington, D.C.: The CSIS Press, 1998), 32.



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Firms, Governments, and the Negotiations

The argument being advanced here is that firms respond to institutional change by structuring their organizations to take advantage of the incentives provided by new institutions. We see the most obvious result of institutional change in the form of increased trade flows. However, experience also tells us that firms contribute to institutional change through the public policy process.[388] This was readily apparent during the NAFTA negotiations. When negotiations began in Toronto in June 1991, there were important differences in initial negotiating positions between the three governments, but also important differences between auto industry and the three governments. In particular, the Big Three auto makers in the United States pressured American negotiators to raise the local content bar for duty free treatment from 50 percent, as under the CUFTA, to 80 percent under the NAFTA rules (although U.S. negotiators opened the talks with a 70 percent threshhold). Part of the rationale for the higher content requirements was the growing "Honda Problem" in which Japanese transplants lured to Canada by its generous duty remission programs presented the Big Three with a kind of home-grown competitive challenge. Even if Japanese transplants in Canada met the higher content requirements, such standards for duty free treatment would at least require those transplants to compete with the Big Three in North America on similar terms by forcing them to source greater proportions of their parts and labor within North America.[389] Initially, Canada had no

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[388]See also William E. James and Masaru Umemoto, "NAFTA Trade with East Asia: Rules of Origin and Market Access in Textiles, Apparel, Footwear and Electrical Machinery," *ASEAN Economic Bulletin* 17 (3) (December 2000): 293-311. James and Umemoto assert that heavy lobbying on the part of industry groups largely set the rules of origin for the NAFTA area which amounted to a form of industrial policy protection for certain sectors affecting Asian producers particularly strongly.

[389]Cameron and Tomlin, *The Making of the NAFTA*, 91-93.



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interest in reopening the auto provisions of the CUFTA, preferring to maintain the local content benchmark for duty free treatment at 50 percent. However, while the Canadian government pursued a 50 percent rule, Canada's negotiators were being pressured from many sides. On one, the Canadian divisions of the U.S. Big Three were pressing for rules of origin well above 50 percent. On another, Honda and Toyota were pressing the Canadian government to maintain the rule of origin at 50, but would accept a higher rule if greater clarity could be brought to the overall package of rules. Finally, the Canadian auto workers union, fearing a loss of jobs if competitive pressures forced the Big Three to rationalize production, also pressed for a high rule of origin of between 65 and 70 percent, in part, also to thwart incursions by largely non-unionized transplant workers.[390]

For its part, Mexico opened the negotiations ambivalent about domestic content rules (50 percent was alright), but insisted upon preserving provisions of the Auto Decrees governing trade balancing and domestic content requirements of Mexican producers that had fostered a vibrant auto parts industry. The United States was insistent that the Auto Decrees be scrapped altogether. Like Canada, Mexico had a number of differing constituent positions bearing down on them from parts producers and foreign producers such as Volkswagen and Nissan which operated transplants in Mexico. Both of these transplants urged lower rules of origin, in part because the majority of their parts were sourced outside North America. However, the flexibility of the Mexican position on higher rules of origin grew when both of these firms decided to use their Mexican operations to concentrate on the Mexican and larger Latin American markets,

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[390]Cameron and Tomlin, *The Making of the NAFTA*, 92.



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respectively.[391] However, the primary Mexican concern was for NAFTA rules that would protect its parts industry. By May 1992, a scheme for gradually easing the transition for auto parts producers by guaranteeing that as trade expanded, some of the new business would be channeled to Mexican parts producers. In essence, the local content provisions of the Auto Decrees that mandated local parts for vehicle sales in the domestic market would be reduced over a period of five years but any additional growth in production would guarantee a declining share of any growth achieved in the auto parts market during the transition (The NAFTA, Appendix 300-A.2.12).[392]

As the NAFTA negotiations dragged on into July 1992, U.S. and Mexican negotiators sought a compromise that would allow the Big Three to increase their exports to Mexico while also reducing their obligation to produce in Mexico under the trade balancing rules of the Auto Decrees (Appendix 300-A.2.2-8). By early August 1992, as the negotiations moved into their final and most critical stage at the Watergate Hotel in Washington, no agreement had been reached on the most basic, but most important provision of the Agreement's auto chapter, the precise content threshold for the rule of origin. As a means of balancing the interests of its newly arrived Japanese transplant as well as those of the Big Three, Canada continued to stand firm in its interest in a 50 percent content rule. At the end, Canada and the United States simply split their differences and agreed to a phased-in 62.5 percent North American content rule to qualify for duty free treatment. Having largely satisfied their desire to protect their auto parts

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[391]Cameron and Tomlin, *The Making of the NAFTA*, 134-135.
[392]Cameron and Tomlin, *The Making of the NAFTA*, 135.



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sector with other provisions of the chapter, the Mexicans went along with the area content threshold.[393]

Since the implementation of the NAFTA began in January 1994, trade in North American autos has largely been shaped by the rules of the NAFTA, but so too has activity at the firm level. The trade statistics are impressive. From 1992 through 1996, U.S. vehicle exports (cars, trucks, busses, and used vehicles, sport utilities) to the world rose in value from $18.8 billion to $24.4 billion. By comparison, the same period's U.S. exports to Canada and Mexico under the NAFTA rose from $8.3 billion to $12.3 billion (50 percent) and from $278 million to $1.3 billion (350 percent) respectively.[394] On the import side, U.S. imports from the rest of the world rose from $57.1 billion to $79.7 billion between 1992 and 1996. By contrast, imports from America's NAFTA partners in the same period rose from $22.5 billion to $33.7 billion in the case of Canada and from $3.1 billion to $11.3 billion in the case of Mexico.[395] The effects of market integration under the NAFTA are also seen in the trade in auto parts where, between 1992 and 1996, U.S. parts exports to non-NAFTA trade partners rose faster than those to Canada or Mexico, while U.S. parts imports from its NAFTA partners far outpaced import levels from non-NAFTA countries.[396]

The incentive structure of the NAFTA's institutions have stimulated significant rationalization of the industry and promoted the specialization of production to take

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[393]Cameron and Tomlin, *The Making of the NAFTA*, 172-173.
[394]Doh, "The Impact of the NAFTA," 19.
[395]Doh, "The Impact of the NAFTA," 20.
[396]Doh, "The Impact of the NAFTA," 29-30.



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advantage of lower border measures. One very important consequence of the specialization of production within firms has been the rise of intra-industry trade in which upstream and downstream production units within firms (such as GM or Ford) or between firms and suppliers grows and can take greater advantage of just-in-time production techniques that reduce the need for large inventories and augment productivity.[397] As barriers to market entry for finished products fall, and rules of origin within the NAFTA facilitate (some would say distort) the exchange of specialized parts such as engines, transmissions, or other parts across borders for final assembly, the production of individual components can increasingly be specialized in single locations. Parts are then transferred within the industry, or within the firm itself, to final assembly plants. Recall Michael Porter's general thesis about clusters and the development challenge his work poses to the idea that reductions in transportation and information costs as a result of globalization have made production location less and less relevant. In a world where input costs are comparable everywhere, how they are employed can make the difference between firm success or failure.[398] We see this in the auto sector where, in spite of the NAFTA, North American auto production still tends to take place within three generalized regions: U.S. Upper Mid-West/ Southwestern Ontario, Northern U.S. South, and Northern Mexico.

Yet, as has been argued throughout this study, we do not live in the kind of

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[397] Kumar and Holmes, "The Impact of NAFTA on the Auto Industry in Canada,"145-152. Canadian Manufacturers & Exporters has estimated that approximately 60 percent of Canada's two-way trade with the U.S. is intra-industry. Source: *Isolation or Integration: Canada's Role in North America*, Speaking Notes for the Hon. Perrin Beatty, President and CEO, Canadian Manufacturers & Exporters, before the Saskatchewan Trade & Export Partnership, Saskatoon, Saskatchewan, August 28, 2002.

[398] See Porter, *The Competitive Advantage of Nations*, 1-30.



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transaction cost-free world in which inputs such as capital and labor can be costlessly exchanged between and within sectors of an economy, much less across borders, regardless of where they are located. The institutions of the NAFTA go some distance in helping erase the economic importance of the border (itself a political institution as well as physical barrier), and globalization will likely continue reducing the importance of location in the production decisions of firms. But that day has not arrived just yet in North America. In fact, we have recent evidence about the auto industry itself that suggests production decisions in the NAFTA still have a great deal to do with location. As Ho Yeon Kim argues, standard trade theory predicts that with NAFTA implementation, production decisions in the automotive sector will tend to locate the more labor-intensive production of small cars in Mexico relative to Canada or the United States. The location of auto production is a costly, one-time endeavor in that once a plant is constructed, it is not easily be moved. Nevertheless, Kim's simulation model suggests that future plant location, just as it has in the past, will tend to be selected on the basis production decisions, not the other way around.[399] That means that relatively labor-intensive small car production should gravitate toward Mexico. Patterns of auto plant construction since 1994 and the implementation of the NAFTA support these predictions. Of the seven new auto assembly plants constructed in North America since then, five of them have located in Mexico. During that same period, Mexican vehicles (mostly small) to the U.S. have

[399]Kim, "Impact of Trade Liberalization on the Location of Firms," *The Annals of Regional Science* 37 (2003): 149-73.



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almost doubled.[400]

These findings fall in line with Paul Krugman's discussion of the linkages between trade and location theory in understanding patterns of trade. Some of the most important differences between the two theoretical approaches rest in assumptions about factor mobility. Until the introduction of the Hecksher-Ohlin theorem of factor-price equalization, factors between countries were thought to be immobile, but mobile within. By contrast, location theory sees factors of production– except of course for land– as highly mobile (a la Michael Porter), subject mainly to transportation cost considerations.[401] Although Hecksher-Ohlin suggested a mechanism for factor mobility across borders, trade theory remains primarily concerned with the impact of borders on commercial flows. As the importance of borders declines, location theory will be of greater importance in helping us understand patterns of economic activity in North America.[402] However, until then, we ought to also be focusing our attention on the impact of institutions and institutional change since it is institutions that continue to shape productive decisions in ways not necessarily addressed with our standard set of economic tools.

## The NAFTA as a Trilateral Contract?

One critique of institutional approaches to economic analysis is that the emphasis

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[400]Ibid., 168-69. Kim does note, however, that the model used predicts Mexico as an increasingly strong magnet for labor-intensive auto production only if significant non-tariff barriers in transportation infrastructure and procedures are removed. Tariff reduction alone will not sustain Mexico's position as a low-cost producer of labor-intensive goods.

[401]Krugman, "On the Relationship Between Trade Theory and Location Theory,"115.

[402]Ibid., 110-122.



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on transactions costs is too loosely defined or, in fact, never defined. Because transactions costs are a ubiquitous part of our economic system, the critique goes, virtually any friction or inefficiency in our economic system can be reduced to some kind of transaction cost for which the antidote is a different set of institutions.[403] Although somewhat challenging from an empirical point of view, the concept behind transactions costs necessarily spans the breadth of our economic activity as soon as we move beyond the point of autarky and begin even the simplest of exchange economies. As soon as an autarkic economic system moves toward greater and greater specialization and efficiency, some of that efficiency is lost because of the uncertainty surrounding exchange and the potential for opportunistic behavior by those with whom we are engaged in exchange. The basic institutional structure that has evolved as a means of mitigating these exchange problems is the contract.

From the basic narrative of the NAFTA presented thus far, one might suggest that there is little within the stories of the Financial Services or Automotive Products chapters of the Agreement, or in the subsequent behavior of the firm, that the basic neoclassical model cannot account for. However, when we begin to look at the NAFTA itself as a kind of contract, we see even more clearly why it is important to explicitly consider the role of institutions and institutional change, along with the neoclassical model, in understanding economic performance in North America under the NAFTA's rules. There are three basic kinds of contractual relationships that govern exchange; classical contracting, neoclassical contracting, and relational contracting (see Chapter II). As a brief review,

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[403]Williamson, "Transaction-Cost Economics," 233.



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recall that under classical contracts, virtually all possible contingencies within the exchange relationship are spelled out to the last detail. The nature of the exchange relationship is carefully limited and described within the contract, and explicit procedures are adopted for dealing with non-performance, most of which are easily predictable and therefore readily included within the contract. Such contractual relationships are rare, but may include a range of one-time transactions, such as the purchase of gasoline.

Neoclassical contracting moves one step closer to the vagaries of real-world economics by acknowledging that not all possible contingencies in an exchange relationship can be included within a contract, nor can every possible future eventuality arising from the opportunism be included within a contractual exchange relationship. Neoclassical contracts are often incomplete, containing provision for future contingencies, and frequently have a settlement machinery spelled out as a check on opportunistic behavior. Finally, relational contracting completely abandons the notion that contingencies can be planned for within the contract itself and makes provision for the more realistic proposition that parties to a contract often share a past history of working with one another that is full of precedents that shape the relationship. At this stage of contractual relationship, the contract takes on the "properties of a mini-society with a vast array of norms beyond those centered on the exchange and its immediate processes."[404] In other words, most relational contracts are embedded in relationships that transcend the actual details of the immediate contract. As Gillian Hadfield has written,

Often contracts are necessarily and intentionally incomplete because mutual

[404]Macneil, "Contracts," 902.



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> desires for flexible but bounded responses to uncertain future conditions that limit the scope and precision of verifiable terms. Moreover, incomplete contracts often exist deeply embedded in an ongoing relationship. The parties are not strangers; much of their interaction takes place "off the contract," mediated not by visible terms enforceable by a court, but by a particular balance of cooperation and coercion, communication and strategy.[405]

Contracts essentially detail the how economic rent will be distributed within an exchange relationship. Even more to the point, contracts are determinative of the property rights arrangements between parties to exchange. We are familiar with these kinds of exchange contracts in a variety of settings, most of them purely commercial in nature, and most of them between firms or between firms and consumers. Labor contracts specify the terms by which one's labor will be exchanged for wages. Sales contracts detail things such as the price and quantity by which a product will be exchanged between firms or between firms and consumers. Regardless of the nature of the contract, such agreements detail the terms of exchange and thereby also set the terms (property rights) by which economic rent will be allocated between parties. The NAFTA represents a kind of contractual relationship between all three NAFTA countries that sets the rules of exchange between all three North American economies. Regardless of where we look within the Agreement, the NAFTA is itself a kind of relational contract between the Parties that sets guidelines, rules, and mechanisms for dispute settlement that are embedded in the histories of the relationships between them. Not every contingency is spelled out within the NAFTA, but mechanisms for dealing with them are, thereby extending an ongoing relationship well into the future (shadow of the future).

[405]Hadfield, "Problematic Relations," 927.



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Yet, the Financial Services and Automotive Sector provisions of the NAFTA suggest that depending on where you look in the NAFTA, the provisions of the Agreement have had differing effects on economic performance. The Auto negotiations, in particular, suggest that the contractual relationship established under the NAFTA's auto provisions was not simply one between three sovereign countries, but was also heavily influenced by the auto sector firms themselves. The terms of the auto provisions of the NAFTA determined how and under what terms auto makers could compete to capture economic rent from North American production. The rules were designed and negotiated with the heavy Japanese competition of the late 1980s and early 1990s squarely in mind. If Japanese transplants were going to capture additional rent from a liberalized and integrated North American marketplace, they too were going to have to source at least 62.5 percent of their inputs from domestic sources. At the same time, the governments, particularly Canada (in the CUFTA) and Mexico (in the NAFTA), pledged to eliminate many of their mercantilist automotive policies, thereby also dramatically revamping North American property rights governing auto trade. What was thirty years ago a North American automotive marketplace characterized by three, largely separate, markets for production and sales will, by the time all the provisions of the Agreement have been implemented, become one; one in which the property rights among auto makers, and therefor the distribution of rent among them, are being shaped by the NAFTA.

It may be cliche to suggest that North America is now a single market place for goods, services, and capital, but one of the principal roles the NAFTA has played has



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been in reshaping the rules by which economic activity takes place. That reshaping of the rules between countries was, in effect, the drawing up of a relational contract between the three countries which in turn shaped the choice set facing economic decision makers and firms. It was a choice set shaped by the provisions of an agreement that did not provide for every last contingency, but set down both broad principles and specific rules, along with mechanisms for prolonging these relationships (dispute settlement) that have had an impact on North American economic activity that is much more profound than trade or investment statistics suggest. I earlier cited the example of how nascent property rights development on the open range mitigated the effects of the well-known phenomenon of the tragedy of the commons.[406] To prevent unsustainable resource depletion on the open range, cattlemen's associations restricted entry to the open range to the cattle of members, thereby limiting who could capture rent from the grazing of cattle on the range. The association offered protection of property by excluding outsiders and structuring the distribution of property rights among those within the association. The NAFTA's provisions governing North American auto trade similarly structured the distribution of property rights in North America, in part, by designing rules that favored members (North American firms) over non-members (foreign firms). However, just as the rules of the cattlemen's associations limited and structured the length of time members' could graze their herds, the NAFTA's auto provisions also limited, structured, and provided opportunities within a liberalized North American marketplace. The rules changed the

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[406]Dennen, "Cattlemen's Associations and Property Rights in Land in the American West," 423-36.



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choice set, and did so, albeit in very different ways, for both member and non-member firms.

### The Efficiency of the Rules

If we accept the argument that the rules of the NAFTA have shaped the choice, and therefore incentive, sets confronting economic decision-makers, it seems obvious to suggest that with different rules we might have different choice sets, different incentives, and, of course, different economic outcomes. In Autos we seem to have some confirmation of Douglass North's proposition that the origins of institutional change are found in changing relative prices which leads one or both parties to an existing exchange relationship to seek changes in it.[407] North American auto firms, under pressure from more efficient foreign competitors for much of the 1980s, responded by pushing for ever-higher thresholds for area content requirements. However, we return to the question of efficiency in institutional change. Within the neoclassical model's frictionless world, outcomes are theorized to be the product of simple a simple maximization model. Ultimately, it is assumed, the inefficient maximization of production will ultimately give way to that which makes more efficient use of scarce resources.

However, as soon as we begin dealing with uncertainty, opportunism, and a range of transactions costs, we have to challenge the very rationality postulate that allows us to engage in maximizing behavior. In such circumstances, we begin redefining rationality by deferring to Simon's concept of bounded rationality. If we are only boundedly rational,

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[407]North, *Institutions, Institutional Change and Economic Performance*, 86.



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can we then, at best, only be boundedly efficient as well? Yet, all of this assumes that efficiency is the objective. In institutions we are dealing with inherently human creations, ranging from informal norms of behavior and customs, all the way to formal legal structures, none of which are necessarily efficient. We have seen numerous examples already of how the patently inefficient becomes entrenched in the way we work (ie. QWERTY). Within the NAFTA, we have the same phenomenon. Only through an examination of the path dependent nature of institutions and institutional change, we can come to understand how many of the most inefficient institutions around us also become so deeply entrenched. The rules of origin of the NAFTA are one such set of inefficient institutions and as the autos story suggests, was not the random product of poor negotiators, but the willful product of an effort to provide preferential treatment to automakers within the NAFTA.

Anyone who reads the rules of origin chapter of the NAFTA (Chapter 4) will immediately note the cumbersome and labyrinth calculations involved in ensuring production within the NAFTA area adheres to the content requirements necessary to receive preferential treatment. The 62.5 percent area content requirement imposed on autos represents just one standard for just one of the economic sectors covered by the Agreement, all of which must meet various requirements for duty free treatment.[408] As students of trade policy know well, rules of origin are designed to ensure that out-of-area products are not mistakenly accorded duty free status when crossing borders within the

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[408]In fact, the specific rules of origin covered in NAFTA Annex 401 span more than 175 pages of Volume II of the Agreement and involve every product classification in the Harmonized System of Tariffs.



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free trade area. There are those who see rules of origin as anachronisms within a free trade area– some even view them as veiled industrial policy[409]-- because they impose new burdens (to meet content requirements) on producers where such agreements are designed to do exactly the opposite. The burdens imposed on manufacturers by the NAFTA's rules of origin have once been simplified for a narrow range of products,[410] been targeted for elimination in proposals for deepening the NAFTA, and have been a central motivation for proposals to engage in a brand new integration project such as a customs union that would completely eliminate rules of origin by harmonizing all three NAFTA Parties' tariff schedules.[411] Furthermore, agreements such as the NAFTA have themselves been viewed by economists as somewhat anachronistic in terms of their liberalizing effects on trade since they are also inherently preferential and, in some instances, may divert as well as liberalize trade.[412] Only by looking at the institutions of agreements like the NAFTA can we come to understand how additional trade might be created through them, but also

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[409]See Hirofumi Shibatta, "The Theory of Economic Unions: A Comparative Analysis of Customs Unions, Free Trade Areas and Tax Unions," in Carl S. Shoup ed., *Fiscal Harmonization in Common Markets, Vol. 1, Theory* (New York: Columbia University Press, 1967): 144-264, especially 172-177.

[410]In the fall of 2002, the NAFTA Commission approved revisions to the specific rules of origin (Annex 401) for a narrow range of products including some beverages and spirits (HTS 22), mineral fuels, oils and waxes (HTS 27), organic chemicals (HTS 29), some precious metals and stones (HTS 71), electrical machinery (HTS 85), some vehicle categories (HTS 87), and precision medical, optical, and photographic instruments (HTS 90).

[411]See Wendy Dobson, *Shaping the Future of the North American Economic Space: A Framework for Action, C.D. Howe Commentary No. 162* (Toronto: C.D. Howe Institute, 2003); William B.P. Robson and David Laidler, *No Small Change: The Awkward Economics and Politics of North American Monetary Integration, C.D. Howe Institute Commentary No. 167* (Toronto: C.D. Howe Institute, 2002); Danielle Goldfarb, *The Road to a Canada-U.S. Customs Union: Step-by-Step or in a Single Bound?, C.D. Howe Institute Commentary No. 184* (Toronto: C.D. Howe Institute, 2003); Canada, House of Commons, Report of the Standing Committee on
Foreign Affairs and International Trade, *Partners in North America: Advancing Canada's Relations with the United States and Mexico*, (Ottawa: 2002).

[412]In fact, GATT Article XXIV.4-5, which for years sanctioned the creation of free trade areas, only did so insofar as such areas liberalized more trade than they restricted.



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how far some of that additional activity departs from the economic ideals of production based upon specialization and comparative advantage as suggested by the likes of Adam Smith or David Ricardo in the 18th and 19th Centuries.

Are there calls for the elimination of cumbersome rules of origin? Yes. In fact, even under the NAFTA, all three Parties have periodically looked for ways in which to revise and simplify them, albeit with limited success.[413] Are rules of origin a kind of blunt instrument that offsets some of the benefits of comparative advantage that trade liberalization brings? Yes.[414] Yet, in addition to guarding against preferential transhipment of third-party goods, the rules of origin also bring a kind of uncertainty to the NAFTA area regarding patterns of treatment for NAFTA goods that from a purely economic point of view may be inefficient and generate significant additional transactions costs. However, where institutions are concerned, efficiency is not always as important as the reduction of uncertainty. Rules of origin, inelegant though they might be, have brought some certainty to the marketplace regarding the treatment of NAFTA goods versus third party products. That all three governments continue looking for ways in which reduce the impact of rules of origin speaks to their inefficiency and their potential to generate transactions costs greater than the impact of the uncertainty they are designed to mitigate.

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[413]In September 2002, the NAFTA Commission announced revisions to the rules of origin covering only seven HTS-2 tariff categories and their joint statement of October 2003 said that work on further liberalization would continue.

[414]See James and Umemoto, "NAFTA Trade with East Asia," 293-311.



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Institutions and Incrementalism

We are accustomed to thinking about contracts in economic terms because such contracts are almost everywhere in specialized exchange economies. Everything from a simple sales receipt to the most complicated labor contracts to the terms of mergers and acquisitions all shape the distribution of economic rent between the parties to the contract. Although we seldom think of them as such, international treaties are also contracts which bind and obligate parties to them to comply with them (*Pacta Sunt Servanda*).[415] Like contracts between economic actors, agreements like the NAFTA bind governments to commitments that shape the terms of commercial activity (ie. the distribution of economic rent). Yet, governments, by and large, are not the ones actually delivering goods and services across borders. Instead, as the narrative covering Financial Services and Autos suggests, there is an interaction between the firms whose choice sets are being shaped by the agreement, and the governments actually doing the negotiating. Therein undoubtedly reside clues to the reasons behind the relative efficiency (or lack thereof) of institutions and institutional change.

Yet, neither the interaction between governments and economic actors in setting negotiating objectives, nor the dynamics of the negotiating process itself, can be separated from the broader context in which negotiations over a particular sector take place. Much of the public policy literature on the NAFTA tends to attribute a broad range of outcomes, both economic and non-economic, to the Agreement itself. There are of course the impressive figures on trade flows, but there are also assertions that the NAFTA has been

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[415]See 1969 *Vienna Convention on the Law of Treaties* Articles 26 and 27.



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essential to the strengthening of hemispheric democracy, fostered civil society and stake holder outreach, and improved transparency in governance, reduced the scope for corruption, and reinforced the rule of law.[416] We frequently read about either the CUFTA or the NAFTA being watershed agreements, almost as though trade between the three countries did not exist prior to these contractual arrangements. In the same vein are those in the Canadian business and academic communities who have been calling for major changes to the Canada-U.S. bilateral economic relationship, some even calling for the creation of a customs or monetary union between the two countries that would address post-9/11 security and economics. Through an examination of institutional change leading to the NAFTA, we see that many of the changes to institutional structure shaping economic activity in North America were more incremental than revolutionary. That the NAFTA contains so many changes affecting so many economic sectors unquestionably makes the Agreement a significant milestone. But within each of the chapters and within each of the changes to the institutional structure of economic governance in North America, the changes were largely incremental rather revolutionary, and largely built upon existing economic trends and concerns in all three NAFTA countries. Hence, in political terms, we frequently read that the NAFTA "locked-in" a range of economic and political reforms sweeping through all three countries in the 1980s and early 1990s.

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[416]See, for example, Remarks by Deputy U.S. Trade Representative Peter Allgeier, *The First Decade of NAFTA*, Michigan State University, East Lansing, October 16, 2003.



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## Conclusions

The original thesis of this chapter was a test of the proposition that the NAFTA's institutions *have had a significant impact on micro-level economic performance by inducing changes to industrial organization (firms) to take advantage of new incentive structures and by shaping the way actors, such as firms, cognitively evaluate their economic choice set.* When we look purely at trade flow statistics, the answer seems to be an emphatic, yes. What this chapter has tried to examine is a little deeper and more subtle than flows of goods and services in an integrated market place. In both Financial Services and Autos, we intuitively understand and reason that firms have been continually responding to ever changing market conditions. Normally missing from analyses of firm-level changes are the institutions that generate the choice sets which structure the incentives available to us under prevailing market conditions. In Autos, Annex 300-A (Trade and Investment in the Automotive Sector) and Chapter 4 (Rules of Origin) set the rules of the game by which production and trade of autos and auto parts would be conducted in North America. They were generated in the context of a broader history of managed trade and mercantilist industrial policies in all three countries and to which the major auto producers responded by rationalizing production, increasing specialization, and raising production efficiency. By contrast, the Financial Services sector has been shaped for many years by global forces and institutions to which the NAFTA added very little. Financial organizations have been responding to competitive conditions, and pushing to shape institutional change (ie. McFadden and Glass-Steagall Acts), but have not done so within the context of the NAFTA.



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Yet, whether we consider firm-level activity inside or outside the terms of the NAFTA, we see how institutions are instrumental in shaping their decision making. More importantly, we see that institutional change is not one directional in the sense that firms merely respond to, rather than also shape, that change. Within the NAFTA, the interaction between firms, governments, and the institutions that are finally created is a dynamic and reciprocal interaction, shaped by history and circumstance. It is to that dynamic that we now turn our attention.



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# CHAPTER VI
# THE DYNAMICS OF INSTITUTIONAL CHANGE

To this point, I have tried to make the case that the NAFTA, as a set of rules defining trade relations in North America, is actually a set of institutions as defined in terms of property rights, transactions costs, and contractual relations. Much as our legal system defines the permissible limits of individual liberty versus the collective welfare of the whole, thereby shaping, but not dictating, outcomes in many of our most basic societal activities, the rules of the game in economics likewise define how our exchange economy operates, but do not dictate the precise outcomes. The NAFTA is an important set of institutions for governing exchange in North America.

In virtually every chapter of the NAFTA, the rules have contributed to redefining the distribution of economic rent in North America by reducing transactions costs in a range of areas including, most obviously, reducing the impact of border measures on the exchange of goods and services. However, changes in the rules have also reduced transactions costs in other, less visible, areas of economic activity as well by reducing the impact of uncertainty, in the form of risk premiums, on many kinds of transborder exchange.

With the tools of the basic neoclassical economic model, we can readily demonstrate the trade, growth, and efficiency-facilitating benefits of lower trade barriers. However, less obvious, but potentially more profound are reductions in a range of other



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transactions costs, shifts in property rights, and the structuring of contractual relations that the reduction of border measures under the NAFTA has brought about. The neoclassical model assumes away too many of the uncertainties associated with imperfect information, the costs of exchange, uncertainty, or the impact of regulations on economic activity for the theory to paint anything but a rarefied snapshot of our economic system. The central purpose of this entire study is to advance our understanding of trade liberalization beyond the limitations of chalkboard-style, neoclassical economics. More specifically, *this particular chapter will be a test of the hypothesis that the explicit consideration of institutions can extend the basic neoclassical theory so we can better understand how the NAFTA came into being and how it has affected North American economic development.*

## A Brief Summation

Up to this point, I have tried to place the NAFTA within the literature of the new economics of institutions and tried to make an argument in favor of viewing the NAFTA more as a set of economic institutions that shape outcomes than just as an agreement that lowers trade barriers in accordance with the neoclassical model. The implications of this literature for the study of the NAFTA specifically, but also North American integration more broadly have been highlighted in important scholarship that has begun to uncover the important linkages between the rules of the economic game themselves and economic performance. We are regularly bombarded with news accounts of the inefficiencies of government regulation, redundancies and waste in government, or the impediments



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associated with differing jurisdictional standards. With all of these, we intuitively understand that if we could eliminate or change many of them, it would free our economic system to more efficiently take greater advantage of economies of scale and specialization from exchange than we do at present. The work of Hernando De Soto, for example, has spectacularly demonstrated how ill-defined property rights regimes and high transactions costs generated by myriad and impenetrable regulatory systems hinder development in some of the world's poorest countries. The implications of this work spread well beyond the developing world and contain important lessons for economic governance in the developed world as well.

We then argued that one by-product of institutional change was that the institutions themselves generate the incentive structure within which economic activity takes place. We can readily demonstrate how the reduction of border measures stimulated a burst of increased cross-border trade flows. Just as standard economic theory suggests, the reduction of trade barriers leads to the stimulation of additional trade based more purely upon the principles of comparative advantage. However, less obvious are the shifts in incentive structures and economic activity as a result of the NAFTA's rule changes in areas other than the mere reduction of border measures. Like the rules of a football game that structure how the game is played, the rules themselves present strategic opportunities for teams to exploit different strategies for winning the game. We demonstrated that Chapter 11 of the NAFTA, covering the rules of foreign direct investment, altered the structure and definition of property rights in North America and offered a range of new incentives, primarily through the investor-state dispute settlement mechanism, for



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economic actors to pursue the defense of those new property rights. In essence, the argument of Chapter 3 of this study was that the way in which the investor state provisions were written in the NAFTA filled the hole in international law in which non-state actors had little standing in a legal system entrenched around notions of state sovereignty. However, as the various tribunal challenges under NAFTA Chapter 11 have begun to suggest, the rules of the NAFTA have also reconstituted the incentive structure within which firms are seeking to defend their property rights and the Agreement itself may have left the door open for an important re-definition of property rights in North America.

We then made the important distinction between institutions as they are typically defined in international relations and organizations as defined by institutional economists; a distinction critical to understanding the NAFTA as a set of rules and how those rule changes have affected firm behavior in North America. Sets of institutions, like the NAFTA, form part of the incentive structure to which firms respond in the form of changes to their contractual arrangements and production decisions. Related, and equally important, are the changes to the firm's organizational structure itself which are induced by changing incentive structures. Here the evidence that the NAFTA has contributed to changing organizational structures as firms move to take maximum advantage of new incentive structures by restructuring their organizations appears to vary by sector and by NAFTA Chapter. For instance, in banking, many of the changes to the structure of firm activity in North America have been driven less by the rules of the NAFTA itself than by a range of other historical trends and exogenous factors apart from the actual Agreement.



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By contrast, the North American auto sector has dramatically restructured its operations in response to a series of trade agreements, starting with the 1965 Canada-U.S. Auto Pact and culminating with the NAFTA's rules governing trade in autos and the critical rules of origin.

Yet, when looking at the auto sector, we are confronted with a series of "chicken or egg" questions involving the interaction of institutional change and firm activity, the most important of which involve understanding how and why institutional change comes about at all. Douglass North posits that institutional change is largely the product of relative factor price changes that create positive returns to institutions and, therefore, institutional change.[417] Left unclear from this formulation are details of the obvious political, social, as well as economic, dynamics leading to institutional change. For the sake of argument, assume that we can demonstrate there were shifts in relative factor prices in the North American auto industry during the 1980s and early 1990s that would lead industry leaders to seek new rules of trade which would reduce the cost of transacting, establishing contractual relations, and would then provide greater certainty for firm activities. At what point are price changes large enough to persuade a range of actors-- political, social, and economic-- to undertake the desired institutional change? At what point do relative price changes become so profound as to induce this kind of change in a single sector across three different countries, each of which has been shaped by different historical forces? Do relative price changes also bring about a kind of symmetry of ideas in terms of the need for institutional change? In a purely domestic context, we

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[417]North, *Institutions, Institutional Change, and Economic Performance*, 84.



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can intuitively understand that structural price shifts in either localized or nationally integrated economies could generate the kind of political pressures for legal changes that we have observed in a number of contexts such as the early mining camps of the American west or the emergence of property rights on western grazing lands.[418] Challenging as such drives for institutional change might be domestically, those challenges are even greater when trying to bring about those institutional changes internationally.

### A Regulatory Chicken or Egg?

It is obvious to anyone who has run a business that regulations, however defined, can be a significant drain on resources. Since regulatory burdens often vary considerably between different jurisdictions, the particular burdens– say in labor, environmental, or tax law– of one jurisdiction relative to another offer the incentives to locate or expand business activity in a particular jurisdiction.[419] In the case of individual business decisions, the causal linkage between regulation and business decision-making seems always to be in the direction of regulation first, then business response to the incentives

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[418]Umbeck, "The California Gold Rush," 197-226; Dennen, "Cattlemen's Associations and Property Rights in Land in the American West," 423-436.

[419]Miles Kahler, "Modeling Races to the Bottom," Paper prepared for delivery to the 1998 Meetings of the American Political Science Association, Boston, MA, September 3-6, 1998; Geoffrey Garrett, "Globalization and Government Spending Around the World," Paper prepared for presentation at the American Political Science Association Meetings, Atlanta, GA, September 1999. A range of interest groups have expressed concerns over the implications of competitive deregulation for the environment and for so-called sun-set industries which allegedly opt to locate where they can take advantage of low-wage production and lax labor or environmental standards in order to cut costs. The research suggests that this phenomenon is not nearly as wide spread as often feared. See also, Dani Rodrick, *Has Globalization Gone Too Far?*, (Washington, D.C.: Institute for International Economics, 1997).



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the new institutional structures provide. In other words, from the perspective of an individual business, regulations simply come into existence, mix with exogenous economic conditions, and force firms to adapt to the new incentive structures they provide.

Since we are applying the lessons of institutions and institutional change to the NAFTA, we might first consider how in-country regulatory differences affect macro-economies before considering whether institutional change under the NAFTA can be considered in the same light. Research strongly suggests that borders matter in economic terms, and are difficult enough to overcome within integrated national economies, much less between sovereign jurisdictions.[420] In the United States, the debate over internal barriers to goods, services, and labor between various jurisdictions was resolved in Article I Section 8 of the U.S. Constitution which confers virtually all authority over international trade and inter-state commerce to the U.S. Congress. If we think of the U.S. Constitution itself as a set of institutions, the simple set of passages in Article I Section 8 have perhaps done more than any other set of regulations or conventions to ensure that the United States is one of the world's most seamless and integrated common markets. By contrast, Canada's constitutional structure, much like the U.S. Constitution, outlines the

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[420]See Daniel Schwanen, "Happy Birthday, AIT!," *Policy Options*, July/August 2000, 51-55; Bruce G. Doern and Mark MacDonald, *Free-Trade Federalism: Negotiating the Canadian Agreement on Internal Trade*, (Toronto: University of Toronto Press, 1999); Charles Engel and John H. Rogers, "How Wide is the Border?," *American Economic Review* 86 (5) (December 1996): 1112-1125; John McCallum, "National Borders Matter: Canada-U.S. Regional Trade Patterns," *American Economic Review* 85 (3) (June 1995): 615-623; John F. Helliwell and Geneveve Verdier, "Measuring Internal Trade Distances: A New Method Applied to Estimate Provincial Border Effects," *Canadian Journal of Economics* 34 (4) (November 2001): 1024-1041; Ceglowski, "The Law of One Price," 373-400; Ceglowski, "Has the Border Narrowed?," 61-75.



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limits of authority granted to each level of government. Yet, Canada's constitutional history has been one characterized by the struggle to integrate each of its jurisdictions into a single, national market, in part, because federalism in Canada grants considerable jurisdictional authority to each of its provinces and territories.[421] As a result, provincial and territorial boundaries represent significant barriers to economic activity across the nation, prevent many of Canada's firms from fully exploiting economies of scale, and have contributed to Canada's struggles to integrate itself politically, socially, and economically. While there are no border measures such as tariffs to impede trade in goods and services, provincial powers over the regulation of health and safety, natural resource use and development, and the environment created a patchwork of differential regulatory and standard setting regimes that have plagued the Canadian polity almost from its inception in 1867. In July 1994, a major effort at resolving some of these internal regulatory barriers to economic activity concluded with the Agreement on Internal Trade (AIT) which brought NAFTA-like rules to internal Canadian trade, complete with dispute settlement mechanisms.[422] By all accounts, the operation of the AIT has fallen well short of expectations and in some areas completely ground to a halt, in part because the Agreement's dispute settlement mechanisms are non-binding.[423] Whether we look at regulation from a micro or macro economic point of view, the questions are the same:

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[421]For example, compare the U.S. Constitution's Article I, Section 8 with the Canada's Constitution Act 1867 Section VI, Articles 92-95, and Part VI, Article 92A of the Constitution Act 1982.

[422]Schwanen, "Happy Birthday, AIT!,"51-55; Bruce G. Doern and Mark MacDonald, *Free-Trade Federalism: Negotiating the Canadian Agreement on Internal Trade*, (Toronto: University of Toronto Press, 1999).

[423]Organization for Economic Cooperation and Development, *Economic Survey, Canada 2003*, 13.



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what drives the process of regulation, de-regulation, or even re-regulation? Why exactly does the interaction of economic conditions, institutional structures, and the incentives they create generate the conditions for economic growth in some periods, while the same institutions interacting with slightly different exogenous economic conditions in another period does not?

When we consider the implications of regulation for economic performance, we are explicitly talking about institutions. But in addition to a kind of "chicken or egg" problem of causation, how are we to understand the process of change in regulatory, and therefore institutional, governance. The work of Hernando De Soto and others rightly point out the many inefficiencies associated with the excessive regulation of an economic system, the negative effects of unspecified property rights, or the high transactions costs inherent in doing business in some countries, in many cases because of the absence of the rule of law in defense of property rights.[424]

While the elimination of government regulation of all kinds could be a panacea to some for stimulating economic growth, the development and function of the welfare state in the postwar period has been a key part of sustaining many liberal, pluralistic democracies.[425] Simply eliminating the rules of the game is not necessarily the answer to economic efficiency and there are numerous examples of patently inefficient economic institutions that endure, often becoming industry standards (ie. keyboard layouts,

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[424]See for example, "Survey of Sub-Saharan Africa, *The Economist*, January 17, 2004.

[425]John G. Ruggie, "Trade, Protectionism, and the Future of Welfare Capitalism," *Journal of International Affairs* 48 (Summer, 1994), 1-11; Greg Anderson, "The Compromise of Embedded Liberalism, American Trade Remedy Law, and Canadian Softwood Lumber: Can't We All Just Get Along?" *Canadian Foreign Policy* 10 (Winter 2003): 87-108.



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Microsoft Windows operating system).

## What About the NAFTA?

Scholars of institutions have focused their work on the impact of institutions and institutional change on domestic or localized economic systems. Those who have studied the impact of trade liberalization tend to take either a macro-level approach to overall economic performance as a result of the liberalization of border measures, or a more micro approach that emphasizes localized adjustment. Left in between, and largely unexamined, rests the role of institutions and institutional change in international trade. It is an approach to the study of the impact of trade liberalization that moves beyond the neoclassical model's blackboard assumptions and analyses of border measures, while at the same time explicitly considering the economic impact of the creation of new rules apart from those that merely eliminate formal barriers to trade. To what degree can the NAFTA, its creation and evolution, as well as contemporary calls for the deepening of the NAFTA, be better understood by looking through the prism of institutions and institutional change?

### Institutions and Wealth Creation

Throughout this study, we have argued that institutions, be they efficient or inefficient, at a minimum provide a kind of certainty to the process of market exchange. As soon as an economy's productive capacity moves beyond self-sufficiency (ie. beyond the case of an autarkic farm economy) and adopts some level of specialization and



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exchange, the need for conventions and norms of behavior within that exchange economy grows along with it. Familial ties to regularize and bring predictability to the process of exchange of specialized production suffice for a time, but, as the neoclassical model suggests, the process of wealth creation depends critically upon the ability to specialize and exchange based upon one's comparative advantage in production. Along with high degrees of economic specialization come greater and greater degrees of productivity and exchange that are critical to the creation of wealth. Institutions, even in many instances inefficient ones, facilitate this whole process by reducing the uncertainty and risk associated with exchange.

In Figure 6.1, we have a schematic of the role institutions play in setting incentive structures, reducing transactions costs, facilitating exchange, and generating economic outcomes. We begin with a simple set of institutions, such as property rights, which, when combined with a range of exogenous political, economic, or social variables, generate the incentive structure within which economic actors make decisions about contractual relationships, external and internal, as well as organizational decisions about the firm itself.



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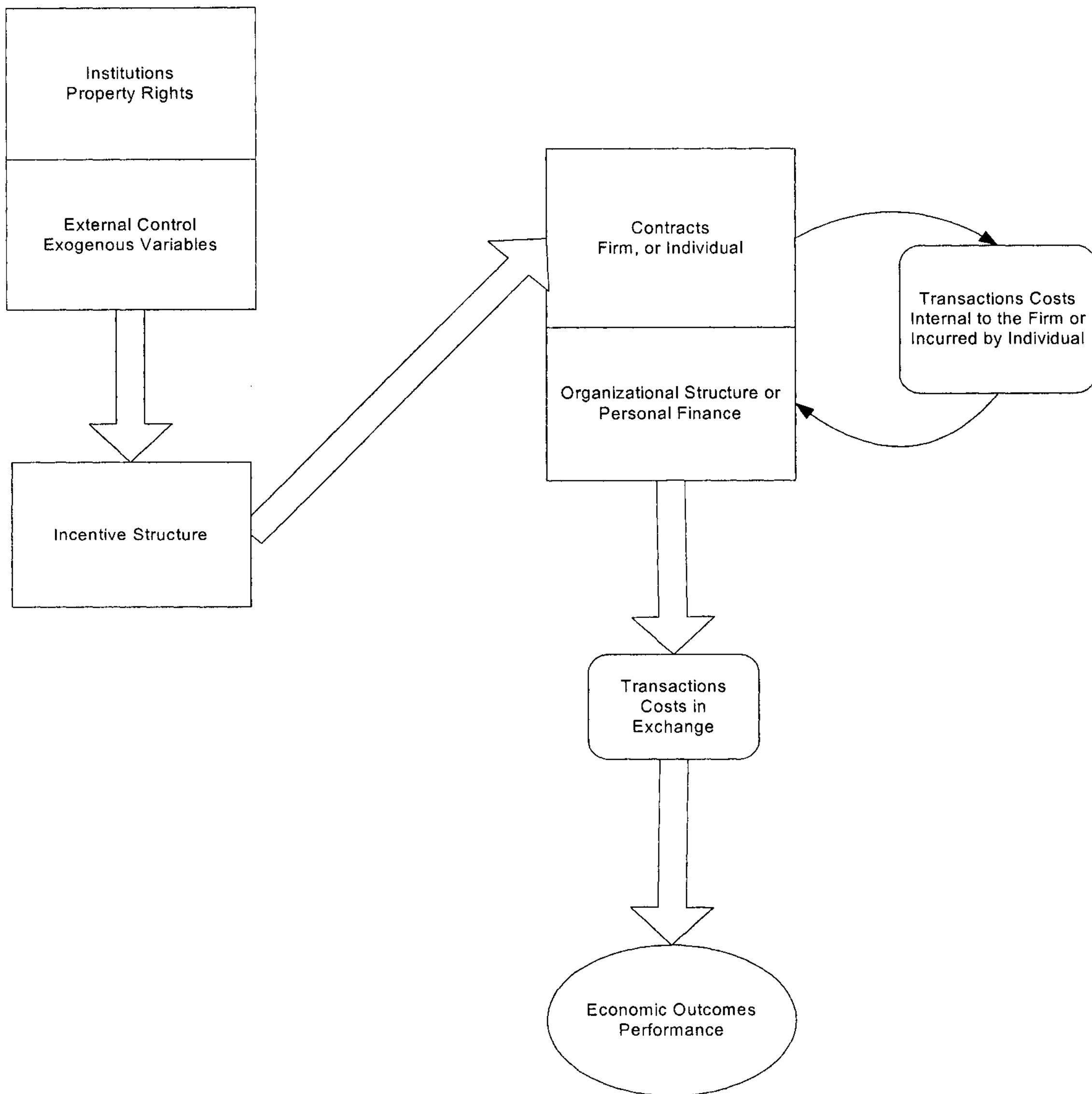
Figure 6.1
Institutions and Wealth
Creation
(Macroeconomic Performance)




At this stage, transactions costs are borne by both firms and individuals and based on boundedly rational perceptions about the world around them, which in turn shape the



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nature of the contractual relationships established to engage in exchange. Recall that contractual relationships are ubiquitous in an exchange economy and range in form from a simple sales receipt, to employment contracts, to the most complex of financial transactions. For firms, in particular, the incentive structure generated by institutions has important implications regarding the organizational structure of the firm itself, and both its internal and external contractual relationships (see Figure 6.2 below). In short, how best should a firm organize itself to utilize its scarce resources? In all of this, there are a range of transactions costs involved in gathering and processing information, settling contractual relations within a firm, between firms, or between individuals in setting out the terms of exchange. However, because of the institutions set in place and the incentive structure they generate for economic actors, the precise nature of the contracts and the costs incurred under each transaction varies as a result. Institutions, by setting the rules at the outset, reduce the uncertainty that would otherwise be associated with this process, help structure the complexity of the information that confronts economic actors, and ultimately shapes economic performance and the creation of wealth. Left largely unaddressed is the question of whether new institutional structures consistently facilitate the creation of wealth, even as they reduce uncertainty in exchange. For instance, property rights may be the institutional building blocks for economic growth, but improperly specified rights can also lead to inefficiency that actually hinders growth.



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## The NAFTA

In Chapter V's treatment of the investment provisions of the NAFTA, I outlined an historical process that largely fits the more abstract process outlined in Figure 6.1. The historical needs of developing countries like Mexico for foreign direct investment capital, coupled with the clash of interests and rights between the holders of private capital and traditional notions of state sovereignty in international relations have led to the creation of institutional mechanisms, such as bilateral investment treaties, that largely circumvent these issues and provide mechanisms for private suppliers of capital to developing countries with uncertain property rights structures to seek compensation in the event their property is expropriated by the state. Chapter 11 of the NAFTA built upon these historical mechanisms by defining the terms under which foreign capital would be accorded national treatment, introduced concepts such as "fair and equitable" treatment under domestic laws, and established a third party arbitration mechanism for pursuing due process in the event of expropriation or state actions tantamount to expropriation.

Chapter 11 of the NAFTA was intended to bring an added measure of certainty to foreign investment in Mexico by establishing a set of rules regarding the treatment of foreign capital. The Agreement has largely done so by helping to overcome uncertainties regarding Mexico's commitment to enforcing the rights of property holders. The incentive structure created by Chapter 11's institutions (rules) has, by many measures, contributed to Mexico's becoming a stable and attractive location for foreign direct investment. However, the institutions of Chapter 11 have also generated a firestorm of criticism because the Agreement's provisions have unexpectedly, but increasingly, been



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used to challenge the regulatory authority of the state in Canada and the United States as well. Through an examination of some of the most important cases the have arisen under the dispute settlement provisions of Chapter 11, we see that the definitions of terms such as "expropriation,""fair and equitable treatment," or "tantamount to expropriation" are in fact still being defined as these cases are being litigated. The absence of precise definition within the NAFTA itself and the cases that have arisen are the subject of grave concerns on the part of non-governmental organizations who fear that judicial interpretation of the meaning of the Agreement may severely limit the ability of the state to regulate in the public interest. However, at a minimum, what we are observing with each Chapter 11 case is that the lack of definition within NAFTA has provided the incentive structure for firms to push the limits of those meanings in an effort to redefine property rights in a manner favorable to firms seeking to reduce their regulatory burdens. If successful in having their property rights under the NAFTA defined in terms that will allow them to challenge state regulatory changes (themselves rules and institutions), such firms may well be able to re-define their contractual relationships, eliminate uncertainties regarding the state's power to regulate their businesses in the future, and reduce some of their current regulation-related transaction costs.

The point is that Chapter 11 of the NAFTA brought about a new set of institutional rules governing foreign direct investment and property rights in North America. In part because of the ill-defined nature (improper or incomplete specification of property rights), the Agreement itself has created incentive structures to which economic actors are responding; albeit with lawsuits. In the Methanex case, for example,



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changes to the definition (or, rather the ill-definition) of property rights under Chapter 11, combined with a California law banning the use of MTBE, provided the incentive structure under which Methanex chose to invoke the provisions of the dispute settlement mechanism. If Methanex ultimately wins its case, it will likely only receive monetary compensation. However, a victory for Methanex could result in profound changes to our notions of private property and the ability of the state to regulate in the public interest that in turn lead to changes in the way firms structure the contractual relationships that govern production by bringing greater certainty to the public regulatory process, reduce transactions costs that arose from uncertainty, and ultimately affect the economic performance of a range of economic actors.

Whether the institutions of Chapter 11, or the NAFTA writ-large, are efficient is important, but so is the function those institutions perform in structuring our decision making. For instance, standard economic theory suggests to us that one of the negative by-products of establishing free trade areas is the potential for trade diversion in which higher-cost, within-area goods and services are exchanged between parties to the agreement rather than traded between those countries (members or non-members) which enjoy real comparative advantages in production. Similarly, a particularly inefficient aspect of free trade areas is the need for cumbersome rules of origin to guard against the extension of area preferences to non-member goods and services.[426] Comprising more than two-hundred pages of the NAFTA, the rules of origin have become a cumbersome drag on efficiency as firms and exporters make efforts to comply with them to ensure

[426]See James and Umemoto, "NAFTA Trade with East Asia," 293-311.



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their products receive NAFTA preferences. Cumbersome though they may be, the rules of origin do, nevertheless, shape the incentive structure that firms confront and around which firms shape their operations. There are ongoing efforts by all three governments to liberalize the NAFTA's rules of origin to make them less cumbersome. Likewise, the unexpected use of NAFTA Chapter 11 in the pursuit of damages resulting from state regulatory changes has led to revisions of these provisions under subsequent agreements like the U.S.-Central American Free Trade Agreement such that private investors will no longer be able to expand the meaning of concepts like most favored nation treatment to seek preferential treatment standards greater than those envisioned by negotiators.

## Institutions and Organizational Structure

In Chapter VI of this study, we examined the relationship between institutional change and internal firm behavior, in reality a sub-component of the process depicted in Figure 6.1 and outlined in Chapter V's discussion of the NAFTA's Chapter 11. More specifically, Figure 6.2 depicts the process internal to the firm that takes place at the contracts/organization phase of Figure 6.1; in essence, the process a firm goes through in adapting to institutional change. In the industries used as examples, financial services and the automotive sector, we wanted to assess how institutional changes in the provisions of the NAFTA would induce alterations in their production activities and firm structure.

In Figure 6.2, we again start with a set of institutions such as property rights or regulatory rules that set the incentive structure around which firms organize, produce, and make contractual arrangements both internal and external to the firm. One of the key



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issues facing a firm is, given the institutional and incentive structure confronting it, exogenous economic factors, and competitive pressures from other firms, how best can a firm organize and employ its scarce resources such that it can realize positive profits? From the known set of organizational structures a firm could adopt (ie. limited partnerships, franchise establishments, centralized decision-making, decentralized decision-making), only a small sub-set of them will flourish given the institutional structure within which they operate. While some flounder and fail, others flourish, and others still engage in a kind of learning-by-doing process of trial and error in which their organizational structures are refined in the face of competitive pressures. Those firms which survive become part of the set of actual organizations and have contractual relationships within (wage rates, unionization, executive compensation) and external to the firm (contracts with suppliers and purchasers) that then generate economic outcomes, hopefully in the form of positive profits. All of this stems from the particular form of institution responsible for setting the incentive structure confronting the firm. Or does it?

The NAFTA

Our examination of the North American banking sector in the context of the NAFTA suggested that while firm strategies and structure in banking have changed in many ways over the past couple of decades, and several firms, particularly Canada's Bank of Montreal, have adopted an explicitly North American strategy through U.S. and Mexican acquisitions, changes to the delivery of financial services have actually been driven by a broader set of global institutional and exogenous factors, not the provisions of



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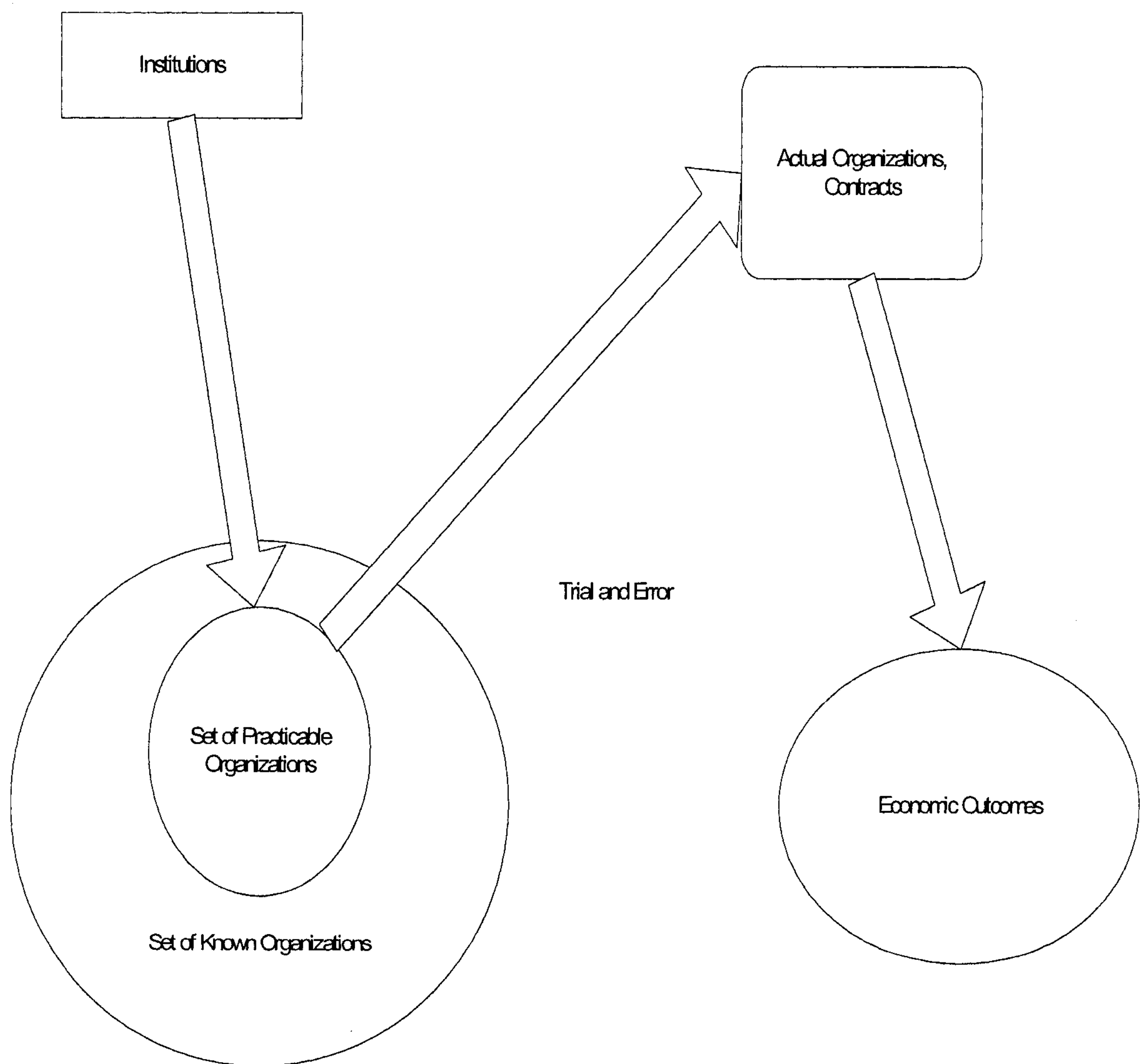
Figure 6.2
Institutions and Organizational
Structure
(The Microeconomics of the
Firm)



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the NAFTA itself. However, the provisions of the NAFTA covering autos were a very different story. If we ignore the history of the North American auto sector and the role played by the auto firms in shaping the contours of the NAFTA's automotive provisions, the chain of events following the implementation of the Agreement looks a lot like that depicted in Figure 6.2. Once the automotive provisions of the NAFTA came into force in January 1994, automotive trade statistics suggest that the Agreement's institutions provided the incentive structure that induced firms to raise production levels and engage in substantially more intra-industry and intra-area trade. In short, if we look only at statistics in the auto sector, it appears that firms are reactionary actors in the process, not active participants. Douglass North, for one, suggests that institutional change is, on the whole, immune from rent-seeking by organizations.

> Maximizing behavior by the firm can take the form of making choices within the existing set of constraints or of altering the constraints... Such maximizing behavior by the firm results from learning by doing and from investing in the kinds of skills and knowledge that will pay off. But an alternative is to devote resources to changing the institutional constraints... Organizations with sufficient bargaining strength will use the polity to achieve objectives when the payoff from maximizing in that direction exceeds the payoff from investing within the existing constraints. But the incremental change in the overall institutional framework is more comprehensive than what happens when organizations devote resources to changing political rules directly to increase profitability.[427]

Yet, the historical evidence surrounding the NAFTA seems to paint a different story, one in which the North American auto sector played a critical role in setting the institutional structures. Part of the problem rests in how we define institutional change. It is hard to quibble with North's argument that national economic performance and the

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[427]North, *Institutions, Institutional Change, and Economic Performance*, 79.



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creation of wealth depend heavily on the broad matrix of institutions that shape and constrain economic activity, that most institutional change takes place at the margins, or that, taken as a whole, rent-seeking organizations seldom have the power to affect wholesale change to institutional structures.[428] North concedes that there are historical periods in which institutional change is particularly dramatic, such as wars, revolutions, or natural disasters; what North calls "discontinuous institutional change."[429] Does the NAFTA rise the level of "discontinuous institutional change?" What about individual provisions of the Agreement, such as Chapter 11 or the auto provisions? Are these incremental or discontinuous? Looked at from a long enough historical perspective, each of these issue areas, as well as banking, could be seen as part of a much longer process of incremental institutional change. But, in terms of the impact institutional change under the NAFTA is having upon matters such as property rights or the evolution of the auto sector in North America, one could just as easily conclude that the NAFTA is a form of discontinuous institutional change. Then again, patterns of institutional change may not be restricted to such linear causation.

The Missing Links?

The historical evidence presented in this study suggests that institutional change in international economic relations is more readily explained as a dynamic process full of response and feedback. Consider the contrast between Figures 6.2 and 6.2.1. In Figure

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[428]Ibid., 68, 78-79, 86-87.
[429]Ibid., 89.



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6.2, we began with a given set of institutions which set the incentive structure within which firms then organize, conclude contracts for production and exchange, and generate economic outcomes; in essence a linear process by which institutions materialize as though generated by government or some other authority. Our historical evidence of the NAFTA negotiations strongly suggests that a range of actors participated heavily in the process of creating the Agreement. Within each of the NAFTA governments, extensive stakeholder consultations were undertaken to evaluate and establish negotiating positions. Firms and industry associations, constituency organizations, environmental and human rights groups, and labor organizations featuring a range of viewpoints all featured prominently in the process. Once the negotiations were underway, the consultative process with stakeholders continued and many industry groups, autos in particular, were never far from the negotiating process. At the microeconomic (firm) level, a dynamic process of institutional change



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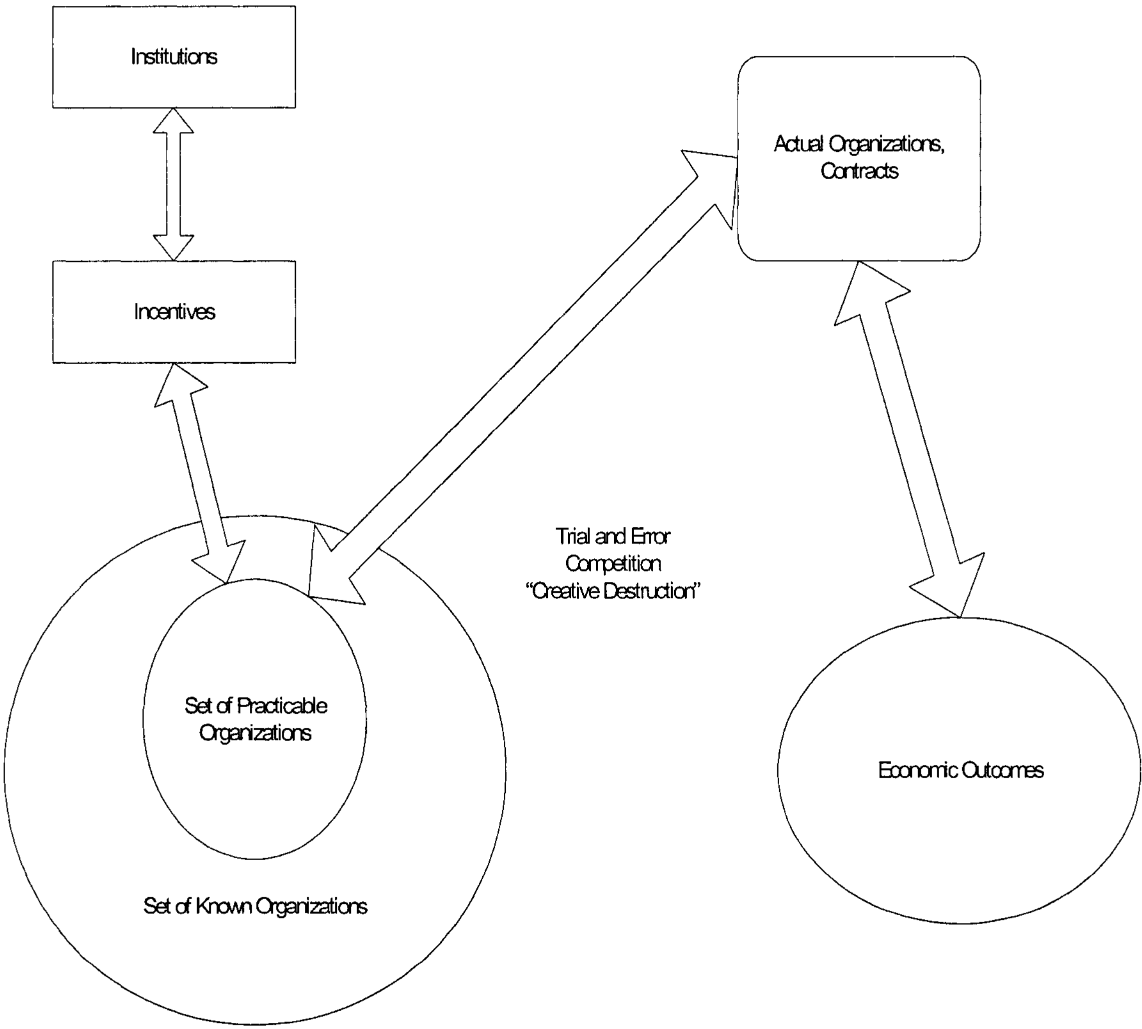
Figure 6.2.1
Institutions and Organizational
Structure
(The Microeconomics of the
Firm)



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might look more like that depicted in Figure 6.2.1 in which feedback starting from adverse economic outcomes or poor firm performance generates the incentive structure to spend more and more resources pressing for institutional change itself. Also missing from the mixture here is the fundamental role of the state in concluding international agreements. While the role of non-state actors in international affairs has been growing, and particularly so in recent years with respect to international trade, the sovereign state nevertheless remains the center piece of the international system.[430] Understanding the role of the state within an institutional framework for analyzing international trade agreements may be the central weakness of this whole approach, an issue taken up in more detail below. We can begin that discussion by looking at institutional change as a dynamic process that involves the state's internal political systems.

## The Dynamics of Institutional Change

Figure 6.3 diagrams the relationships between institutions, institutional change, and economic performance. Importantly, Figure 6.3 more explicitly acknowledges the critical role of domestic political institutions within the framework. We begin again with an existing stock of institutions which set the incentive structure within which economic organizations and households make exchange decisions. Those decisions result in economic outcomes, but also generate feedback about how well, given a range of

[430]The role of the state in the international system is at the center of many debates between realists and interdependence theorists in international relations. See Waltz, "The Stability of the Bipolar World," 881-909; Nye and Keohane, *Power and Interdependence*, (Glenview, IL: Scott, Foresman, 1989); Krasner, "Structural Causes and Regime Consequences: Regimes as Intervening Variables," 1-21; Keohane, *After Hegemony*, (Princeton: Princeton University Press, 1984); Nye and Donahue eds., *Governance in a Globalizing World*, (Washington, D.C.: Brookings Institution Press, 2000).



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exogenous conditions, institutions are facilitating economic exchange, promoting productivity, and stimulating economic growth: we are of course talking about collective action problems. There is a rich and extensive literature on public choice and public choice theory that cannot be recounted in depth here, but is useful here in understanding how public preferences are translated into and interpreted by domestic political systems to generate public policy outcomes.[431] However, in general, dissatisfaction with a particular set of economic outcomes may stimulate demands on the part of these same organizations and households for institutional change (ie. they detect positive returns to institutional change), which are expressed to a nation's existing political institutions (constitutions, legal code) through a range of rent-seeking bodies such as interest groups, political parties, and lobbyists, or through legal challenge, the ballot box, or even public protest.

Rent-seeking activities on the part of organizations and households may, in the short-term, translate into political responses without movement toward the kind of fundamental, broad-based institutional change suggested by Douglass North. At the same time, public or organizational (firm) preferences are eventually reflected in legal rulings or legislative changes that alter the stock of institutions, which re-orders the incentive structure facing organizations and households, resulting in different economic outcomes. Note in Figure 6.3 that the flow from institutions to organizations and households is one

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[431]See Destler, *American Trade Politics*, (Washington, D.C.: Institute for International Economics, 1995); Donald J. Savioe, *Governing From the Centre: The Concentration of Power in Canadian Politics* (Toronto: University of Toronto Press, 1999); More broadly, see James M. Buchanan and Gordon Tullock, *The Calculus of Consent: Logical Foundations of Constitutional Democracy*, (Ann Arbor: The University of Michigan Press, 1962); Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups*, (Cambridge, MA: Harvard University Press, 1971).



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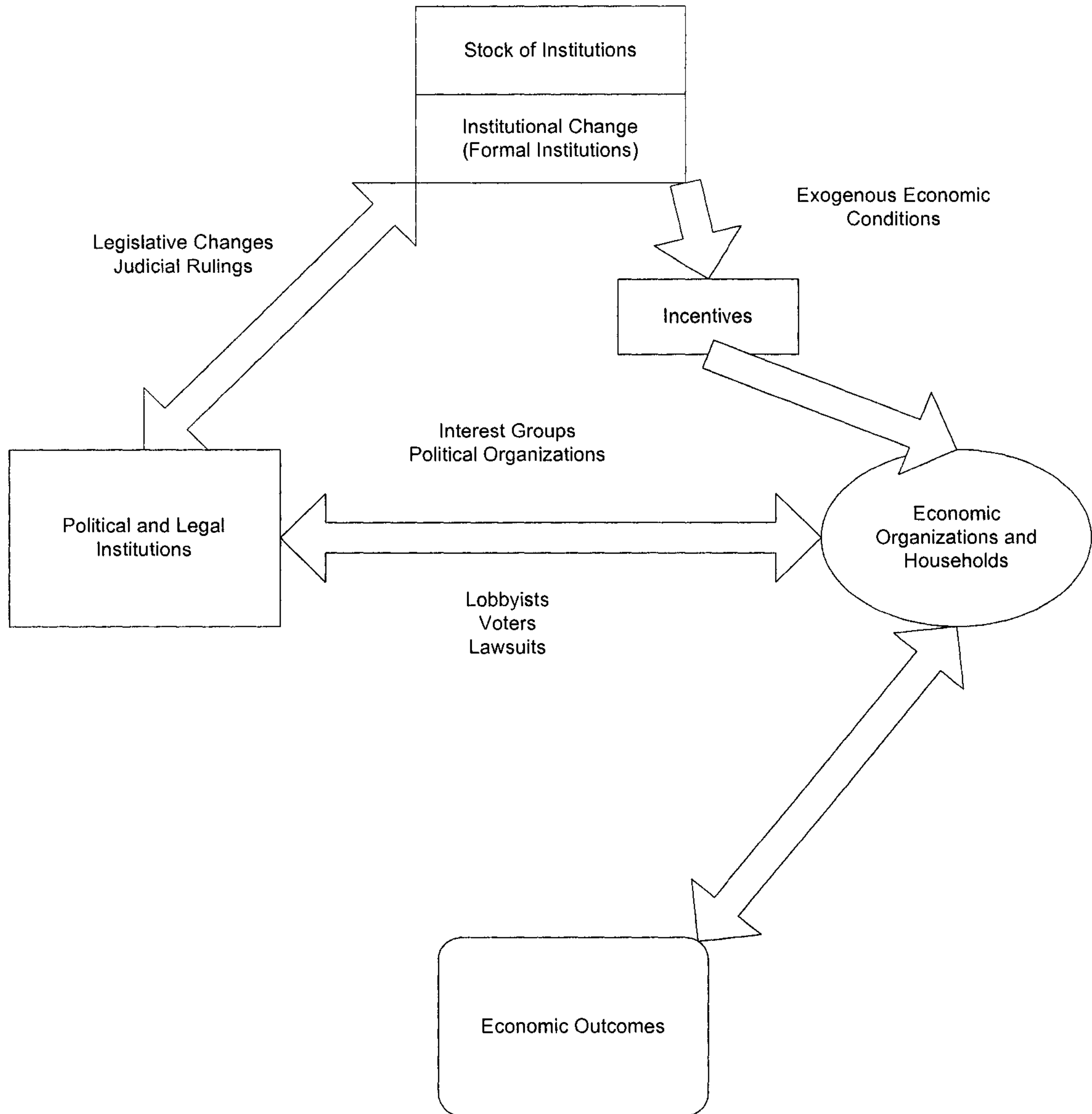
Figure 6.3
The Dynamics of
Institutional Change




directional, largely in keeping with North's argument regarding the difficulty of small groups of rent-seekers to have a fundamental impact on the stock of institutions within a society. Instead, their preferences are expressed through a domestic political apparatus



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that, in systems of representative governance, translate them into new institutional structures.

## The NAFTA

Following Figure 6.3, the evolution of the NAFTA as seen through the lens of institutions might have started as the product of unsatisfactory economic outcomes in the early 1990s. Economic organizations and households would then have pressed for institutional changes to the North American trade policy regime through lobbying, the ballot box, political organizations, or interest group pressure on the political and legal institutions of all three countries which in turn led to trilateral negotiations and institutional change in the form of the NAFTA. There were then, as there are now, organized groups of interests, primarily business organizations, that had long-advocated the conclusion of a new economic arrangement in North America. Yet, the historical evidence strongly suggests that the NAFTA was driven at least as much by political elites as it was by selected interest group pressure. Indeed, recall that in the summer of 1990, it was Mexico's Carlos Salinas de Gortari that formally proposed an agreement with the United States which Canada quickly joined. Support for the negotiations could be found in many quarters in each of Canada, the United States, and Mexico. Yet, it was hardly a groundswell of public support. Organized labor and the environmental community were distrustful of the agreement from the beginning, and insisted on labor and environmental side agreements to win their guarded support. Exporters and manufacturing interests generally saw the Agreement as being in their interests, while import-competing interests



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in all three countries viewed the Agreement as inherently threatening to their futures. In the end, the political battle to win passage of the NAFTA in all three countries, but particularly in the United States, was a bruising affair, one which some scholars have cited as the start of the current popular movement against globalization.[432] At the very least, the broad outlines of the NAFTA suggest that an institutional framework for viewing the NAFTA did not begin with unsatisfactory economic outcomes that generated popular support for institutional change and could not have been the product of the relative factor price changes that have, according to Douglass North, historically generated fundamental institutional change.

While the role of a range of stakeholders in shaping the NAFTA was pivotal, the Agreement was also heavily driven by a remarkable convergence of elite political opinion regarding trade liberalization in the early 1990s.[433] We can also see in Figure 6.3 that the process of institutional change can be generated from the legislative, judicial, and regulatory side as well through changes to political and legal institutions that, as in the case of the NAFTA, themselves have a significant impact on economic outcomes. In fact, the actual path of institutional change leading to the NAFTA may be more akin to Figure 6.3.1 whereby political elites initiate legislative changes that alter the political and legal institutions governing trade in North America.

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[432]Daniel C. Esty, *Greening the GATT*, (Washington, D.C.: Institute for International Economics, 1994), esp Chapter 1.

[433]Greg Anderson, "Hemispheric Integration in the Post-Seattle Era: The Promise and Problems for the FTAA," *International Journal* 56 (Spring 2001): 207-233. See also Judith Goldstein, "Ideas, Institutions, and American Trade Policy," *International Organization* 42 (1) (Winter 1988): 179-217; Judith Goldstein and Robert Keohane, "Ideas and Foreign Policy: An Analytical Framework," in Judith Goldstein and Robert Keohane, *Ideas and Foreign Policy: Beliefs, Institutions, and Political Change*, (Ithica: Cornell University Press, 1993): 3-30.



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The pivotal role of government in helping to set the conditions for positive economic and productivity growth in market economies are well known. It seems reasonable to include a mechanism in the Figure 6.3.1 for elected representatives to alter the institutional matrix of a nation without waiting for a popular uprising of some kind. This particular pattern of institutional change fits well with the NAFTA and a range of other institutional changes that typically take place within countries. Patterns of regulation, de-regulation or rule making in most states suggest that institutional change is not necessarily a bottom-up process driven by fluctuations in relative factor price changes. The contemporary process of trade liberalization itself continues to be heavily government driven, albeit, again with heavy input from domestic stakeholder interests.

While the basic story of institutions and institutional change is one of a long-term process of change to the matrix of institutions that fundamentally influence economic outcomes through the incentives they create, the precise mixture of societal interests and the pivotal role of the state in shaping the institutions of international trade complicates the analysis. Furthermore, by adding a mechanism for institutional change from above (elite driven institutional change) as was done in Figure 6.3.1, we risk making the whole analysis somewhat circular; a kind of hodge-podge approach which essentially says everything is related to everything else. We can take a longer view of institutional change leading to the NAFTA and suggest that the whole process began when Ronald Reagan



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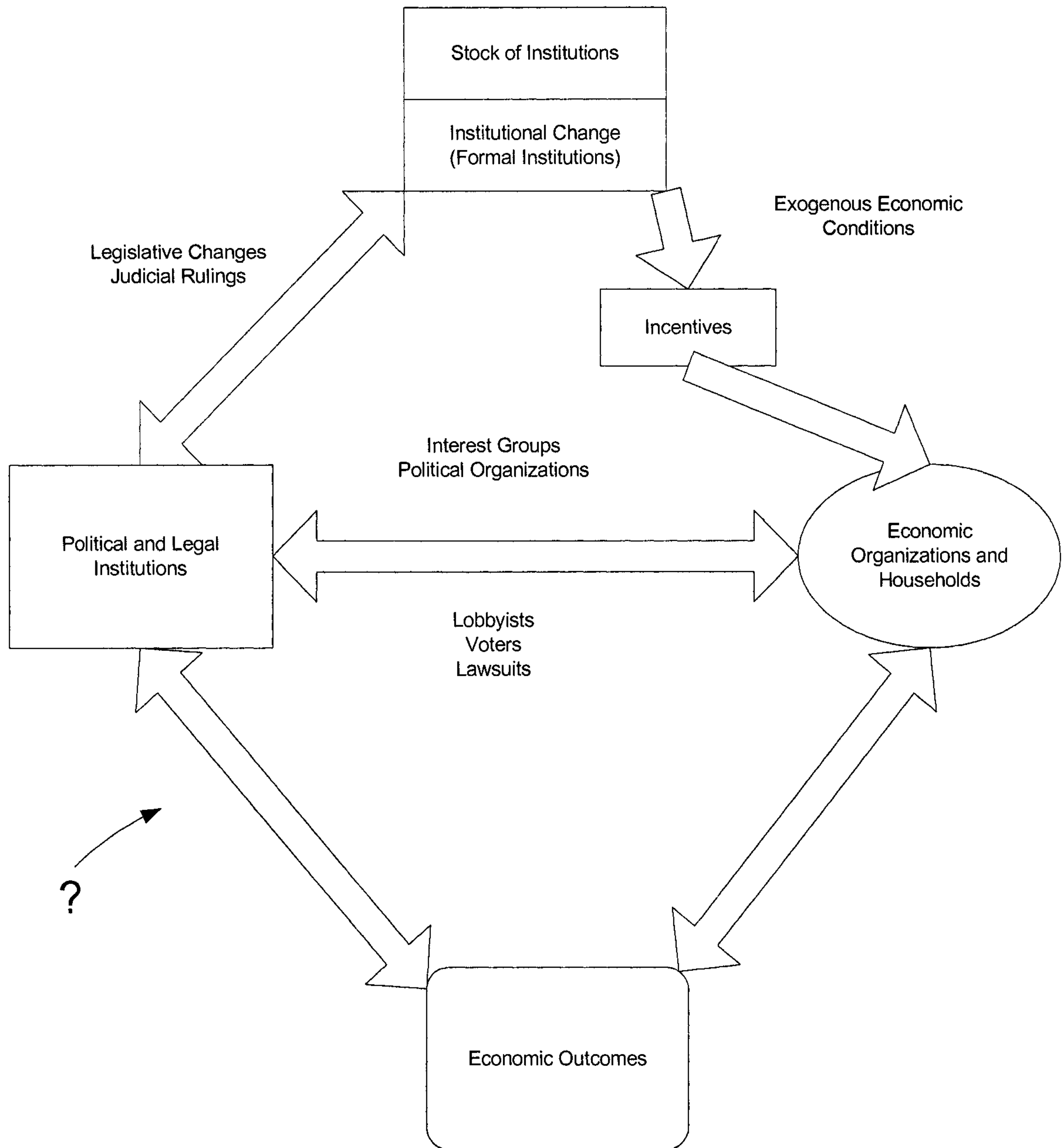
Figure 6.3.1
The Dynamics of
Institutional Change




announced he was running for president in November of 1979 and made vague reference



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to the pursuit of a "North American Accord" as part of his economic platform.[434]

Yet, even if we are able to demonstrate that Mr. Reagan's desire for a "North American Accord" reflected the economic pre-conditions for fundamental institutional change, namely factor price changes that demonstrate positive returns to institutions, the role of the state seriously complicates the analysis of the kind of institutional change we are talking about here in international affairs.

## The State

When we introduce the role of the state into understanding institutional change under the NAFTA, we, in effect, open a kind of Pandora's box of considerations that tap into literatures in international relations, conflict management, and public choice, each of which are each too extensive to exhaustively recount here. Instead, this section will highlight some of the issues that future work in this area will need to confront if an institutional approach to understanding the emergence of the NAFTA and similar agreements is to have increasing utility along side the neoclassical model as a framework of analysis.

### The Domestic State

There are several ways in which we can think about the role and purpose of the state from an economic point of view. In simple terms, we can think about the state as a

[434]When he announced he would run for president in the 1980 campaign, Ronald Reagan outlined parts of his platform, part of which called for a "North American Accord." See *New York Times,* November 14, 1979.



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kind of contractual arrangement between rulers and the ruled in which physical protection from external threats and the defense of a set of internal property rights by the ruler are exchanged for loyalty, obedience, and often a certain level of taxation on the part of the ruled. We can also think about the state as the manifestation of public preferences in the form of a set of constraints and obligations embodied in formal laws and expectations regarding informal customs and behavioral patterns, all of which are placed upon one another for the collective good.[435] Several studies of the state from the point of view of institutions and institutional change have examined the role of federalism as an institutional structure in supporting open markets,[436] the impact of institutions within legislative bodies in setting patterns of legislative rent distribution,[437] and, of course, the role of national constitutions in setting both economic and political relationships between the public and their representatives in government; the classic principal-agent relationship.[438] Yet, it is with principal-agent formulations of public choice by institutionalists that we begin to run into problems in dealing with the state in relation to institutional change under international agreements like the NAFTA. Most studies of institutions and institutional change, including those cited above, are focused almost entirely on domestic institutions. Some are modeled on descriptions of changes to the

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[435]See Douglass North, *Structure and Change in Economic History* (New York: Norton, 1981), 23.

[436]Barry Weingast, "The Economic Role of Political Institutions: Market-Preserving Federalism and Economic Development," *Journal of Law, Economics, and Organization* 11(1) (1995):1-31.

[437]Weingast and Marshall, "The Industrial Organization of Congress,"132-163; Kenneth A. Shepsle and Barry R. Weingast, "The Institutional Foundations of Committee Power," *The American Political Science Review* 81 (1) (1987): 85-104.

[438]Douglass North and Barry Weingast, "Constitutions and Commitment: The Evolution of Institutional Governing Public Choice in Seventeenth Century England," *Journal of Economic History* 49 (4)(1989): 803-832.



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basic agency relationship between elected representatives and their constituents. In these studies, the constituents, as principals, elect agents to represent them in government. In one formulation, a nation's constitution represents a kind of relational contract between principal (the voting public) and agent (elected officials) to act on their behalf in a nation's political bodies within the parameters of the constitution. However, as Terry Moe has argued, many efforts by organizational theorists and institutional scholars have focused too narrowly on legislative bodies and assumed this kind of simplistic agency relationship, either between voters and legislators or between the legislators themselves in the allocation of committee jurisdiction and power.[439] The principal-agent relationships outlined within these studies have a key flaw; the principals and agents are specified exactly opposite to the way they operate in practice. Specifically, when thinking about the functions of the state, it is the agent (legislator, president) who is often in effective control, not the principal (voters). Public authority, even in democratic systems, is effectively in the hands of the agents because their accountability to the public wanes between election cycles. In practice, it is the agents who write laws, create new regulations, and spend tax dollars, much of it without a direct mandate from the voter, or principal. As Moe further notes, the actions of agents under the standard agency models are a far cry from that which could be reasonably described as shirking– "the agents are in charge, setting the structure, exercising control, taking steps to ensure that the principals

[439]Terry M. Moe, "Politics and the Theory of Organization," *Journal of Law, Economics, and Organization* 7 (1991):118-119; Terry M. Moe, "Political Institutions: The Neglected Side of the Story," *Journal of Law, Economics, and Organization*, 6 (1990): 215-216.



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comply with their wishes. The tables are turned."[440] In essence, the role of principal and agent, in practice, is exactly backwards.

The problem is that, unlike economic institutions such as contracts which involve voluntary and mutually beneficial cooperation between principal and agent, it is more difficult to understand political institutions in the same light of voluntary participation and mutual benefit.[441] If we are going to understand how political institutions such as the structure of public bureaucracies or legislative assemblies affect political outcomes, much as economic institutions affect economic outcomes, there needs to be greater attention paid to the intricacies of institutional change to political institutions. The NAFTA is not only an economic agreement, it is also widely thought of as a political one as well.[442] Moe raises several important questions that are critical for understanding how the NAFTA, as the product of a public deliberative process filtered through political institutions, was created and can be understood. In particular, Moe argues that because political exchange is not mutually beneficial in the same way economic exchange is, politics is inherently about winners and losers. However, while the winners at any particular time may be able to design institutional arrangements that favor their interests, the design of institutions nevertheless frequently incorporate many of the interests of the losers out of the pragmatic recognition that political fortunes may one day be reversed.[443] We need a more sophisticated approach to the incorporation of the role of preferences in the design of both

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[440]Moe, "Political Institutions," 233.

[441]Moe, "Political Institutions," 221.

[442]Paul Krugman, "The Uncomfortable Truth About NAFTA: It's Foreign Policy, Stupid," *Foreign Affairs* 72 (5) (November/December 1993): 13-19. Joseph Stiglitz, "The Broken Promise of NAFTA," *New York Times*, January 6, 2004.

[443]Moe, "Political Institutions: The Neglected Side of the Story," 229-230, 234-235.



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political and economic institutions. As Moe suggests, legislators are not the direct conduits of public preferences, but rather have their own preferences, and work within party and legislative structures that shape political outcomes.[444] Interest group approaches to understanding the NAFTA need additional work along these lines as well. For instance, the legislation implementing the NAFTA in the United States has been resoundingly attacked by anti-globalization groups as being the product of interest group politics that forced the Clinton Administration to make numerous promises to legislators on Capitol Hill in order to secure their votes in favor of the Agreement.[445] Yet, we also know from work on interest group politics that the dynamics of interest groups and their role in political and economic life is not clear cut in terms of the degree of their influence or unanimity of view point. For instance, the work of the economist Mancur Olsen argues that while interest groups often wield significant power in democratic political systems, their membership is more readily explained by the side benefits individuals reap from them rather than the collective goals of the organization itself.[446]

The Foreign Policy State

However, even if we are able to understand the NAFTA's evolution within the domestic sphere, something that is in need of much more research, there is still the international side of the equation. As with the domestic state, we can look in fairly

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[444]Ibid., 236-238.

[445]See for example, Public Citizen, Global Trade Watch, NAFTA and Democracy, at http://www.citizen.org/trade/nafta/votes/.

[446]Olsen, *The Logic of Collective Action*, 132-167.



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simplistic institutional terms at the NAFTA and argue that it is merely a relational contract between states. While there has been considerable scholarly research into the growing role of non-governmental organizations in international affairs along with the rise of terms like globalization, interdependence, and multilateralism, the state remains the primary actor under international law and in international affairs more broadly.[447] Looking at the NAFTA in terms of it being a relational contract between states advances this line of thinking; the NAFTA as a contract between states, enforceable under international law. The complication is that in the NAFTA we are trying to describe a relational contract between three sovereign national governments, each of which has their own domestic institutions and processes through which preferences are both shaped and expressed. International relations theory tends to personify many of the characteristics of the state, in some ways over-simplifying the process by which states arrive at foreign policy positions. Each state has their acknowledged foreign policy apparatuses and decision making processes, but the state itself is too often thought of as a unitary body with assumed preferences and goals that then compete with those of other states much as two individuals might compete with one another in a game of chess.

Both international relations theory and research in conflict management can tell us a lot about the process and dynamic of international negotiations and conflict resolution, but in trying to adopt an approach to understanding the NAFTA that focuses on institutions and institutional change, as we have here, there needs to be a bridge between

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[447]Even the newly created International Criminal Court, whose mandate is to hold individuals accountable for international human rights abuses, relies largely upon the support and sanction of states within the international system for its legitimacy.



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the analysis of institutional change domestically and internationally. Within the literature on institutions cited in this study, none of it focuses on applying the lessons of institutional economics to institutional change in international relations. There are studies on the development of localized property rights, principal-agent models in legislative bodies, even broad accounts of the impact of constitutional structures on national economic performance. But to date, there has been precious little work done in applying these lessons to international relations. If scholars of international relations are at all guilty of focusing some of their research too narrowly on "billiard-ball style models" of state behavior within the international system to the detriment of any consideration of domestic influences, institutional economics has done the opposite by focusing their work too narrowly on domestic institutional change without giving due consideration to how institutional change comes about internationally as well.

Figure 6.3.1 represents a reasonable expression of the pathways of institutional change in the domestic sphere. Yet, when considering the NAFTA from this point of view, three separate diagrams– one for each country's domestic process– are needed, combined with additional research into the international linkages that then translate each domestic process into broad based international institutional change such as that we now have under the NAFTA.

### The NAFTA as a Trilateral Contract...Really?

Back in Chapter V, I referred to the NAFTA as a kind of trilateral relational contract between Canada, the United States, and Mexico. Viewing the NAFTA in this



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light provides interesting insights into the ongoing relationship between the three parties and fits well with the basic neoclassical view of the state itself advanced above. If we view the state as the product of a kind of contractual relationship between principles and agents, or the ruled and rulers, that yields insights into domestic policy processes, we ought, in principle, to be able to apply this same kind of contractual reasoning to international affairs. In a range of areas, we can. Once in place, international agreements like the NAFTA can easily be viewed as contracts between states, enforceable under the rules of international law. However, as our discussion of the dynamic of institutional change has suggested, looking at the NAFTA simply as a trilateral contract may be more complicated than this.

Although international law fails to provide the kind of contractual enforcement mechanisms available to domestic contractual parties, based as it is on principles of sovereignty and reliance upon principles like *pacta sunt servanta* (see Chapter IV), most of the post-contractual enforcement issues we might find between individuals also beleaguer states. How do you design mechanisms for monitoring against post-contractual opportunism? What enforcement mechanisms can be designed into an agreement? What mechanisms will be invoked should a party breach the agreement? Will there be sanctions for such a breach? How will they be enforced? What role will investment specificity between parties play in extending their cooperative arrangement into the future and how will that influence the distribution of rent between them? Unfortunately, institutional economics and a contracts view of international affairs have failed to add significantly to our existing knowledge of agreements like the NAFTA than those that have come from



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other disciplines such as international relations or conflict management. Scholars in these disciplines are just as interested in questions about how international regimes come into being, how they operate, are supported, and, of course, why the fail.[448]

For example, we can view the NAFTA as a contract, but how far can a theory of contracts take us in understanding state-to-state relations when such an approach tends to treat states in much the same way contract theory treats firms in a domestic setting? At a minimum, we must adopt a more complex view of the state in establishing inter-state contractual relations, much as the theory of the firm has begun trying to explain the nature of the modern corporation in which the ownership of the firm is quite separate from the agents (often mid-level management) who make operational decisions.[449] Separation and control issues do not materialize when talking about contractual relations between firms with single owners, such as small businesses. However, in larger, multi-divisional firms, many of which have widely variant ownership structures, and therefore internal decision-making apparatuses, there are at least two tiers of contractual principal-agent relationships; one between investors and corporate headquarters and another between corporate headquarters and the firm's divisions. All of this complicates the basic contractual relations view of the firm, as it does for a contractual view of the state in international relations. If we think of the state as a large corporation, the agents of the state who negotiate agreements like the NAFTA are analogous to middle management in

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[448]See for example, A.T. Kronman, "Contract Law and the State of Nature," *Journal of Law, Economics, and Organization* 1 (1985): 5-32; Axelrod and Keohane, "Achieving Cooperation Under Anarchy," 226-254; Oye, "Explaining Cooperation Under Anarchy," 1-24.

[449]See Patrick Bolton and David S. Scharfstein, "Corporate Finance, the Theory of the Firm, and Organizations," *Journal of Economic Perspectives*, 12 (4) (Autumn, 1998): 95-114.



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terms of the operational control over trade policy which then is largely separate from oversight and review by the public, who are ostensibly the principals in the relationship. In short, viewing the state as a party to a contractual relationship yields insights into the operation of the NAFTA, but only insofar as the state can legitimately be seen as the product of a standard principal-agent relationship in which the agents (government negotiators) are sent on behalf of the principals (the voters).Yet, we have seen that, like the multidivisional firm, the agency relationship within the state is often one in which ownership (the principal) is often quite separate from control (management).

## The Theory of the Firm and Quebec

In Chapter IV, we suggested that firms respond to the incentive structures which institutions and institutional change generate. We began with the Coase's inquiry into the nature of the firm, largely following his assertion that firm size will largely be dictated by whether or not additional economies can be realized through internalizing market-based transactions. This line of reasoning is the basis for the present day controversy over outsourcing, as well as the more common and traditional considerations of mergers and acquisitions. As the cost of contracting for inputs in the open market rises, so the Coase Theorem holds, the incentives for internalizing many of those costs through a merger or acquisition of that supplier rises. Internalizing market-based transactions costs serves to reduce all kinds of uncertainty about the market– everything from information discovery to imperfections in the information to the potential for "hold-up" costs because of contractual disputes– by bringing those transactions "closer to home" where such things



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as monitoring against opportunistic behavior on the part of agents is more easily done. [450] Likewise, when a range of transactions are more cost-effective if contracted in the open market, the reverse can take place and outsourcing of various firm activities makes more sense.

While a basic contracts approach to the NAFTA is useful in understanding elements of the Agreement, the transactions cost approach to the theory of the firm also yields several important insights into what we now observe taking place within the NAFTA area. Specifically, the theory of the firm's emphasis on internalizing transactions costs through integration of firm functions under one roof is similar in logic to the basic neoclassical trade theory view behind the integration of markets. In the same way a firm might seek to bring more and more of its functions under one roof to get the factors of production to operate more seamlessly, the legal and regulatory institutions of national economies are analogous to the efforts of a firm to economize and take advantage of economies of scale through the internalization of transactions costs. The United States, for example, is a collection of sub-federal entities that has, through the evolution of its constitutional, legal, and regulatory structure, become one of the most integrated, seamless, single markets in the world. The European Union has for much of the past half century tried to knit its various entities together in a similar fashion. We may refer to the U.S. or European Union as common markets or as single monetary areas, respectively,

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[450]See Patrick Bolton and David S. Scharfstein, "Corporate Finance, the Theory of the Firm, and Organizations," 95-114. Bolton and Scharfstein recount this logic as part of the basic line of reasoning behind the Coase Theorem, but challenge the simplicity of the Theory in reexamining the well-known example of General Motor's acquisition of Fisher Auto Body in 1926.



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but the principle behind the integration of markets is essentially the same as that behind mergers and acquisitions at the level of the firm: reduce those frictions internal to the national border that hinder economic activity to take maximum advantage of economies of scale available within the nation-state. In essence, generate the kind of institutional structure, internal to the country (ie. internal to the firm) that facilitates, rather than hinders, the process of exchange, and therefore also stimulates economic development. As we have emphasized throughout this study, such institutional structures are found in many places and include both formal rules, such as laws, regulations, and treaties, and informal rules, such as customs and accepted practices, many of which are eventually embodied in formal rules. Hernando de Soto has powerfully demonstrated what sorts of development challenges dysfunctional institutional structures present for a country, yet nearly all countries confront them in varying degrees.[451]

If we accept the logic of the Coase Theorem in terms of the rationalization of transactions costs as applicable to integration of both firms and countries, we have to confront the possibility that as international institutional structures like the NAFTA shift incentives and alter patterns of economic activity, that those incentive structures might actually be sowing the seeds for reconstituting the nation-state. We might ask whether agreements like the NAFTA could be the source of a kind of outsourcing of the nation state whereby transactions that were carried out within a state are now more cheaply done between states as a result of institutional change? If the state, like a multi-divisional firm, discovers that the transactions between sub-federal entities that had for many years been

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[451]de Soto, *The Mystery of Capital*, (New York: Basic Books, 2000).



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internalized nationally were simply too costly, why not "outsource" many of them to the open market? Why not allow inefficient, or costly provinces freely contract in the open market, much like a firm would compel inefficient divisional units to do?

At first blush, Canada looks like a great candidate for a kind of outsourcing of the central state, something Canadian nationalists have long feared would be the result of free trade with the United States.[452] Canada's history is largely a story of the struggle to unite a vast, but sparsely populated, geographical area together into a coherent economic and political unit.[453] Integrating the Canadian economy and ensuring that east-west patterns of economic activity augmented the strength of the Canadian polity has been expensive and often involved explicit forms of import substitution and other industrial policies. Canada is deeply tied both economically and politically east to west, but both the Canada-U.S. Free Trade Agreement and the NAFTA have dramatically transformed significant portions of the Canadian economy that once flowed east and west into more regional patterns that now flow north and south into and from the United States.[454] Whereas only

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[452]See Hurtig, *The Vanishing Country*, (Toronto: M&S, 2002); Hurtig, *At Twilight in the Country*, (Toronto: Stoddard, 1996); Clarkson, *Uncle Sam and Us*, (Toronto: University of Toronto Press, 2002); see also Charles F. Doran, *Why Canadian Unity Matters and Why Americans Care: Democratic Pluralism at Risk*, (Toronto: University of Toronto Press, 2001), 131-32.

[453]See Chapter IV as well as Norrie, Orwam, and Herbert Emery, *A History of the Canadian Economy*, (Scarborough, ON: Nelson Thompson Learning, 2002), especially Chapter 11; See also, John M. Munro, "Transportation and Canadian Nationalism," *Canadian Review of Studies in Nationalism* 7 (1) (1980): 88-106; J.C. Hebert Emery and Kenneth J. McKenzie, "Damned If You Do, Damned If You Don't: An Option Value Approach to Evaluating the Subsidy of the CPR Mainline," *Canadian Journal of Economics* 29 (2) (May 1996): 255-270.

[454]There is some controversy over this issue. Trade theory and the research into the impact of borders on economic activity cited above suggests that as tariffs and other border measures are eliminated, we ought to see increased flows of goods and services across national borders, possibly reorienting regional patterns of trade. Since the advent of the CUFTA, growth in Canada-U.S. trade has considerably outstripped growth in Canada's inter-provincial trade. In fact, Canada's east-west goods trade dropped from 93 percent of its north-south trade in 1988 to 52 percent in 1996. Studies agree that internal trade intensity remains much higher than regional trade between provinces and states, but those patterns did change under the CUFTA and NAFTA. See John F. Helliwell, Frank C. Lee, and Hans Messinger,



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twenty years ago, the U.S. share of Canadian exports was roughly 70 percent, in 2002 it was more than 87% and was responsible for more than 40 percent of Canada's GDP.[455] The 1994 Agreement on Internal Trade was modeled on the NAFTA, complete with dispute resolution mechanisms, and aimed at doing for Canada's internal commercial activity what the NAFTA did for national borders in terms of reducing impediments to flows of goods and services. The results have been mixed, and Canada's internal trade continues to be hindered by a less than fully integrated national economy.[456] This state of affairs is partially due to Canada's constitutional structure which confers specific powers to the provinces over natural resources, education, and health that at best require extensive consultations between federal and provincial authorities, and at worst boil over into open conflict over policy. Canada's restless French population has twice held referenda on separation from Canada, and Canada's restive Western provinces, led by Alberta, frequently flout federal leadership emanating from Ottawa while periodically spawning their own brand of separatism.[457] In recent years, federal-provincial efforts at

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"Effects of the Canada-United States Free Trade Agreement on Interprovincial Trade," Industry Canada, *Perspectives on North America Free Trade Series*, April 1999; James A. Brox, "Changing Patterns of Regional and International Trade: The Case of Canada Under NAFTA," *The International Trade Journal* 15 (4) (Winter 2001): 383-407; Mario Polese, "Is Quebec Special in the Emerging North American Economy?," *Canadian Journal of Regional Science* 23 (2) (Summer 2000): 187-212; Ceglowski, "Has the Border Narrowed?," 61-75.

[455]Source: Canada, Department of Foreign Affairs and International Trade and Statistics Canada, "Provincial Pocket Facts."

[456]See Daniel Schwanen, "Happy Birthday AIT," 51-55; See also Doern and MacDonald, *Free-Trade Federalism: Negotiating the Canadian Agreement on Internal Trade*, (Toronto: University of Toronto Press, 1999).

[457] Charles F. Doran, "Will Canada Unravel?" *Foreign Affairs* 75 (5) (September/October 1996): 97-109; Roger Gibbins, "Western Canada: 'The West Wants In,'" in Kenneth McRoberts ed., *Beyond Quebec: Taking Stock of Canada* (Peterborogh, ON: Broadview Press, 1995):45-60; Stephane Dion, "Explaining Quebec Nationalism," in R. Kent Weaver ed. *The Collapse of Canada?* (Washington, D.C.: The Brookings Institution, 1992): 77-121.



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policy harmony have resulted in the progressive devolution of more and more responsibilities from Ottawa to each of Canada's provinces, ones that provinces like Quebec and Alberta are only too happy to accept while also demanding additional policy autonomy.[458]

We have plenty of evidence that both national and provincial political borders have a significant impact upon economic activity, and that national borders have a greater impact than provincial borders in the Canadian context.[459] Much of this same research also demonstrates that provincial borders are having an important negative impact on the kind of price convergence we ought to see in a fully integrated national market.[460] We also know that location and distance are major factors determining flows of international trade between markets.[461] In fact, using data from the late 1980s, John McCallum demonstrated that prior to the Canada-U.S. Free Trade Agreement, Canadian economic activity was solidly rooted in flows east and west across the country. However, using a basic gravity model McCallum estimates that with the advent of the CUFTA, the pull of

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[458]Alan Cairns, "The Electoral System and the Party System in Canada," *Canadian Journal of Political Science* (1) (1968): 55-80; R. Kent Weaver, "Electoral Systems and Electoral Reform in Canada," in Matthew Shugart and Martin Wattenberg eds., *Mixed Electoral Systems: The Best of Both Worlds*, (New York: Oxford University Press, 2000): 1-47; J. Stephan Dupre, "The Workability of Executive Federalism in Canada," in Herman Bakvis and William M. Chandler eds., *Federalism and the Role of the State* (Toronto: University of Toronto Press, 1987): 236-258; Kathy L. Brock, "The End of Executive Federalism?," in Francois Rocher and Miriam Smith eds., *New Trends in Canadian Federalism* (Peterborough, ON: Broadview Press, 1995): 91-108.

[459]Engel and Rogers, "How Wide is the Border?,"1112-1125; McCallum, "National Borders Matter," 615-623; Helliwell and Verdier, "Measuring Trade Distances,"1024-1041; Ceglowski, "The Law of One Price: Intranational Evidence for Canada," 373-400; Ceglowski, "Has the Border Narrowed?," 61-75.

[460]Ceglowski, "The Law of One Price," 373-400; Helliwell and Verdier, "Measuring Trade Distances," 1024-1041.

[461]Krugman, "On the Relationship Between Trade Theory and Location Theory," 110-122; Engle and Rogers, "How Wide is The Border," 1112-1125; John McCallum, "National Borders Matter," 615-623.



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north-south regional markets would generate a marked shift in commercial flows away from Canada's traditional east-west orientation with a greater focus on north-south flows even while the Canada-U.S. border continues to have a major impact on trade flows.[462] Patterns have since largely confirmed these predictions as the Canadian economy orients more and more of its GDP toward the U.S. market.[463]

Put this way, Canada seems like an comparatively high transactions cost country. Could new institutional structures, such as the NAFTA, that shift the incentives for internal integration, not undermine the institutional foundations of the state itself? Quebec sovereigntists frequently argue that an independent Quebec could survive quite nicely on its own because it would inevitably, if not automatically, become a full fledged partner in the NAFTA and that the provisions of the Agreement would preserve Quebec's market access rights in both the United States and English Canada. In essence, Quebec could achieve political autonomy from Ottawa, while preserving its economy. There has been no shortage of debate over the viability of such a plan, but in many sovereigntist quarters, support for free trade in North America has been premised on the notion that the NAFTA will help the province sustain its economy. Economic theory suggests that as the importance of borders declines, we will see more and more economic activity flowing across those borders. But as economic integration deepens between national economies, ever greater degrees of political integration may not be far behind. At the same time the

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[462]McCallum, "National Borders Matter," 616-617, 622.

[463]See Helliwell, Lee, and Messinger, "Effects of the Canada-United States Free Trade Agreement on Interprovincial Trade;" Brox, "Changing Patterns of Regional and International Trade," 383-407; Polese, "Is Quebec Special in the Emerging North American Economy?," 187-212; Ceglowski, "Has the Border Narrowed?," 61-75.



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institutional rules of the NAFTA are generating new incentives for deeper economic and political integration, they are slowly reshaping the political and economic logic behind the integration of national economies themselves.

That said, Quebec sovereigntists would be premature in thinking that the NAFTA, and a range of other phenomena associated with globalization, are rapidly making the political bonds of the nation-state irrelevant. Even as free trade has reoriented more of the Canadian economy toward the United States, the importance of inter-provincial trade flows to Canadian prosperity remains pivotal.[464] Were the Canada-U.S. border to decline in economic and political terms, perhaps even disappear completely, the economic logic of east-west integration in terms of economizing on transactions costs might shift dramatically toward the eventual political disintegration of Canada– possibly a happy day for Quebec sovereigntists. Yet, a post-independence Quebec would face much "thicker" international borders, even with membership in the NAFTA, than it now enjoys in its trade with other provinces. In fact, since the terrorist attacks of September 11, 2001, an argument could be made that as a result of new security measures put in place since, the border has actually become an even more prominent factor in cross border commercial flows. In addition, when looked at from the point view of the theory of the firm, the rational for outsourcing of the Canadian state might equally be applied to Quebec itself.

In the completely border-less world of economics, which is really to say a zero transactions costs world, we ought to be able to freely contract in the open market for

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[464]Helliwell, Lee, and Messinger (1999) in particular estimate that interprovincial trade intensities remain13 times higher than those between U.S. states and Canadian provinces, although that is down considerably from the 18 to 20 times higher in the period prior to the CUFTA.



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everything, thereby eliminating the incentive to integrate. At that point, the size of a country, just like the size of a firm (indeed the purpose of a firm) should not matter because most conceivable functions of the state could be instantly and costlessly contracted in an open market setting. Yet, since we do not live in such a world, consider some of the issues identified by Alberto Alesina and Enrico Spolaore with respect to the size and number of countries in the international system that generate incentives for integration or disintegration. At the same time political openness and market size allow a state to take advantage of economies of scale through integration, these political forces also tend to make the management of heterogeneous populations more difficult, generating incentives for disaffected groups to secede.[465] Too many such small countries– or in terms of the Theory of the Firm, too much outsourcing– may generate too much inefficiency and too many transactions costs in international markets. In other words, there may come a point in which the openness and democracy that generate pressures for dessagregation of the nation state could swing the other direction and provide incentives for the re-integration of many small nation-states back into larger ones.[466]

Doran argues this exact point in demonstrating that among advanced industrial countries a size/growth threshold exists in which per capita income growth rates increase very rapidly for small polities and then suddenly reach a threshold after which increasing size seems less and less important.[467] In fact, Doran estimates that beyond a population

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[465]Alberto Alesina and Enrico Spolaore, "On the Number and Size of Nations," *The Quarterly Journal of Economics* 112 (4)(November 1997): 1027-1056.

[466]Alesina and Spolaore, 1029.

[467]Charles F. Doran, *Why Canadian Unity Matters and Why Americans Care: Democratic Pluralism at Risk*, (Toronto: University of Toronto Press, 2001), 162-66, 177-80.



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base of between 25 and 30 million people (an obvious indicator of the size depth of a domestic market place), fewer additional opportunities for economies of scale exist, and therefore per capital income growth rates level off. [468] The converse of this argument is that a small polity of less than 25 million people (such as Quebec with roughly 7.5 million) could potentially pay a significant premium for independence from a larger, more integrated Canadian polity.

The NAFTA may have deepened North American integration between nations, but empirical evidence suggests that transactions costs incurred at national borders remain higher than those incurred at sub-national borders such as those between Canada's provinces. Indeed, following Doran, it is possible that the rate of decline in transactions costs follows the same size/growth threshold as economies of scale, but as an inverse function of costs. When a polity is small, significant economies of scale can be realized through growth in the size of the polity up to a threshold beyond which the rate of increase in such economies flattens out and declines-- a kind of upper limit to the benefits of size. Similarly, but inversely, when a polity is small, the rate of internal transactions costs may decline rapidly as the polity grows, but will eventually flatten, then decline as the size of the polity reaches a size/growth threshold, perhaps between 25 and 30 million people.

From this follows the possibility that as state size moves beyond its size/growth threshold, the failure to realize ever greater reductions in transactions costs could eventually alter the logic for the integration of the state itself because transactions costs

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[468]Ibid., 185-89.



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internal to the state eventually become higher than the savings which could be realized outside the bounds of the state (ie. the outsourcing of the state). In any event, because most separatist entities are small (and in the case of Quebec, likely to remain small for some time), sovereignty will likely result in both forgone economies of scale and significantly higher, possibly devastating, transactions costs borne both internally and in the international marketplace.[469]

An important point here is that there is no bright line in the sand beyond which the integration or outsourcing of the firm makes sense. For the nation state, there may in fact be a threshold of between 25 and 30 million people, beyond which, outsourcing makes increasingly more sense. There are a range of important factors in determining the optimal size of a country, such as population, gross domestic product, or resource endowments,[470] but each of those factors still needs consideration in the context of their interaction with the institutional environment of which they are a part. In different periods, the broad institutional framework and incentives it generates may alternatively suggest outsourcing or integration. As such, before Quebec sovereigntists begin planning the next referendum on independence, they ought to consider that institutional structures such as those contained in the NAFTA reduce, but to not eliminate, the impact of international borders. Deeper levels of integration such as customs or monetary unions, or perhaps even a common market, might change the calculus of transactions costs and sovereignty significantly. Yet, with ever deeper levels of economic integration come the

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[469]Ibid., 178-80.
[470]Alesina and Spolaore, 1027-1056.



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obvious, and not necessarily palatable, trade offs of deeper political integration such schemes would entail for Quebeckers.

## Conclusions

The purpose of this chapter was to assess the utility of an institutional approach to the NAFTA as a means of better understanding how the NAFTA came into being and how it has affected North American economic development. On the latter point about economic development, we see considerable evidence of the impact that the NAFTA's institutions are having on patterns of economic activity at both the micro and macroeconomic levels in North America (discussion of Figure 6.1). We also see evidence at the firm level of the NAFTA's impact on organizational structure and can understand it in terms of institutions generating incentives for organizational change (discussion of Figure 6.2). Internationally, an institutional approach can also usefully describe relations between states under those institutions. For example, if we view the NAFTA as a relational contract between states, we can understand the various obligations each state undertakes with respect to the implementation of tariff reductions, dispute settlement provisions, and even the environment. As new issues arise under the Agreement, the NAFTA's provisions provide direction as to each state's obligations. Finally, we can even schematically understand the dynamic of institutional change in a domestic setting (discussion of Figure 6.3).

However, as soon as we introduce the role of politics and political institutions to the process of institutional change, we enter a different realm in which economic



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decision-makers, or the personified versions of states, are no longer simply responding to institutions and the incentives they generate. Instead, we encounter a series "chicken or egg" problems in which we are trying to understand where institutions come from and what drives institutional change. For Douglass North, fundamental institutional change is driven by basic shifts in factor prices. In either a localized economy, such as the prairie grazing lands in need of a system of property rights, or a national economy in need of a constitutional structure, factor price changes may generate the incentives for such institutional change; such changes create the potential for positive returns to institutions. But can this point of view be as usefully applied to institutions like the NAFTA that bridge more than one national economy? Both politics and political institutions have had pivotal roles to play in the creation of the NAFTA. But does the utility of institutional economics in understanding institutional change end at a nation's shoreline? Do standard theories and frameworks for international relations and conflict management such as game theory, regime theory, interdependence, hegemonic stability, or power cycle then take over as the prime explanatory vehicles for the NAFTA as an international agreement? Or can the theory of the firm or viewing international economic agreements like the NAFTA as contractual relationships assist us in bringing additional clarity to understanding to a trilateral relationship in North America that is as much political as it is economic? This study has demonstrated that the NAFTA has numerous elements that lend themselves to greater understanding through the explicit consideration of economic institutions and institutional change. Yet, when we reach beyond the domestic setting, we run into problems with applying this approach to international institutional change. While



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it demonstrates a weakness in this theoretical approach to studying the NAFTA, it also represents an important call for more research into the area.



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## CHAPTER VII
## CONCLUSIONS

So where does all of this leave us, and where can we place the theories of the new institutional economists in terms of their utility in providing insights into the genesis and operation of the North American Free Trade Agreement? The collective conclusions of this study could, perhaps, be summarized very simply in the following way: the economics of institutions and institutional change has plenty to say regarding the micro-level responses of firms to institutions and the incentive structures they create, but has a more difficult time accounting for and explaining institutional change at the macro, state-centered level that describes how the NAFTA came into being. Here, we are forced back into some of the more traditional approaches to international relations, such as the debate between realism and liberal institutionalism, or the approaches offered by conflict management which seek to understand the dynamics of negotiation, all of which attempt to explain the origins, evolution, and maintenance or international regimes. But before we delimit the utility of the economics of institutions in helping us understand international economic agreements like the NAFTA, let's recall the origins of this study.

The ideas behind this study originate out of a divergence between theoretical academic literature on international trade and monetary relations and pragmatic policy making that is either, in the first instance, so full of assumptions and caveats that it seldom reflects the realities of every day experience, or in the latter, is so narrowly



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focused on legalities and compromise that "big picture" concepts such as efficiency and welfare are often lost in the process. When it comes to economic theory, we have well-developed, if highly simplified, models that demonstrate the potential welfare benefits of both current and capital account liberalization. In an idealized world, policy makers would consistently have these models in mind, both in pursuit of broad policy goals and when sitting at the negotiating table. The NAFTA was, at best, the imperfect product of both of these poles in the policy process. On the one hand, the likes of Adam Smith and David Ricardo could look at the NAFTA and be pleased that the Agreement, as broadly conceived, evolved largely in accordance with principles like comparative advantage, the elimination of impediments to exchange, and the facilitation of efficiency generating economies of scale in all three NAFTA countries. Yet, as we know, there are areas within the NAFTA in which political realities clashed with ideal notions of economic efficiency. As important as those imperfections are, the basic argument of this study has been that economic performance under the NAFTA has been as much about the predicted economic effects of tariff reductions as it has about the way in which the rules of the NAFTA have been written, imperfections and all. In short, institutions matter for economic performance, but are too seldom an explicit part of the public policy and scholarly debate over the NAFTA. Observers of this debate are all too familiar with the competing sets of statistics and studies offering definitive proof of the NAFTA's efficacy or failure to bring many of the welfare gains promised by neoclassical trade models. The NAFTA has variously helped or harmed the environment, undermined the rights of labor or brought more scrutiny to labor issues, been a boon working families or sent their jobs



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to Mexico. While pundits seemingly search in vane for definitive quantifiable measures of the numerical costs and benefits of the NAFTA, the real impact of the NAFTA may actually be the institutional structures the Agreement created.

There are two basic approaches to economic history; the use of economic theory to advance our understanding of history, or the use of history as a laboratory to test economic theory. This study has been some of both, but more heavily the latter. In addition to re-asserting simply that institutions matter for economic performance, this study has focused that premise on applying the economics of institutions and institutional change to the NAFTA. We adopted the definition of institutions put forward by Douglass North that they are the "humanly devised constraints that structure political, economic, and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, and property rights)." We know that the NAFTA is about much more than tariff reductions and also covers investment, government procurement, the provision of services, and labor mobility (temporary entry), among others. We argued that the entire document, including its three separate schedules for phased elimination of tariffs over fifteen years, represents the kind of institutional structures described by North. But, if institutions matter, and the NAFTA is a set of institutions, we know very little about how they matter, or came into being for neither economic theory nor public policy practitioners give enough importance to the precise impact economic institutions have on economic performance. Our standard neoclassical models only include concepts such as property rights, transactions costs, or the intricacies of contracting as addendums to the standard model rather than explicitly



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considering how they affect economic performance. Likewise, public policy practitioners are too preoccupied with the pursuit of what is politically possible to concern themselves with how the precise language of the rules they create through policy or negotiation might affect economic performance.

In essence, we can come to appreciate abstract concepts embodied in discussions of property rights, transactions costs, and contracts in ordering economic activity, or the role such institutions play in mitigating risk. Anyone who has used an automated teller machine and been charged a service fee can appreciate the concept of transactions costs, since that is often what they are called. However, transactions costs are more varied than a monetary fee-for-service cost, and are as often found in the form of the opportunity costs generated because of the costs of gathering information, or the possession of imperfect information. Yet, while the NAFTA is at its core a set of institutions that helps structure the way we think about our economic choice set, in many cases shifting the distribution of property rights, reducing transactions costs (or raising them in the case of rules of origin), or generating incentives for production decisions, the focus of the debate over the NAFTA remains locked in trying to assess how many dollars the NAFTA has put into, or taken our of, the pockets of a typical American family. This is not to trivialize the importance of such questions, but rather to emphasize that some of the NAFTA's most important economic, social, and political effects have yet to generate the kind of sustained attention they deserve.

In recent years, the subject of outsourcing has garnered considerable media attention as manufacturing, and increasingly even high tech, jobs are moved off shore to



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China or India. The popular press reports these shifts as responses to competitive conditions that lead firms to shift as much labor-intensive activity to low-wage countries as possible.[471] Seldom mentioned are the agreements on government procurement or trade in services reached within the context of the WTO which have created agreed rules on reducing barriers and altering the incentive structure such that many firms now see low-wage, but high-skill India, as a tremendous resource for computer software development and call-center technical support. Why did this trend toward outsourcing technical positions to India not take place sooner than it has? Could it be that a range of institutional structures, such as changes to American immigration law that capped Visa numbers and limited the number of foreign professionals American firms could hire, have generated new incentives to simply send more and more of that work overseas? And what about the German and Japanese firms who now build cars in places like California, South Carolina, or Alabama? Were these jobs "outsourced" to the United States? Was the construction of auto plants in non-traditional American states due, in part, to sets of institutions like the NAFTA that altered the choice sets of those firms and caused them to alter their own production decisions?

The importance of institutions in setting incentive structures can also be seen in the setting of regulations (themselves institutions or rules of the game). In January 2004, the Japanese automaker, Subaru, announced that the 2005 version of its popular Outback sedan/wagon would be larger than previous models and be classified and marketed as a

[471]See *The Economist*, "America's Pain, India's Gain," January 9, 2003; "Back Office to the World," May 3, 2001.



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sport utility vehicle to fit the U.S. National Highway Transportation Safety Administration's definition of a light truck. Why the change? Subaru claims that customer feedback about older models led to the changes.[472] Sport utility vehicles have been among the most lucrative segments of the car market in recent years. However, critics of the move point out that the changes to the vehicle are minor (like raising its ground clearance by less than two inches), will not make the Outback look anything like other light trucks in its class, and are really designed to allow Subaru to evade U.S. fuel economy rules that mandate each automaker's full fleet of passenger cars must average 27.5 miles per gallon of gasoline. By slightly modifying the gas guzzling Outback for 2005 as a sport utility vehicle, Subaru can considerably improve the chances that the rest of its car line will meet the 27.5 mile per gallon average.[473] Are Subaru's actions the result of customer input or the lucrative nature of the sport utility vehicle market? Sure. Are they also carefully calculated moves designed to give the firm breathing space in meeting its obligations under U.S. fuel economy regulations? Certainly. But they are also responses to institutional changes that shift the choice set confronting Subaru of America that have now altered their production decisions regarding the cars they produce. Instead of engineering the Subaru Outback such that it attained greater fuel economies, the firm simply shifted it out of that particular class of automobile into one not governed by those particular fuel economy rules. It may be a shameless, environmentally unfriendly move on the part of the automaker, but it is a direct result of fuel economy regulations–

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[472]Mr. T.K Saito, Chairman, President & CEO, Subaru of America, Letter to the editor of the *New York Times*, January 13, 2004.

[473]*New York Times*, January 13, 2004.



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institutions.

A similar story of institutions and their impact on economic activity and the environment can be found in the Province of New Brunswick where every ten years the Crown holds an auction for angling leases along the province's famous, and popular Restigouche, Miramichi, and Tabusintac Rivers.[474] While officials in New Brunswick's Department of Natural Resources and Energy are likely more focused on the estimated $C50 million in revenue generated from the sale of exclusive sport-fishing lease rights along the banks of these rivers, the practical impact of these sales stems from an observation Aristotle made in the 4th Century BCE:

> For that which is common to the greatest number has the least care bestowed upon it. Everyone thinks chiefly of his own, hardly at all of the common interest; and only when he is himself concerned as an individual.[475]

The auction of lease rights on New Brunswick's rivers will bring the well-known benefits of defined property rights to the rivers, structuring development of the sport-fishing industry, but more importantly, eliminating the potential for a tragedy of the commons scenario that could lead to over-fishing. In addition to granting exclusive lease and fishing rights along each river to individuals who, as decade-long lessors, will be more likely to ensure the maintenance of their lease holdings, both the anglers and the province's fisheries authorities can more easily monitor fish populations than if rights were held in common and ensure over-fishing does not threaten the sustainability of the

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[474]See News Release, New Brunswick, Department of Natural Resources and Energy, January 14, 2003 at http://www.gnb.ca/cnb/news/nre/2003e0029.nr.htm

[475]Aristotle, *Politics*, Book 2, Chapter 3, translated by Trevor J. Saunders, (New York : Oxford University Press, 1995).



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resource. Again, institutions such as the rules imposed on lessors for the duration of their ten-year fishing leases on New Brunswick's rivers structure the use of resources where in the absence of such rules rent dissipation and resource depletion would prevail.

However, these, like the case studies on the foreign direct investment provisions of the NAFTA's Chapter 11 and the responses of the banking and auto sectors to the NAFTA, are all essentially domestic in nature. In each instance, firms or individuals are seen responding to, or, as in the case of autos, influencing, the development of new institutional structures. As the institutional matrix shifts, so do the choice sets and incentive structures within which firms and individuals make decisions about everything from the production of a new car line to the purchase of dish soap in the supermarket. As has been argued throughout this study, institutions shape our choice set by reducing the uncertainty and risk associated with imperfect information and channeling the information available to us into a more practical, usable form. Whether we are talking about the price system's utility as the sender of important pricing signals to individual consumers in its capacity as a kind of clearing house for the countless decisions of others, the practical impact of well-specified property rights on economic development and the generation of wealth, or the way in which all manner of laws and regulations structure our behavior, we are talking about the simplification and enhanced predictability of decision making that institutions and institutional change represent.

Yet, as this study seems to demonstrate, understanding the origins and development of these same kinds of institutions is more complicated when this kind of analysis is expanded beyond the domestic political economy. Our experience with



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automatic teller machines, traffic rules, or regulations governing health and safety provides us with an understanding of concepts like transactions costs that we can apply to a range of scenarios, including the NAFTA's impact on North American integration. It is an intuitive and conceptual appreciation of the NAFTA as a set of rules, similar to health and safety regulations or traffic rules, that shapes economic decision making for a broad range of actors. But it is also one that is poorly understood when we begin talking about rules-based international trade agreements like the NAFTA. Moreover, the importance of these issues for economic performance is almost completely lost amid the impassioned debates over how much trade and investment activity the NAFTA has created, whether the Agreement has been good or bad for labor, or helped or harmed the environment.

Since sound public policy ought to be based less on conjecture and more empirical evidence, we ought to be focusing more of the contemporary debate over deeper North American integration on the elements of process described in this study. Rather than focusing this debate over how many extra dollars deeper integration might place in the pockets of consumers, or how many manufacturing jobs could be created with a customs or monetary union, we ought to be focusing more of our attention on how agreements like the NAFTA or a future customs or monetary union could structure the incentives for North American economic activity. Regrettably, there are countless obvious examples of failed or inefficient institutions in the developing world that stifle broad-based economic growth. However, even in the developed world, there are countless examples of inefficient, poorly designed institutions that are so inefficient as to defeat their original purpose. Public policy practitioners are undoubtedly concerned with the details of the



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international agreements they conclude. But it is sometimes only after the ink has dried that we see how the institutions they design shape the choice sets available to economic decision makers, and therefore, dramatically affect economic activity in ways not often predicted by basic trade theory covering the reduction of border measures like tariffs.

While this study points to the considerable utility an institutional approach to the NAFTA brings to understanding how the Agreement has evolved and operated, this approach falls short in providing convincing insights into the process of institutional change outside the domestic setting. While we might be able to accept the argument of Douglass North that institutional change is the product of relative factor price changes in a domestic setting, thereby leading to increasing returns to new institutions, this line of reasoning is not so easily applied to the international setting. Instead, the main insights provided by an institutional approach to the NAFTA as a trilateral contractual relationship are most apparent only once agreements such as this are in place. Once institutional arrangements like the NAFTA are in place, it is relatively easy to understand them as a set of rules that help shape economic relations between each of the Parties and among firms as they make a range of decisions within the choice set the NAFTA largely helps structure. Yet, before throwing out institutions as a means of understanding the NAFTA and calls for deeper integration, this study offers sufficiently tantalizing insights, particularly with respect to examinations of the state through the theory of the firm that, at a minimum, call for even more study.



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# APPENDIX A
# MODELING TRANSACTIONS COSTS

Since the standard neoclassical model effectively assumes away the impact of institutions on economic performance, it also neglects to explicitly include the role institutions play in either increasing or mitigating the significant impact of transactions costs. In most standard textbooks, the neoclassical production function is given by Q = F(K, L) where output (Q) is a function (F) of capital (K) and labor (L). Factors other than capital and labor, such as land, knowledge, technology, organization, energy, and even elusive factors such as entrepreneurship, are often added by economists to the mix of inputs affecting output. Although transactions costs are not explicitly considered within most neoclassical models, they, like knowledge or organization, could reasonably be included within this list, and therefore also modeled in much the same the same way if we assume that "transactions" activities are in essence a kind of production input.

Figure 2.1 depicts the relationship between consumers (Yc) and producers (Yp) in the exchange of a single product like wheat. Values along the x-axis represent the amount the producer promises to deliver, while values along the y-axis represent the amount the consumer wishes to accept from the producer. The activity "transaction," defined as the purchase of wheat, may, in analogy, be represented by the transaction function Yc = F(Yp) where p represents wheat promised to be delivered by the producer and c represents wheat promised to be accepted by the consumer. In the absence of transactions



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costs, a producer would deliver OC units of wheat exactly equal to the CD units the consumer wishes to accept along the 45° line. This represents a rarified, and unrealistic no transactions costs world featuring, among other things, perfect information, instantaneous contracting, enforcement, and the direct interaction of a consumer and a producer (ie. no middle men).

However, since real world transactions costs are positive, the transaction function Yc = F(Yp) rests below the 45° line. In the presence of positive transactions costs, the producer promises a larger "transaction input" value (OA) for the same "transaction output" level AB. The distance BD represents the cost of the transaction itself. The slope of the transaction curve is the marginal productivity of the transaction process and depicts how many units of additional wheat the consumer is willing to accept for every unit of additional wheat supplied in the presence of positive transactions costs. Figure 2.1 may be a special case in that the transaction curve is subject to diminishing returns. It may be that the marginal productivity of the transactions process declines with the volume of wheat traded, perhaps because of increasing monitoring and enforcement costs.

Suppose that a firm or middle man now enters the picture (Figure 2.2). Suppose that a "transaction firm" purchases wheat from the producer at price Pp and then sells it to the consumer at price Pc. What will the model look like in the presence of the transaction firm and its efforts to maximize



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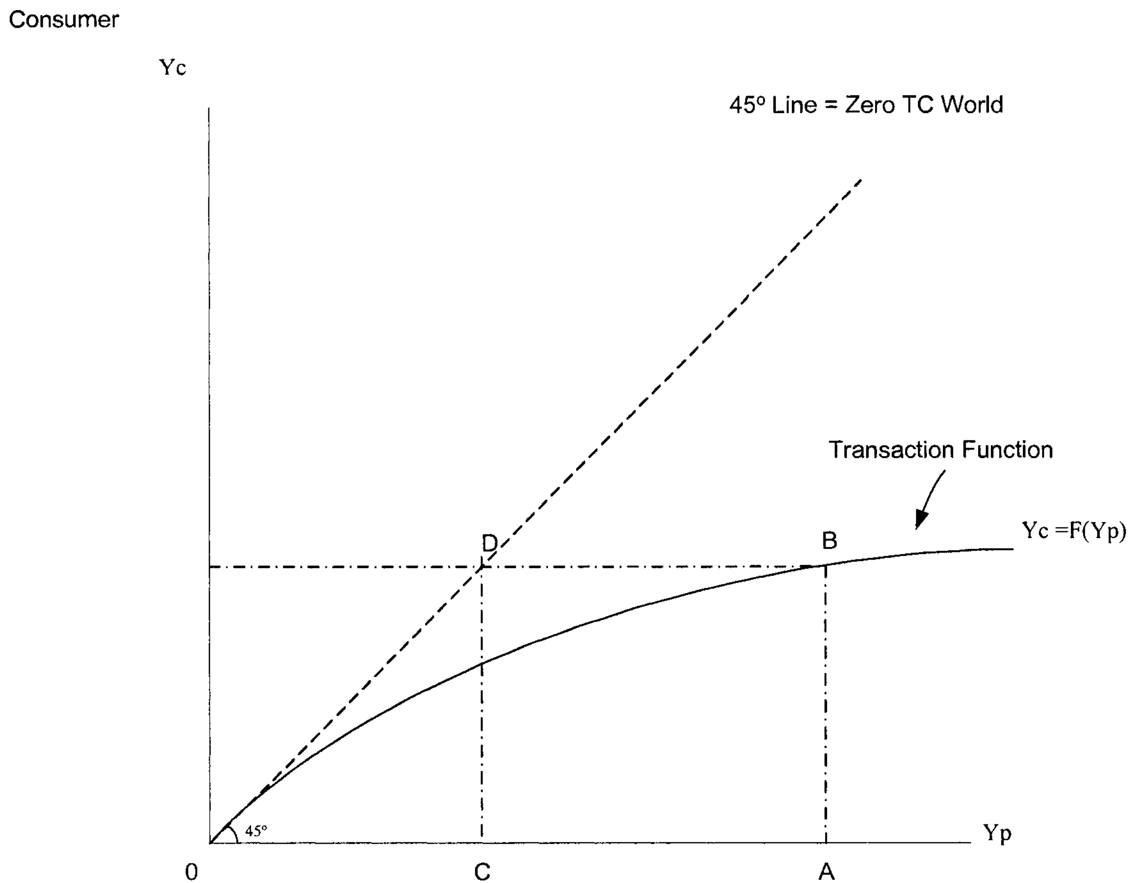
Figure 2.1
The Transaction Curve




profit (R) through the wheat transaction subject to the transaction function:

$$\text{Max } R = PcYc - PpYp$$
$$\text{subject to } Yc = F(Yp)$$

The necessary condition for a profit maximizing transaction firm is then given by:



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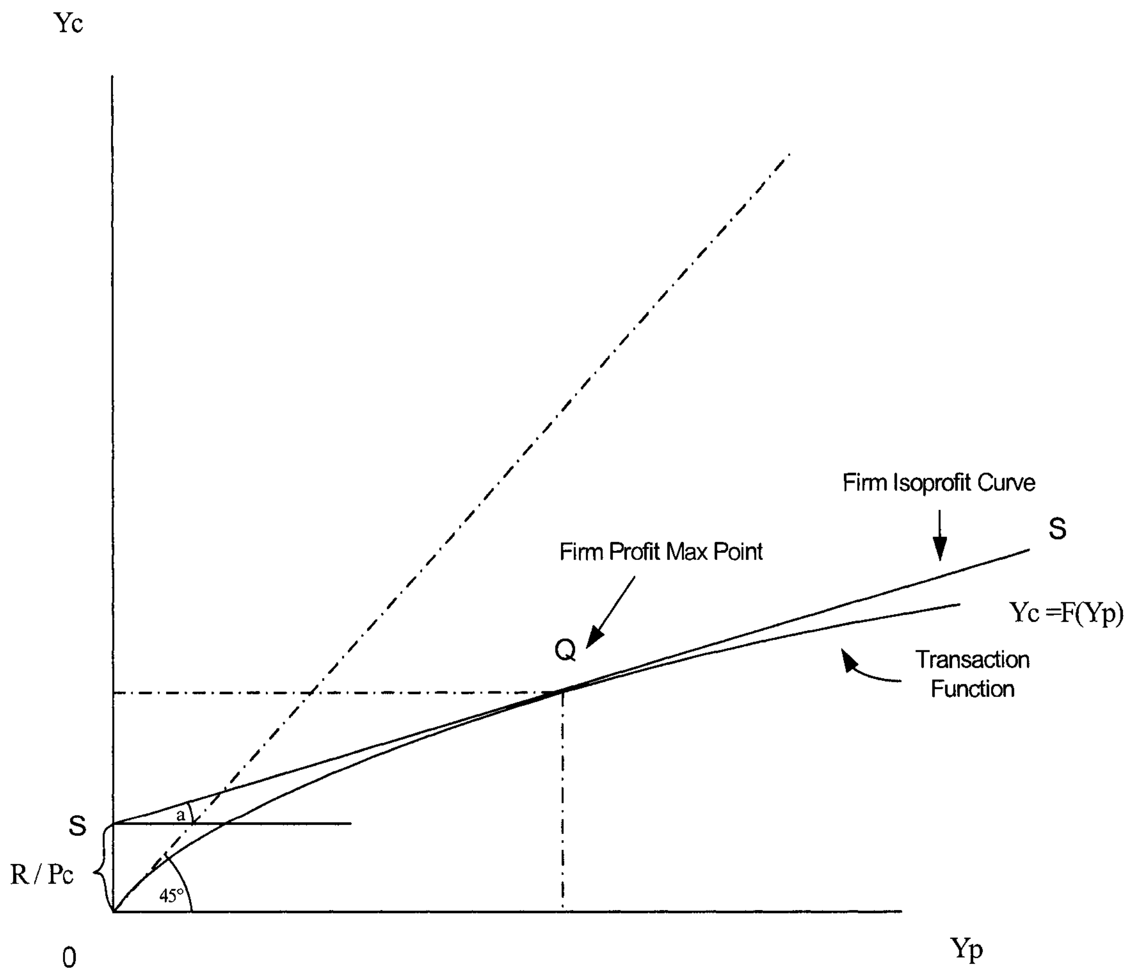
$$\frac{dYc}{dYp} = \frac{Pp}{Pc}$$

Figure 2.2 The Profit Maximizing Transaction Plan



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The firm's ideal profit maximization point is Q, the intersection of the transaction function and the firm's isoprofit curve (SS). Under the assumption that transactions costs are positive, the transaction function will everywhere be less than 1 ( $dYc/dYp < 1$) and that the consumer pays more for the traded wheat than the producer receives from the intermediary firm ($Pp < Pc$). Beyond the maximization point (Q), each additional unit of wheat obtained from producers and offered to consumers by the firm results in diminishing marginal returns.

Note that the schema given in Figure 2.2 ignores transactions costs incurred by either the consumer or the producer in this process. For this, we turn to Figure 2.3 which can be applied to either the production firm's or the household's transaction cost burden. Conceptually, the application of transactions costs considerations to a firm's production function is simple: subtract the value of transactions costs from the firms gross aggregate production function. The basic message of Figure 2.3 is that with a given level of technical knowledge, the further the net aggregate production function lies below the gross aggregate production function, the less efficient the coordination of exchange within an economy is. In other words, the larger the gap between the gross and net production functions, the larger the impact of transactions costs on economic activity.



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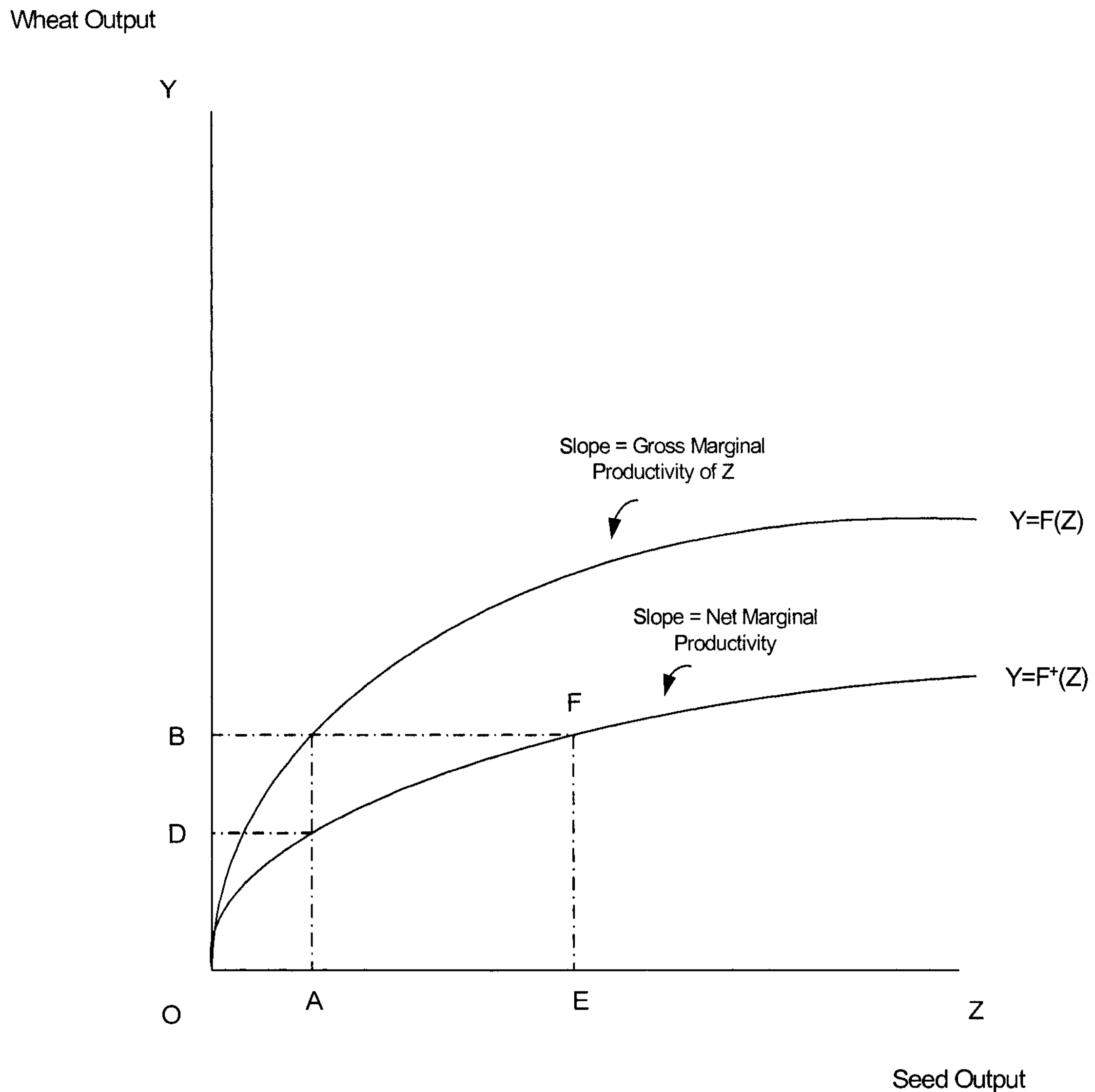
Figure 2.3 Gross and Net
Production Curves




In Figure 2.3, Y represents the firm's output of wheat and Z the input of seed in wheat's production. A producer that wishes to sell OB units of wheat cannot do so if he produces OA units of wheat. Why? Because the producer's optimization concerns are now focused on the net aggregate production function, producing at OA units of wheat will entail



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incurring transactions costs equivalent to DB units. In addition, if the producer is committed to delivery of OB units, the difference in the slopes of the gross and net aggregate production functions suggest that each additional unit of wheat produced by the farmer will yield fewer and fewer units of salable wheat output. In other words, the net marginal productivity of each input of Z is smaller than the corresponding gross marginal productivity of each Z input( $\Delta$NMP < $\Delta$GMP). In order for the producer to deliver OB units of wheat net of transactions costs, he would actually have to produce OE units. Again, the wider the gap between the gross and net aggregate production functions, the less efficient and more costly transactions are likely to be.

Part of the critique of the neoclassical model made by scholars of institutions is that the neoclassical model assumes away the impact of transactions costs on economic performance. However, in extending the neoclassical model to consider transactions costs, the same has been done here. For example, if transactions costs entail the use of scarce resources, the expenditure of such resources will affect other inputs to the production function, such as factor endowments or information gathering. The point really is simply to illustrate that the impact of transactions costs on the production function can be modeled within the neoclassical model in a manner similar to the way transportation or other costs are often explicitly incorporated. In spite of its limitations and assumptions, the neoclassical model is a highly useful tool for exploring a range of economic relationships.



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## APPENDIX B
## MODELING PROPERTY RIGHTS

Throughout the discussion of institutions and their impact on economic performance, the issue of efficiency repeatedly arises. In a world of positive transactions costs, the institutions which help govern property rights have a significant impact on the magnitude of those transactions costs. Equally important, the precise structure of property rights is determinative of who will bear the largest share of those transactions costs. The importance of private ownership in terms of both the development and efficiency of economic activity has already been mentioned. But neither property rights nor efficiency emerge automatically. Significant transactions costs are often incurred in merely specifying what those property rights will be, who will be the beneficiaries of which rights, to whom those rights will apply, and, of course, the enforcement of those rights.

The process of specifying property rights is not as straight forward as it might seem. There are many goods, such as air, for which complete property rights specification is often impractical or impossible. Who owns the right to clean air? Who own right to pollute some of that air? Where do the obligations of clean air and pollution rights holders meet, clash, or overlap? Conflict over property rights, or 'externality' problems, typically arise because of the lack of specification, or incomplete rights, in the allocation of property rights. An externality is said to exist in situations in which one person's economic position is affected by what others do with respect to consumption or



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production. We say that externalities may be either harmful or beneficial to an individual. But in a private-ownership economy with freedom of contract, whether an individual has to suffer from the harmful negative effects or can costlessly enjoy the beneficial ones, depends largely on the specification and transfer costs of property rights. In a well-functioning capitalist system, externalities will be internalized by the transfer of the relevant property rights. The necessary conditions for internalizing the effects of externalities include: 1) sufficiently clear specification of property rights and 2) freedom for their exchange. In a world of costless transactions, parties will ideally trade their rights in such a way as to reach a Pareto-efficient allocation of resources. In other words, the marginal benefit of the transfer of property rights will equal the marginal disbenefit.

This process of exchange and the importance of specification of property rights in a transactions cost-free world can be usefully illustrated with a familiar Edgeworth Exchange Box (Fig.2.4).



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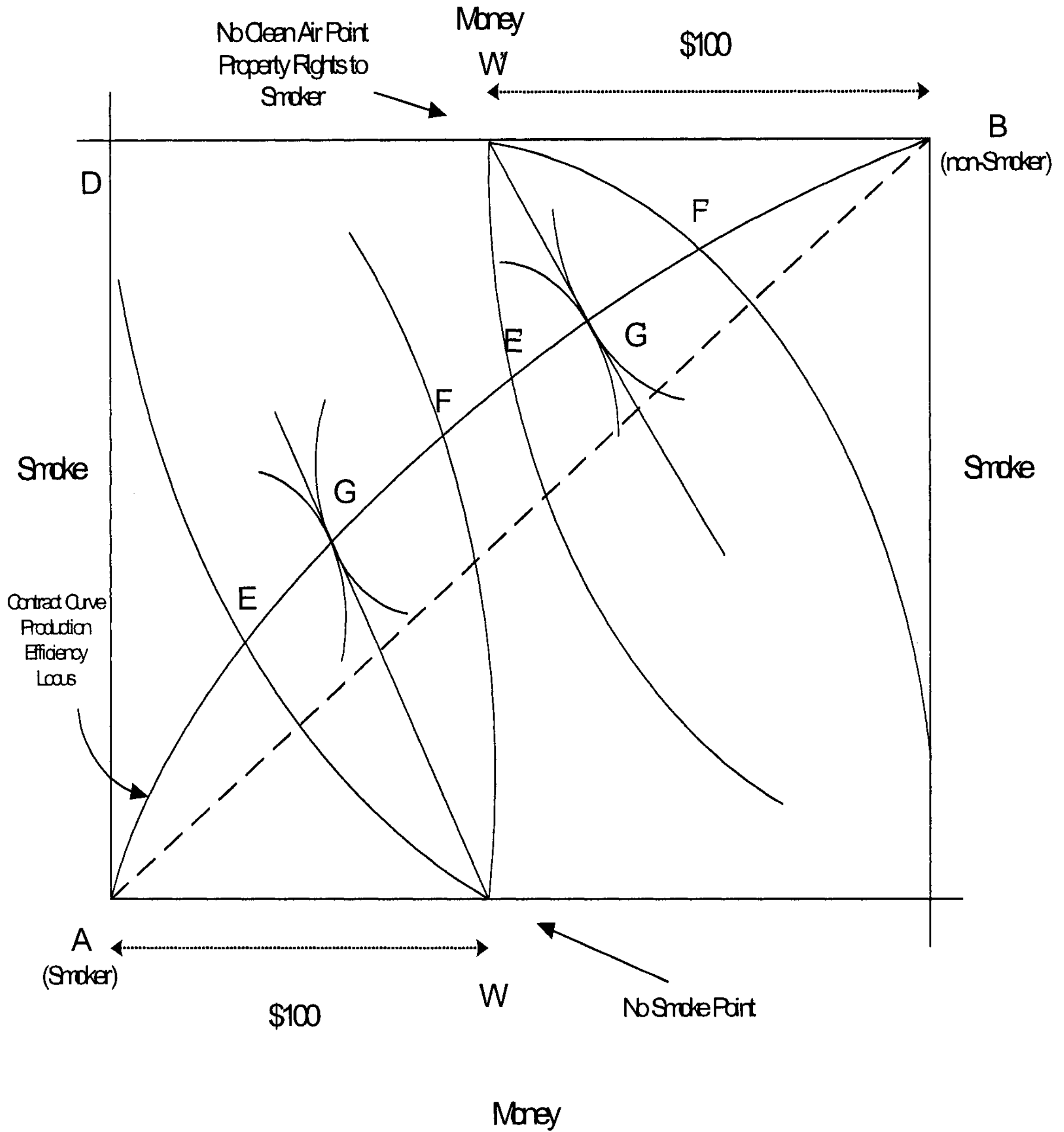
Figure 2.4 Property Rights:
Smoker and Non-Smoker
Exchange Money for
Smoke



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Depicted here is the exchange of rights as a result of externalities generated by smoking. Let's first assume that in the specification of property rights, the liability for the externality (smoke) is placed upon the smoker. In other words, a well-defined property rights structure provides the non-smoker with the right to clean air. This situation is represented by point W along the bottom axis. However, the smoker obviously wishes to light a few cigarettes and, under this property rights structure, is willing to exchange money for a portion of the non-smoker's rights to clean air up to a certain point. Efficient allocations of scarce resources (money and clean air) can be found along the contract curve AB. Since smoke cannot necessarily be exchanged unit for unit with clean air, the shape of the contract curve represents the relative intensity with which money and smoke are employed by each Party. In this instance, the smoker's preference intensity for smoke and the non-smoker's preference intensity for money result in a curve the rests above the dashed diagonal line. At point W (the no-smoke point), the indifference curves of each party intersect, but suggest that a pareto efficient allocation of scarce resources could be obtained somewhere between E and F along the contract curve through a process of exchange. Along the indifference curve passing through F, the non-smoker is willing to accept a range of combinations of smoke or money, as is the smoker along the indifference curve passing through E. Through a process of exchange of rights for money, the two parties can reach a mutually advantageous, and efficient, allocation of resources, say at point G, in which the smoker exchanges money for the right to pollute the air and the non-smoker relinquishes some of his rights to clean air in exchange for the money.



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The new equilibrium exchange point G represents the new equilibrium supply and demand for smoke and money defined in terms of price (the slope of the price line GW).

If we reverse the initial conditions and assign all property rights to the smoker in terms of his/her right to pollute the air, the same analysis holds, but with a very different outcome in terms of how much smoke or clean air will result. At point W', the smoker holds the exclusive rights to pollute the air. In order to obtain some of the smoker's rights to pollute the air (ie. obtain the right to cleaner air), the non-smoker is willing to accept any combinations of money and smoke along indifference curve F' while the smoker is willing to relinquish some of his rights to smoke in exchange for money along indifference curve E'. The same conditions for a Pareto efficient exchange of resources exist and, through bargaining, a new allocation of smoke and money is reached at point G'. At G', the supply and demand for smoke and money are in equilibrium defined in terms of price along line W'G'.

The difference between the two is obvious. Here we have two sets of clearly specified property rights allocations, each of which results in very different allocations smoke and money. In each instance, the process of exchange tends to leave the original rights holder with more of those rights in their possession. In the case of the non-smoker, the specification of property rights in favor of clean air results in more units of clean air over smoke following the process of exchange. Likewise, the specification of property rights in favor of the smoker tends to allocate more units of smoke to the smoker than the non-smoker is willing to purchase. In both scenarios, the process of exchange allows both the smoker and non-smoker also reach a higher level of satisfaction in the allocation of



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property rights.

Recall, however, that this example represents the process of exchange in property rights within the neoclassical model and excludes the impact of transactions costs like adverse selection or asymmetric information that are inherent parts of the bargaining process. Here, property rights are well defined, even over an externality such as pollution, and the process of exchange takes place in a costless environment of perfect information, including the specific preferences of the Parties to the exchange. However, whereas the specification of property rights, even those covering externalities, is well-defined here, problems arise when those rights are not well-defined, as they often are not in the case of environmental pollution. How can you trade rights to things over which rights are not allocated to anyone in particular?

The process of exchange in well-defined property rights was a key argument in Ronald Coase's seminal 1960 paper, "The Problem of Social Cost."[476] As Coase himself argues, the ability to exchange property rights in this way very much depends on the extent to which those rights are actually specified and the degree to which transactions costs are positive. However, Coase highlighted an important point with respect to efficiency and property rights when he asserted that the initial specification of property rights (which rights were allocated to whom) was unimportant for efficiency so long as they could be exchanged. Coase argued that Pareto-optimal allocations of resources would emerge through exchange regardless of the initial allocation or the extent of

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[476]Ronald Coase, "The Problem of Social Cost," 1960 reprinted in R.H. Coase, *The Firm, the Market and the Law*, (Chicago: University of Chicago Press, 1988), 95-156.



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externalities generated by the Parties. Assume, for example, that exchange between the smoker and non-smoker will always result in the same level of externality (the generation of smoke). This situation is represented by the horizontal contract curve in Figure 2.5.

Exchange of property rights in this case will not reduce or raise the level of smoke. However, what remains to be decided through exchange is the distribution of the right to smoke or clean air between the two parties. A similar resolution to the first scenario emerges. The non-smoker will end up with a larger amount of money than his initial endowment (at point W) if the right to clean air is allocated to him. The smoker, in effect, has to pay the non-smoker for the right to smoke. But, if the right to generate smoke is allocated to the smoker, then a portion of the non-smoker's initial endowment of $100 (point W') will be used to purchase rights to clean air from the smoker. In other words, from a distributional point of view, it matters a great deal who has the initial property rights in goods that generate negative externalities. The amount of property one has command over directly affects his wealth position.

Of course, this extreme example of Coase's theorem assumes both that externalities can be assigned as a form of property and assumes away the impact of such externalities on the process of exchange. Yet it is the impact of externalities on the process of exchange that Coase so masterfully highlighted. How can parties contract with one another costlessly when so much of the information needed to conclude contracts, such as the discovery of one's preferences, not to mention the time and effort need to conclude negotiations (assuming they are successful), all entail costs.



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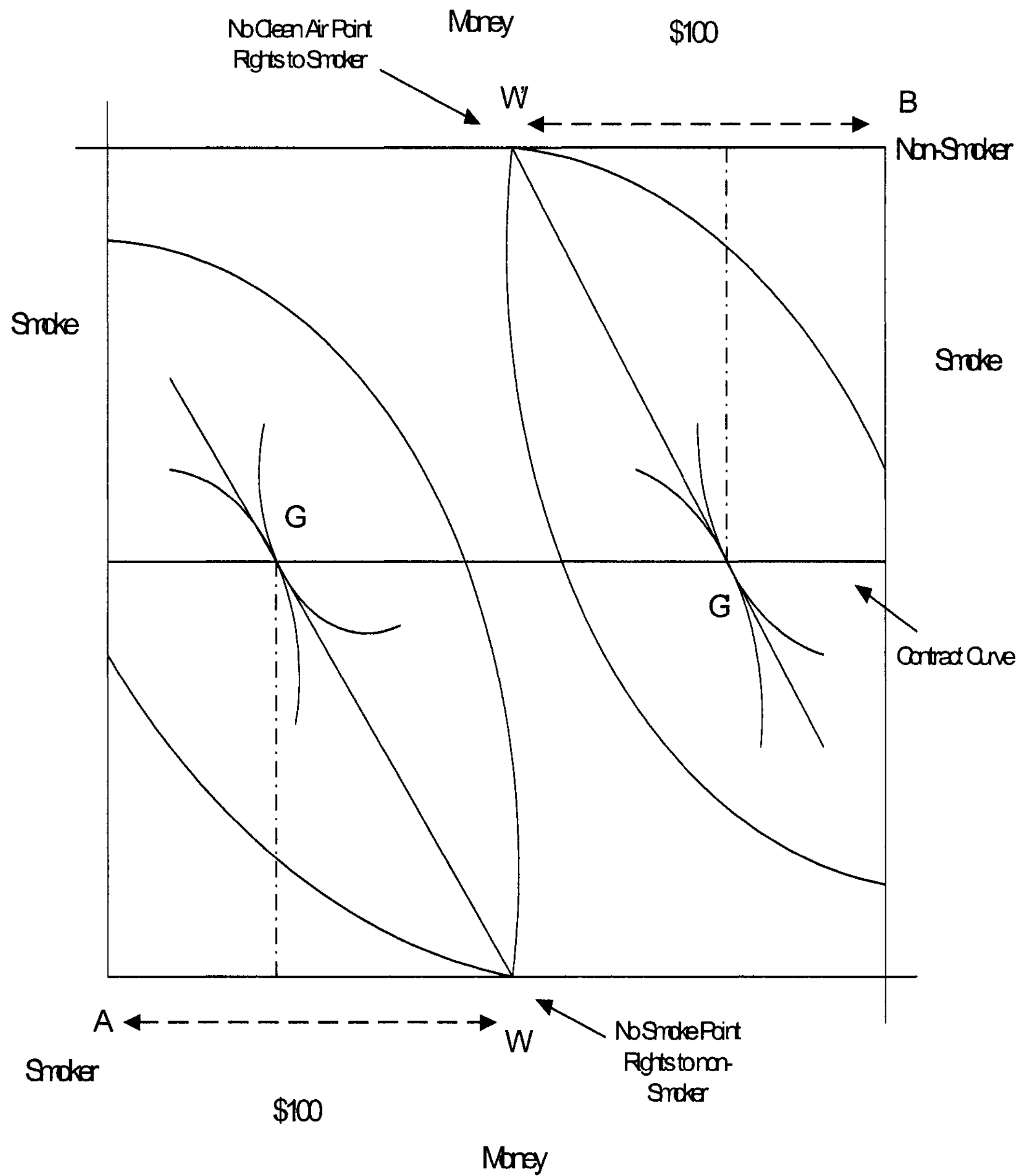
Figure 2.5 Coase
Theorem Strong Form



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## Efficiency

One of the problems for scholars of institutions in dealing with efficiency is that any inefficiency that is found could be rationalized as being the product of some kind of friction in the form of a transactions cost, an improperly specified property right, or a poorly negotiated contractual relationship. This problem continues even if we begin to talk about a kind of constrained or limited maximization that somehow accounts for some of these restrictions and argues that economic institutions are efficient "subject to certain constraints." It seems reasonable to talk about inefficiencies as the product of certain constraints to be avoided with the aim of improving efficiency. But even if we can all agree that certain constraints on efficiency are present, there are no criteria upon which to argue for which are avoidable and which are not. In addition, as we have seen in the main text of this study, many inefficiencies arise, not as a result of frictions, but as a result of institutional arrangements themselves. One of the most common of these in property rights is the so-called tragedy of the commons.

## Tragedy of the Commons

There are instances in which the costs of defining, enforcing, and monitoring property rights, or internalizing such costs within an organization, are so high as to make the specification of property rights prohibitively expensive. Some form of collective action is often then warranted, but we are then faced with the problem of managing common pool resources.



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Economists have long observed that individually rational economic decisions can lead to disastrous, irrational outcomes for the collective. One frequently cited example of this problem is the case of cattle ranching on open access grazing lands. In this scenario, economically rational cattle ranchers may seek to increase the size of their herds believing that sufficient resources exist on the open range to support them. It is economically rational for a rancher to add additional animals to the open range as long as the private return on doing so continues to be greater than the private cost. However, because the open range contains no means to restrict the entry of other herds, and because other ranchers may also seek to increase herd sizes to maximize profits, the collective impact of increasing numbers of cattle on the open range may be to deplete the range's resources. As ranchers add animals to their herds, both resource depletion and diminishing rates of return throughout the range due to each additional animal become significant problems for all ranchers using the range. In effect, each rancher has perverse incentives. Each is motivated to add more and more animals because he receives the direct benefit of his own animals and bears only a share of the collective costs resulting from resource depletion. The tragedy lies in the disastrous logical end toward which all rationally self-interested ranchers rush– resource depletion and diminishing rates of return to the point where ranching becomes unviable for all. Graphically, the problem is represented by Figure 2.6.

In this diagram, $a$ is equal to the value of the milk produced by a single cow. The function $f(C)$ is equal to the value of the milk produced on the grazing lands if $C$ cows are on the common, and therefore, the average product (AP) of the common is simply $f(C)/C$. Finding the maximum number of cows the common can support we solve:



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$$\text{Max } C\,f(C) - aC$$

Maximal production on the range will occur where $f'(C^*) = a$, or where the average product is equal to the price of the value of the milk each cow produces. It will be profitable for each rancher to add more cows to the range so long as the value of the output of the cow is greater than the cost of the cow. This corresponds to point C', where the AP curve intersects with the dotted line *a*, representing the cost of the cow. Ranchers will cease adding animals to the open range only when profits have been driven to zero:

$$f(C')/C' - a = 0 \text{ where } C' > C^* \text{ and } f' < 0$$

Individuals ignore social cost in this situation, namely that each additional cow added to the range beyond C* will reduce the value of the milk output from all the other cows. The socially optimal allocation is C*, the level of input for which *a* is equal to the marginal product of privately owned inputs, and results in an economic surplus of S*.

The obvious solution for ranchers is to somehow restrict access to the open range, in a sense, bringing greater specification as to who owns property rights on the range. In the period before barbed wire and fencing, cattle ranchers achieved this goal through the creation of cattlemen's associations which restricted whose animals could graze on a particular range through the use of branding to identify member animals as well as



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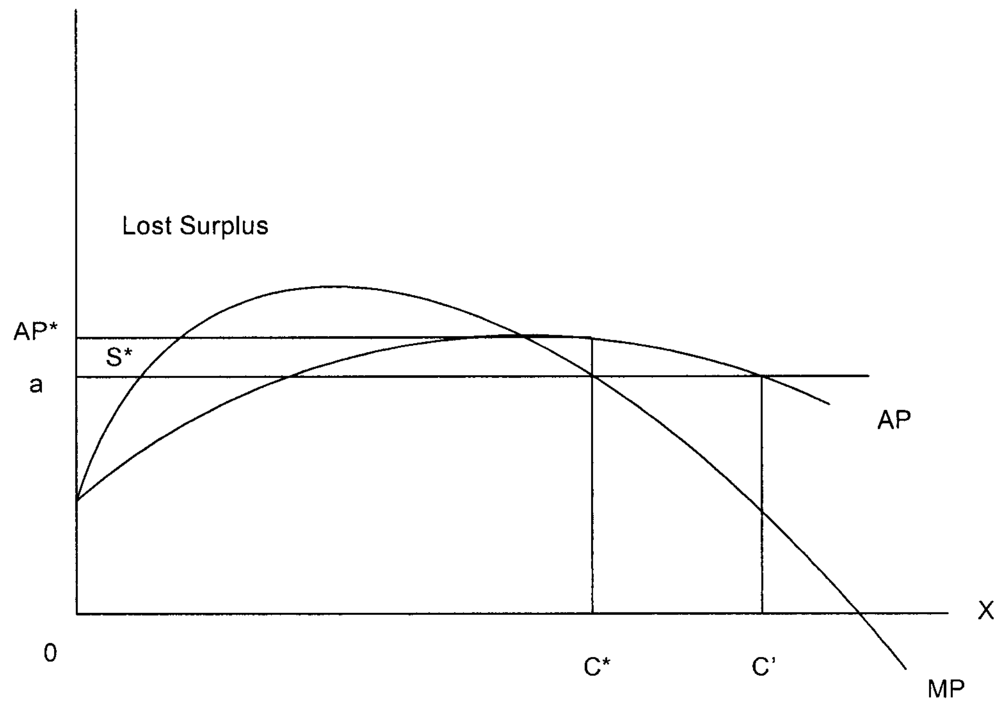
Figure 2.6 Tragedy of the Commons

Output Per Unit of X




Max C f(C) -aC

F' (C*) = a - (cost of a cow)

↓

F(C')/C' - a = 0
where $C' > C^*$
and $f' < 0$

→

Individuals ignore the fact that each additional cow beyond C* reduces the collective output at C'

↓

At C' the $MP < 0$



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cooperative round-ups that explicitly discriminated against non-members. Economic history abounds with examples of institutional change in property rights aimed at restricting access to common pool resources in an effort to manage rent dissipation associated with the tragedy of the commons. Cattlemen's associations represent only one of many such innovative institutions.[477]

[477]See for example, R. Taylor Dennen, "Cattlemen's Associations and Property Rights in Land in the American West," *Explorations in Economic History* 13 (1976): 423-36; Shawn Everett Kantor, "Razorbacks, Ticky Cows and the Closing of the Georgia Open Range: The Dynamics of Institutional Change Uncovered," *The Journal of Economic History* 51 (December 1991): 861-886; John Umbeck, "The California Gold Rush: A Study of Emerging Property Rights," *Explorations in Economic History* 14 (1977): 197-226; Rosemary E. Ommer, "'All the Fish of the Post': Resource Property Rights and Development in a Nineteenth-Century Inshore Fishery," *Acadiensis* 10 (Spring 1981): 107-123.



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# APPENDIX C
# MODELING CONTRACTUAL RELATIONS

As noted in the main body of this text, the literature on contract theory can essentially be lumped into two distinct groupings; one that is largely descriptive and conceptual, another that has become increasingly abstract, mathematical, and theoretical. The focus here will be on the former grouping largely because of its utility for helping to illustrate in basic, easily digestible terms, the importance of contracts and contractual relations to the study of institutions. What the descriptive approach lacks in analytical and mathematical precision it compensates for by being more readily and broadly applicable to every-day situations. Rather than a complete demonstration of the intricacies of contract theory, we need a basic schematic framework in which to place the virtually limitless varieties of contractual relationships that shape our economic lives. Much of what follows here in this appendix has been borrowed from Oliver Williamson and Ian R. Macniel.[478]

While there are many varieties of contracts, one of the keys to distinguishing the characteristics of contracts is to begin by asking what the purpose of the contract actually is. According to Williamson, there are essentially two purposes for concluding contracts; Monopoly and Efficiency. Consider the Cognitive Map of Contracting in Figure 2.7.

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[478]See Oliver E. Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations," *Journal of Law and Economics* 22 (1979): 233-61; Ian R. Macneil, "Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law," *Northwestern University Law Review* 72 (1978): 854-905; Ian R. Macneil, "The Many Futures of Contracts," *Southern California Law Review* 47 (1974): 691-816.



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Williamson starts with the premise that contracting is often just a form of non-market exchange between parties. Yet, if the exchange is going to be of a non-market form, what purpose is the contract really serving?

The monopoly branch of contracting concerns the relationship between contractual parties and third parties such as customers or rivals and involves the departure from classical market norms toward efforts at monopoly-enhancing contractual relations. With respect to customers, contractual parties may, in effect, collude to augment or maintain leverage over consumers and buyers through a range of agreements in areas such as price discrimination, exclusivity of supply, or territorial market share. With respect to rivals, the collusion of contractual parties may serve to raise new and costly market entry barriers to rival firms or involve the strategic coordination of contracting parties' productive efforts. An important distinction among the four branches of monopoly contracting, as indicated by the curved line labeled Production Function Approaches, is that with the exception of Strategic Behavior, which is more closely associated with corporate governance, the others involve considerations of manipulation of a firm's neoclassical production function ($Q = f(K,L)$).

The efficiency branch of contracting is much more concerned with modes of contracting that serve to alter (hopefully improve) efficiency. And, whereas the monopoly



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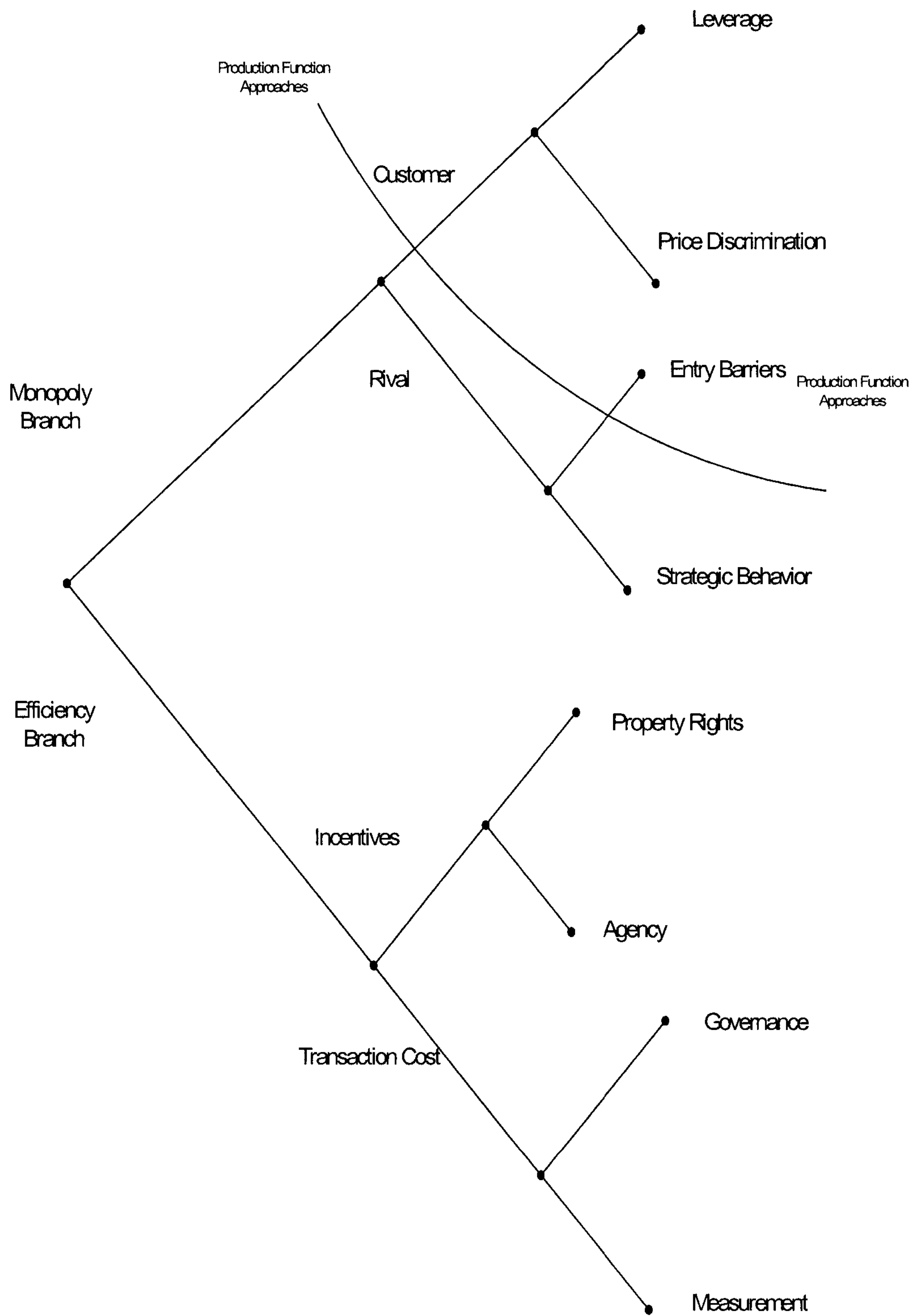




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branch of contracting takes us in the direction of anti-trust and competition law, the efficiency branch is the realm in which institutional economists are most focused and where many of the issues related to transactions costs, incentive structures, and governance of exchange are centered. One node of the efficiency branch concerns the erection of incentive structures for contractual parties that serve to reduce the impact of uncertainty and opportunism on the process of exchange throughout the life of the contract. In the discussion of private property to the efficient allocation of resources in an exchange economy, we saw how the improper assignment of property rights can negatively affect economic performance. Complete rights in private property, including the right to use the asset, accrue returns on investment in it, and the right to sell it, all provide incentives to owners to employ that asset in the most productive means possible. Inefficient productive outcomes are often suggestive of mis-assigned property rights and a restructuring of them, say in the shift from a common pool resource to one in which parties contract to control access to it, dramatically alters the incentive structure for the parties. Agency is a near necessary feature of complex exchange relationships whenever ownership and control of firm activities are separated to any degree, as is the case in relations between labor and ownership. To mitigate the accompanying risk of opportunistic behavior that comes with agency, incentive structures to reduce the impact of self-interested opportunism on the part of agents are often worked into contractual relations. Although there are costs involved in augmenting such incentive structures through such things as higher wage rates, equity stakes, or a range of punitive measures, addressing them often results in shifting the efficiency of the contractual relationship.



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Finally, there is the transaction cost node of the efficiency branch of contracting wherein efforts to mitigate the impact of transactions costs on exchange are focused after contract implementation. Unlike contractual incentive structures which are normally worked out during pre-contractual negotiations and are a form of legal, or court, ordering of those incentives, transactions costs are more often the subject of on-going, private ordering arrangements. In a sense, negotiations to reduce transactions costs between parties are continuous because of the constant need for measurement of contractual performance. Contracts, particularly relational contracts, are dynamic agreements concluded under the constraints of bounded rationality and opportunism that require continual assessments of how the contract is performing as well as complex governance structures suitable for smoothing out the connections between contractual parties. Doing so promotes adaptability, continuity, and extends the shadow of the future of for the relationship that ultimately translates itself into the source of economic value in the contract.

## Transaction-Specificity and Governance

Under the efficiency branch of contracting, there are numerous points in which forms of governance come into play. In effect, the entire field of contracting can loosely be thought of as forms of governance, the governance of the exchange, management, and employment of a range of assets. Within the body of the text we have already suggested that investment-specific transactions involve more complex and specialized kinds of exchange. But how does specialized exchange end up requiring specific kinds of



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governance structures be incorporated into contractual relationships?

Figure 2.8 illustrates a simple contracting scheme that illustrates the differences between exchange under non-specialized conditions of exchange and those utilizing more specialized assets in the process of exchange. Suppose that two parties to a contract exchange products that utilize the same basic, readily available technology (K=0). We can say that where K=0, the impact of transaction-specific investments (ie. specialized technology, know how, or perhaps even rare resources) on the transaction are negligible. Classical, discrete contracting between parties prevails here because all contingencies can be easily dealt with under the terms of the contract. The presence of a readily accessible technology, know-how, or resource suggests the presence of many suppliers and many buyers. Transactions tend to be comparatively instantaneous and take place in a highly competitive exchange market. Under such market conditions, there is no need for protective governance structures to manage the contractual relationship (at point A) because the competitive marketplace entails the existence of many other potential buyers and sellers.

However, a different situation exists where highly specialized kinds of resources are employed within an exchange relationship, ones not readily available to either party in the wider market place. In this case, one or both parties to a contract may use a specific technology (K>0) that sharply reduces the range of potential contractual parties can enter into exchange contracts with. These kinds of specialized exchange arrangements often result in a kind of bilateral supply relationship that is more highly prized by the parties as



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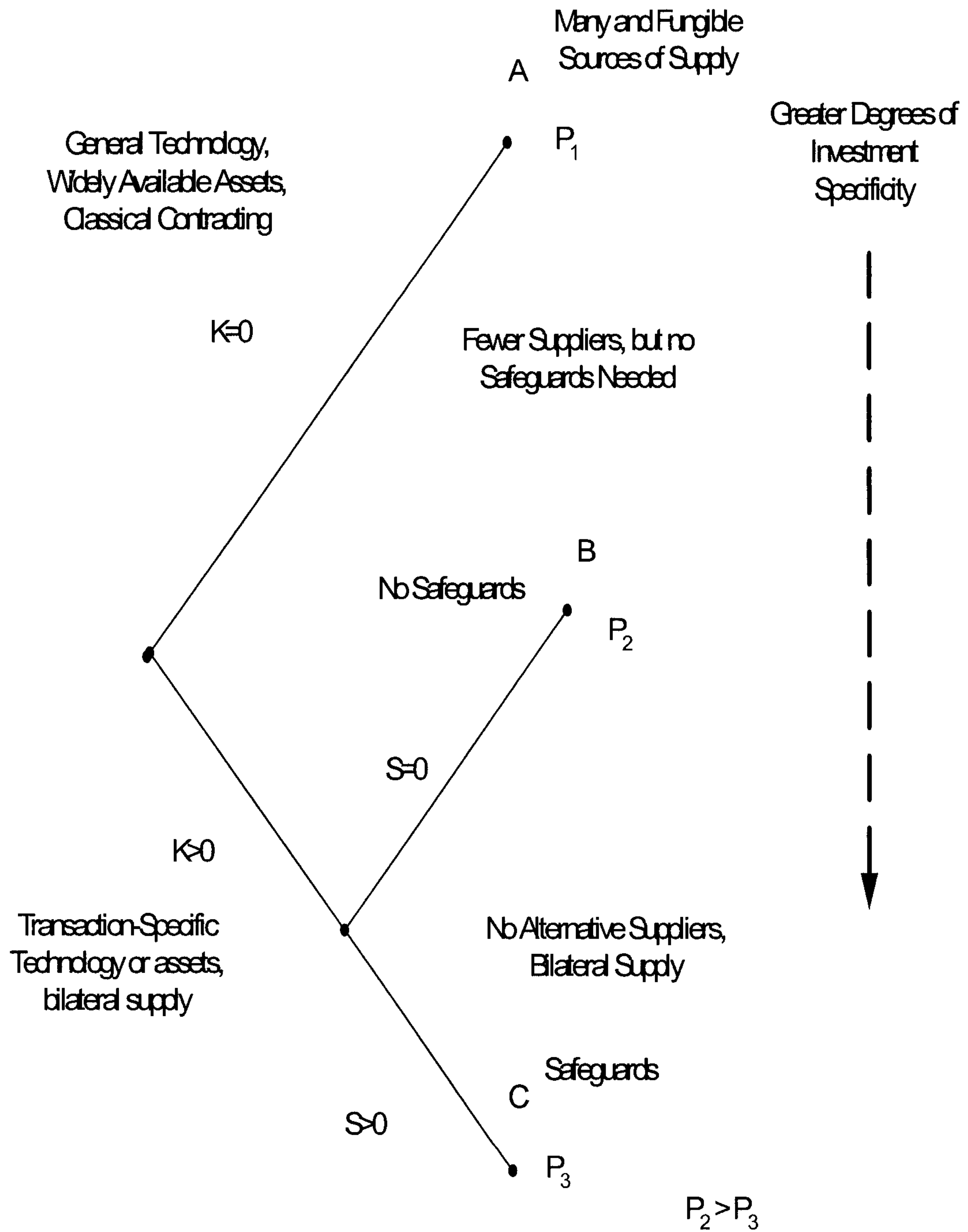




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the specificity of elements to the transaction rise. Under conditions of bilateral supply, parties to the contract have strong incentives to protect their investments through the use of safeguards (S). The importance of such safeguards rises with the specificity of the contractual relationship. One such contractual arrangement in which transaction-specific investments are high (K>0), but for which there are no safeguard provisions (S=0) exists at node B. Although conditions of bilateral exchange exist, node B is inherently unstable because of the absence safeguards to manage opportunistic behavior or the risk involved in committing specific kinds of assets to the contractual relationship.

Such contracts may revert to node A contracting featuring the abandonment of the special use resource and the adoption of a more generally available production input (technology, know-how, resource), or safeguards will ultimately evolve within the contractual relationship, node C. At node C, a range of safeguards within the contractual relationship may include:

1) A realignment of incentive structures (property rights, or agency relationships).
2) The creation and use of governance structures to resolve disputes (governance and measurement).
3) Extend the shadow of the future within the contractual relationship by constructing trading regularities and norms within the contractual relationship.

Such safeguards help reduce the risk to either party to the contract that their transaction-specific investment in the contractual relationship will not be expropriated. However, these safeguards are not without cost to the parties. Whereas at node A classical, discrete contracting is done at a market clearing price $P_1$, contracting between parties utilizing



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transaction-specific investments often involves incurring additional transactions costs, such as when new employees are initially trained for a series of job-specific skills. However, the addition of safeguards to the contractual relationship necessarily involves additional transactions costs in terms of monitoring and enforcement of contractual obligations ($P_2 > P_3$).



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**Scholarly Life**

Greg Anderson was born in Salt Lake City, Utah, but has spent many years living and working in Canada. Before studying at Johns Hopkins/SAIS, Greg earned a B.A. (1992) from Brigham Young University in Provo, Utah, a B.A. (Hon) (1997) and M.A. (1999) from the University of Alberta. Greg also spend two years working as an intern in the Office of the Americas within the Office of the United States Trade Representative in Washington, D.C. where he augmented his scholarly training in the economics and politics of trade policy with real world experience. Greg has also spent time as a trade policy consultant and is the author of several articles on international trade policy.

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