# EUROPEAN INTEGRATION REVISITED

Katja Weber
Department of International Relations
Lehigh University

Prepared for delivery at the Fourth Biennial International Conference of the European Community Studies Association, Hawthorne Suites Hotel, Charleston, South Carolina, May 11-14, 1995.

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The field of international relations is built on a conception of autonomous and self-interested states which, in the anarchic setting of international politics, rely on self-help. And yet, we frequently do see cooperation among states as numerous security and economic arrangements throughout history bear witness to.

To understand world politics, I argue, one must recognize the importance of emerging hierarchies--with nation-states as their constituent elements and institutional structures that take substantial autonomy from the state. Some such hierarchical arrangements are economic (free trade areas, customs unions, common markets), others are military (ententes, formal alliances, confederations).

In this paper, I explore recent integrative moves (Single European Act, Maastricht Treaty) within the European Community. I begin with the conceptualization of a continuum of cooperative economic arrangements with different degrees of bindingness. Setting my argument in the context of traditional explanations I then claim that realism barely recognizes such hierarchical arrangements and that it is inadequate to explain them. Thereafter, I examine the classical argument for the emergence of larger entities, that of economies of scale, and stress that it explains size rather than "bindingness." Recognizing that the solution for hierarchy amidst market anarchy in economics is transaction costs, I then use this insight to develop an autonomous interest-based explanation for cooperative governance structures in international politics.

Continuum of International Economic Arrangements

The history of international politics is replete with different security and economic arrangements. I argue that these arrangements should be viewed as occupying various positions on a continuum which ranges from relationships characterized by high maneuverability or autonomy to highly structured relationships with significantly restricted maneuverability or autonomy. The further a country moves away from arrangements which allow for a high degree of maneuverability toward the more restrictive arrangements, the more limited its freedom of action, the greater its delegation of authority to a centralized political structure, and the higher the costs of exiting the arrangement become.[1] This suggests that the closer countries move on the continuum toward the arrangements that curtail their freedom of action, the more "binding" their commitment will be, since the costs of defecting from a highly structured arrangement are higher, and since the likelihood of defection is reduced. Put differently, bindingness--which entails the curtailment of sovereignty in exchange for greater institutionalization--is likely to decrease opportunistic behavior, since it would be difficult as well as

[1] By "limited" freedom of action I mean to suggest that--by choosing to become a member of a highly structured and institutionalized arrangement--the country cedes some of its sovereignty for the sake of cooperation.

costly in terms of reputation and security (economic well-being) for cheaters or defectors to find a replacement for a structurally sophisticated institutional apparatus.

Given this conceptualization, general trade treaties constitute economic arrangements on the less "binding" side of the continuum and economic confederations represent arrangements on the more "binding" side.[2] A general trade treaty entails some measure of commitment to remove some of the trade impediments between the parties involved in the agreement and there is the assumption that a violation of the agreement would cost something. A confederation, on the other hand, entails a deliberate banding together of states to create a central, permanent, and state-like political structure which is capable of acting like a state, yet is not a single state but a union of states.[3] Or, in other words, a confederation entails a much more formal relationship in which countries agree to create a sophisticated structural apparatus to facilitate their cooperation. Hence, it is important to stress that in both general trade treaties and confederations states retain their sovereignty, in a nominal sense, but that in the latter

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[2] For a discussion of cooperative security arrangements, see Katja Weber, "Hierarchy Amidst Anarchy: Prospects For International Cooperation In A Post-Cold War Environment," (presentation at the Annual Meeting of the American Political Science Association, New York, Sept., 1994).

[3] For a discussion of the term "union of states," see Murray Forsyth, Union of States: The Theory and Practice of Confederation (New York: Leicester Univ. Press, 1981), pp. 1, 7, 206. Note that Forsyth uses the terms "confederation" and "union" interchangeably.

arrangements states are bound much more significantly, due to the elaborate structural make-up which often includes a Diet or Commission, other institutions which make common regulations, arbitration mechanisms, and a central bank.

Beginning with realist premises, i.e., accepting that the international system is anarchic,[4] I arrive at an explanation of international hierarchy that is rooted in the choices of sovereign states. More specifically, I begin with the standard realist assumption of self-interested states in an anarchic environment, acting to assure their survival. I claim that states (as rational actors) choose whether to cooperate or not, they choose with whom to cooperate, and, very importantly, they choose what degree of commitment and what kind of relationship they desire.

It is crucial to understand that general trade treaties and confederations are merely the outer boundaries of the continuum. Countries which have decided to cooperate[5] do not only choose whether to adhere to a general trade treaty or to confederate (face a dichotomous choice), but choose among a variety of economic arrangements which require different degrees of commitments and which entail the surrender of different degrees

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[4] For a constructivist alternative to international relations theory, see Nicholas Onuf, World Of Our Making: Rules And Rule In Social Theory And International Relations (Columbia: Univ. of South Carolina Press, 1989), p. 14, who is skeptical that "anarchy is the central and defining feature of international relations."

[5] Alternatively, countries can pursue a strategy of "going it alone," i.e., self-help.

of freedom of action. For instance, several countries can reach an agreement to create a free trade area, i.e., make the commitment to eliminate all tariffs among member states, while retaining tariffs against nonmembers. A good example of such a free trade area is the European Free Trade Association (EFTA) which, when it was founded in 1960, sought to bring about free trade with a minimum of commitment. EFTA exclusively concerned itself with the removal of restrictions on trade (it would not deal with agricultural products), permitted its members to set their own tariffs concerning nonmembers, and kept institutionalization to a minimum.[6]

Alternatively, countries can opt for a more binding economic arrangement like a customs union. In this case, countries would not only contract to remove all barriers to free trade with each other, but, would also adopt a common tariff to all imports coming from outside (i.e., adopt an external tariff).[7] Part I of the Treaty of Rome, for instance, deals with the formation of a customs union[8] and provides a strict timeframe within which the

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[6] For more detail on the All-European Free Trade Area negotiations see Emile Benoit, Europe at Sixes and Sevens (New York: Columbia Univ. Press, 1961), p. 71 ff. For the actual treaty text of EFTA see, The Council of Europe, European Yearbook, vol. VII (The Hague: Martinus Nijhoff, 1960) pp. 662-727. Note that Article 1 (4) states that "The Institutions of the Association shall be a Council and such other organs as the Council may set up" (p. 663).

[7] See Joan Spero, The Politics of International Economic Relations, 3rd ed. (New York: St. Martin's Press, 1985), p. 399.

[8] It needs to be stressed that the Treaty of Rome envisaged more than the creation of a customs union, namely the creation of a customs union in the broader context of a European common

members of the European Economic Community (EEC) must have (1) reduced internal tariffs; (2) eliminated quantitative trade restrictions; and (3) established uniform external tariffs.[9] Moreover, the EEC differs markedly from EFTA in that, from the outset, the EEC was much more institutionalized to realize its more ambitious goals. A Commission, for example, is responsible for negotiating external tariffs, overseeing the implementation of agreed upon tariffs and quotas, making agricultural policy, etc. Additional governing institutions include a Council of Ministers, a Court of Justice, and an Assembly, each with clearly specified functions.[10]

Furthermore, hybrids exist such as the much fought over North American Free Trade Association (NAFTA). Very much like EFTA it seeks to eliminate barriers to trade and facilitate the cross-border movement of goods and services between members, yet, NAFTA's objectives are more comprehensive. For instance, NAFTA also covers the agricultural sector--calling for the immediate removal of 57% of trade barriers in this area--, contains more elaborate investment policies, and specifies more effective procedures for the implementation and the resolution of disputes

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market.

[9] See Clive Archer and Fiona Butler, The European Community: Structure and Process (New York: St. Martin's Press, 1992), p. 46, who stress that the customs union was realized prior to the 1970 completion date, specified in the Treaty of Rome. Also see, Benoit, Europe at Sixes and Sevens, p. 19 ff.

[10] For a discussion of the various functions of the primary EEC institutions, see Benoit, Europe at Sixes and Sevens, pp. 9-19.

by prescribing the creation of a Free Trade Commission.[11] Nevertheless, NAFTA falls short of being a customs union in that it lacks a common external tariff as well as the greater institutional sophistication of the more integrated customs union. (For a summary of the different types of economic arrangements, see figure 1)[12]

Traditional Realist Model

Realists like Hans Morgenthau and Kenneth Waltz argue that, in a self-help world, self-interested states act to assure their survival.[13] The need to rely on themselves "leads states to value autonomy and independence."[14] It is clear that, if all states pursued their self-interest, the creation of security and/or economic structures--which indicate the existence of

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[11] For the full text of NAFTA see, The U.S. Government Printing Office, The NAFTA, vol. I (Washington, DC, 1993). Note that, since NAFTA is much more comprehensive than EFTA, legislative approval for the former was much more difficult to obtain. Numerous interest groups in the U.S. (as well as Canada and Mexico) fought to retain as much freedom of action as possible and President Clinton had to agree to various side deals to assure passage of NAFTA in the House.

[12] For a discussion of a continuum of cooperative security arrangements see Katja Weber, "Hierarchy Amidst Anarchy: Transaction Costs And International Cooperation," Ph.D. dissertation, University of California, Los Angeles, 1992.

[13] See Morgenthau, Politics Among Nations; also see Waltz, Theory of International Politics (Reading: Addison-Wesley, 1979).

[14] See Joseph Grieco, "Understanding the Problem of International Cooperation: The Limits of Neoliberal Institutionalism and the Future of Realist Theory," in David Baldwin, ed., Neorealism and Neoliberalism: The Contemporary Debate (New York: Columbia Univ. Press, 1993), p. 315.

convergent interests--would be unlikely. At best, cooperative arrangements would be temporary and they would function as signaling devices with which states would inform each other of their individual interests.[15]

Yet, situations do arise in which unilateral action cannot assure the survival (economic well-being) of states, where a strategy of "going it alone" would be inferior to cooperation. Particularly in cases of high threat (military or in the form of economic competition), common interests oftentimes do exist, but the problem is that states have to fear opportunistic behavior on the part of others, i.e., that their allies could defect or cheat. States thus seek to devise institutions which facilitate cooperation by safeguarding against opportunism.[16] Or, put differently, states seek hierarchical arrangements to decrease the chances that their allies will defect when cooperation is needed to offset relative weaknesses vis-a-vis enemies (economic competitors). Hence, even in an anarchic environment that stresses survival and autonomy, self-interested actors voluntarily reduce their freedom of action to obtain necessary assurances.

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[15] See Arthur Stein, Why Nations Cooperate: Circumstance and Choice in International Relations (Ithaca: Cornell Univ. Press, 1990), p. 151, as well as Stein, "Disequilibrium and Equilibrium Theory: Explaining War in a Theory of Peace, Explaining Alliances in a Theory of Autonomy," (presentation at the Annual Meeting of the American Political Science Association, Washington, D.C., Sept. 5, 1993).

[16] See Beth Yarbrough and Robert Yarbrough, "International institutions and the new economics of organization," International Organization 44, no.2 (Spring 1990): 240.

Similarly to the military realm where the level of threat is instrumental in determining the nature and the degree of states' commitment, in the economic realm, I argue, the level of external economic threat (degree of competition) is instrumental in determining what kind of commitment countries are willing to make to each other.[17] If there is little competition, from an economic perspective, there appears to be no need to surrender sovereignty. On the other hand, if competition is high, the outcomes of market-mediated interaction are likely to be suboptimal so that we would expect states to opt for a binding economic arrangement which would give them greater assurances.[18]

However, all international relations theory can tell us is that competition may lead to the creation of cooperative economic structures, it cannot tell us what these structures will look like. Or, put differently, international relations theory, by itself, cannot account for different gradations of bindingness. Thus, we need a theoretical framework which allows us to link

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[17] Other motives for economic cooperation might be the desire to increase a country's wealth or the need to strengthen an already existing alliance to enhance the allies' chances to prevail in a military competition with an adversary. For more detail on the latter, see Joanne Gowa, "Bipolarity, Multipolarity, and Free Trade," American Political Science Review 83, no.4 (1989): 1245-56; and Lars Skalnes, "Allies and Rivals: Politics, Markets, and Grand Strategy," Ph.D. diss., University of California, Los Angeles, 1992.

[18] See Robert Keohane, "The demand for international regimes," in Stephen Krasner, ed., International Regimes (Ithaca: Cornell Univ. Press, 1983).

hierarchical governance structures to the issue of providing protection against competition. That is, we need to know the exact relationship between various hierarchical arrangements and increased economic security. Without such knowledge, international relations theory, at best, can tell us that a high level of competition (economic threat) may be necessary for countries to create a binding economic arrangement, but that high competition is not sufficient.[19]

## Economies of Scale and International Integration

Security and economic arrangements between states are mechanisms for aggregating the capabilities of states in situations in which individually the states have inadequate capability to deal with threats that confront them. In fact, the scale required to generate the capability to assure survival (economic well-being) often exceeds any one state so that cooperation becomes necessary.

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[19] See Grieco, "Understanding the Problem of International Cooperation," who argues that "to date it [realism] has not offered an explanation for the tendency of states to undertake their cooperation through institutionalized (emphasis in original) arrangements" (p. 335). Note that classical liberalism also is inadequate to explain hierarchical arrangements. Although liberals are more optimistic about the prospects of cooperation (states increasingly view each other as partners instead of enemies) and focus on absolute rather than relative gains, these scholars have no conceptual framework which allows them to account for the type of cooperative economic arrangements countries choose. As Stein (1993) correctly points out, liberals view states as "autonomous self-interested actors [who] engage in mutually advantageous exchange. [Thus], the international system, like a market, should involve only discrete interactions and not entail alliances" (p. 14 footnote 35).

Richard Bean, for instance, argues that just as gains from specialization in different activities can give rise to economies of scale for firms, there are advantages of large size among political organizations.[20] But, as Bean puts it, "economies of scale are checked at some point by decreasing returns," i.e., the larger political units become, the greater their problems of command and control so that there is an "optimal range of size."[21] Political units which exceed this optimal range are likely to break apart while those that are smaller than the optimal range are likely to be integrated into other political units.

In short, what Bean and many of his colleagues suggest is that institutions are created to allow individual members to reap the benefits inherent in economies of scale. If we can pinpoint the factors which force political (or economic) actors to merge or collaborate to attain a sufficient size to assure their survival, we then can account for institutional change.[22]

It is important to stress that the economies of scale approach (much like the traditional realist model) focuses on

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[20] See Richard Bean, "War and the Birth of the Nation State," Journal of Economic History 33 (1973): 203-221.

[21] Ibid., pp. 204-205.

[22] For another example of scholarly work which explains change in the relative size of states, see Charles Tilly, ed., The Formation of National States in Western Europe (Princeton: Princeton Univ. Press, 1975). For a study which examines economic factors (changes in relative product and factor prices; changes in the size of markets), see Douglass North and Robert Thomas, "An Economic Theory of the Growth of the Western World," The Economic History Review 23, no.1 (1970): 1-17.

size rather than bindingness. Thus, all economies of scale proponents can tell us is that size considerations may lead to institutional change, but they cannot specify the exact nature (structural makeup) of the new institutional arrangements.[23]

For some time, international relations scholars have borrowed essential ideas from economics to enhance our understanding of how the international system operates. Waltz, for instance, draws an analogy between the anarchic international system populated by competing states and the economic market populated by competing firms.[24] Similarly, Kenneth Boulding compares the "states of the international system" with the "states of the market."[25] Moreover, Thomas Schelling tests how much explanatory power economic theories have outside of economics.[26]

Yet, the competitive market model has proved inadequate in economics, and is thus flawed as an analogy for international politics. That is, although the competitive market analogy is consistent with a world in which small unit level actors

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[23] Also see Hendrik Spruyt, "Institutional Selection in International Relations: State Anarchy as Order," International Organization 48, no.4 (1994) :551, who argues that scholars focusing on size do so at the expense of examining "institutional characteristics."

[24] See Waltz, Theory of International Politics pp. 89-91.

[25] Kenneth Boulding, "Theoretical Systems and Political Realities: A Review of Morton A. Kaplan, System and Process in International Politics," Journal of Conflict Resolution 2 (Dec. 1958): 330.

[26] See Thomas Schelling, Micromotives and Macrobehavior (New York: Norton & Co., 1978), p. 23.

(producers) engage in cooperative exchange, the market analogy cannot account for the creation of larger economic structures such as firms or regional arrangements. If we want to explain the emergence of these larger aggregates, economists like Ronald Coase and Oliver Williamson tell us, we need to focus on transaction costs.[27]

Knowing that the solution for hierarchy amidst market anarchy centers upon transaction costs, I now discuss the role of transaction costs in economics, and then, draw the analogue of the transaction costs argument for international relations.

## Economists and Hierachy

Neoclassical economists view the economic system as being coordinated by price mechanisms (supply is adjusted to demand), and hence, as basically "working itself."[28] The market, these scholars argue, is superior to more centralized organizations, since the market is the "natural and efficient" way to mediate transactions.[29]

Yet, as Coase in his seminal 1937 article "The Nature of the

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[27] See Ronald Coase, "The Nature of the Firm," Economica N.S., 4 (1937): 386-405; also see Oliver Williamson, The Modern Corporation: Origins, Evolution, Attributes," Journal of Economic Literature 19 (Dec. 1981): 1537-1568.

[28] For a more detailed discussion of this position, see Coase, "The Nature of the Firm," p. 387.

[29] See Williamson, "The Modern Corporation," p. 1540; also see p. 1544, where Williamson explains that a transaction occurs "when a good or service is transferred across a technologically separable interface."

Firm" explains, the use of the price mechanism to organize production costs something, since economic agents have to establish what the relevant prices are at a given time and then incur costs in preparing, negotiating, and concluding agreements.[30] Firms thus arise because they are a more efficient way of organizing production. Or, put differently, Coase argues that firms are a response to market failures, i.e., transaction costs.[31] He then qualifies his argument in two important ways, namely by suggesting that without uncertainty a firm probably would not emerge,[32] and by proposing that a firm can be expected to expand only "until the costs of organising an extra transaction within the firm become equal to the costs of carrying out the same transaction ... on the open market."[33]

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[30] Coase, "The Nature of the Firm," pp. 390-91.

[31] See Ernest Englander, "Technology and Oliver Williamson's Transaction Cost Economics," Journal of Economic Behavior and Organization 10 (1988): 340. Note that the real determining factor whether coordination takes place through the market or through organizations is the net balance of organization- and transaction costs. However, since in the security realm organization costs do not play a decisive role--i.e., countries will pay even for high set-up costs of an organization if they feel the organization would enhance their security noticably--, I will neglect organization costs in the following analysis and merely focus on transaction costs. Or, put differently, I suggest that organization costs are not security related, whereas transaction costs are.

[32] For a more detailed discussion of the effects of uncertainty see Frank Knight, Risk, Uncertainty and Profit (1922), pp. 267-68, cited in Coase, "The Nature of the Firm," p. 399. (Note that Knight's book has been reprinted in 1965 by Harper & Row.) Also see Jack Hirshleifer and John Riley, The Analytics of Uncertainty and Information (New York: Cambridge Univ. Press, 1992).

[33] Coase, "The Nature of the Firm," pp. 394-95.

Although Coase--by arguing that hierarchical institutions can be more efficient than the market, and hence, are alternative ways of coordinating production--, significantly contributed to the economic theory of organization, a coherent theory did not come about until the 1970s, when Williamson began to operationalize the concept of transaction costs and to assign different transactions to different governance structures.[34]

Williamson's analysis relies on two assumptions about human nature. Borrowing from Chester Barnard and Herbert Simon,[35] Williamson, first of all, stresses that man possesses only "bounded rationality," i.e., he is limited in his ability to formulate and/or solve complex problems and to process information.[36] Secondly, man acts opportunistically. This means that man occasionally engages in undesirable behavior such as "lying, stealing, and cheating ..." but which also includes "calculated efforts to mislead, distort, disguise."[37] Due to

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[34] Between 1940 and 1970 most scholars continued to characterize firms as production functions, but there were a few noticeable exceptions like Arrow, Barnard, Chandler, or Simon. For a good overview of these scholars' studies which helped bring about a transaction costs theory, see Williamson, The Economic Institutions of Capitalism (New York: The Free Press, 1985), pp. 7-12.

[35] See Chester Barnard, The Functions of the Executive (Cambridge: Harvard Univ. Press, 1938). Also, see Herbert Simon, Administrative Behavior, 2d ed., (New York: Macmillan, [1947] 1961), p. xxiv, who refers to man as "intendedly rational, but only limitedly so."

[36] See Williamson, "The Modern Corporation," p. 1545.

[37] See Williamson, The Economic Institutions of Capitalism, p. 47. Note that Williamson defines opportunism as "self-interest seeking with guile."

these two behavioral characteristics (bounded rationality and opportunism), Williamson argues, man not only substantially differs from the person he is described to be in neoclassical economics--a "trustworthy maximizer"--,[38] but also, man makes it impossible for economic activity to be organized effectively by contract. Williamson then claims that, when the behavioral attributes of bounded rationality and opportunism join with two environmental factors, namely uncertainty and small-numbers bargaining, transaction costs difficulties arise which oftentimes lead to organizational failures.[39]

Refining an earlier definition of transaction costs by Kenneth Arrow,[40] Williamson then differentiates between ex ante and ex post transaction costs. Ex ante transaction costs include the costs of "drafting, negotiating and safeguarding an agreement" whereas ex post transaction costs consist of "haggling, ... setup and running costs of governance structures,

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[38] See Williamson, "The Modern Corporation," p. 1545; Williamson, The Economic Institutions of Capitalism, p. 45.

[39] See Williamson, Markets and Hierarchies: Analysis and Anti-Trust Implications: A Study in the Economics of Internal Organization (New York: The Free Press, 1975), pp. 4, 7.

[40] See Kenneth Arrow, "The Organization of Economic Activity: Issues Pertinent to the Choice of Market Versus Nonmarket Allocation," in The Analysis and Evaluation of Public Expenditures: The PPB System, vol. I. U.S. Joint Economic Committee, 91st Congress, 1st Session (U.S. Government Printing Office, 1969): 59-73. Note that Arrow defines transaction costs as "the costs of running the economic system." For a summary of Arrow's transaction costs discussion, see Williamson, "The Modern Corporation," p. 1541.

... and bonding costs of effecting secure commitments."[41]

As Coase and Arrow before him, Williamson claims that, if transaction costs are high, the market is no longer the most efficient governance structure. The objective thus is to identify the most effective institutional or organizational framework for each transaction, i.e., to assign transactions to appropriate governance structures. To accomplish this task Williamson seeks to ascertain how transactions differ and focuses on three attributes of transactions.

First, he studies the frequency of transactions. He differentiates between transactions which occur only once, those that occur occasionally, and transactions which are recurrent. He claims that the creation of a specialized institutional framework is easier to justify for transactions which are recurrent rather than occasional, since the setup costs of a highly specific structural apparatus oftentimes cannot be recovered for occasional transactions.[42]

A second dimension of transactions Williamson looks at is asset specificity, i.e., the degree to which transaction-specific investments are incurred.[43] Williamson argues that an asset is

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[41] For a more detailed discussion of each of these components of transaction costs, see Williamson, <u>The Economic Institutions of Capitalism</u>, pp. 20-21.

[42] See Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations," <u>The Journal of Law and Economics</u> 22, no.2 (Oct. 1979): 246, 249.

[43] Ibid., p. 239. Also see Benjamin Klein, Robert Crawford, and Armen Alchian, "Vertical integration, appropriable rents, and the competitive contracting process," in Louis Putterman, ed.,

specific, if it is "less transferable to other uses or users."[44] To determine the degree of asset specificity one thus needs to ask how specialized investments are, i.e., whether their assets are redeployable.[45]

If the supplier of an asset can easily find other buyers or if other suppliers are available to the buyer, both parties are protected by the availability of alternative partners so that they incur few transactional risks.[46] If, however, an asset is designed for a particular use by a particular person, and the value of the asset would be significantly reduced if the asset were used otherwise or by another person, a breakdown of this relationship would cause serious damage. In situations like this, Williamson claims, all parties have an incentive to bring about a "fundamental transformation," i.e., to move their relationship out of the market and into a hierarchical governance structure to obtain additional safeguards.[47]

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The Economic Nature of the Firm (Cambridge: Cambridge Univ. Press, 1986), who associate transaction-specific investments with "appropriable quasi-rents."

[44] Williamson, "The Modern Corporation," p. 1548.

[45] Williamson, The Economic Institutions of Capitalism, p. 54.

[46] See Englander, "Technology and Oliver Williamson's Transaction Cost Economics," p. 345; also see Williamson, "Transaction-Cost Economics," p. 239.

[47] For a more detailed discussion of the concept of a "fundamental transformation", see Williamson, The Economic Institutions of Capitalism, p. 61; Yarbrough and Yarbrough, "International institutions and the new economics of organization," pp. 245-46.

Third, Williamson examines the uncertainty under which transactions take place. He argues that, if transactions are nonspecific, an increase in the degree of uncertainty has little effect, since new trading partners can easily be found.[48] However, if transactions entail specific assets, an increase in the degree of uncertainty makes it necessary to move transactions out of the market into firms "since the costs of harmonizing a relation among parties vary directly with the need to adjust to changing circumstances."[49]

A Transaction Costs Model of International Hierarchy

Just as economists argue that, given transaction costs, hierarchical governance structures are more efficient than the market, I claim that there are situations in international relations where it is beneficial to replace anarchy with hierarchy. As discussed above, in cases of high threat (economic competition), states seek to create institutions which facilitate cooperation by raising the costs of opportunistic behavior. Thus, even in a self-help system which stresses autonomy, self-interested actors voluntarily curtail their sovereignty to obtain needed assurances.

I therefore propose that international relations resemble the world of firms in that the provision of economic security can

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[48] See Williamson, The Economic Institutions of Capitalism, p. 59.

[49] See Williamson, "The Modern Corporation," p. 1549; Williamson, The Economic Institutions of Capitalism, p. 60.

require replacing anarchy (market) with hierarchical governance structures (firms), at least among a subset of states. It is important to stress that the substitution of hierarchy for anarchy is costly[50] so that hierarchical governance structures do not only come about because they promise greater economic security, but also, because they can reduce transaction costs. That is, just as economic agents--to minimize transaction costs--tend to arrange themselves hierarchically, threatened states that are weakened by the enormous costs involved in gathering and evaluating information, preparing for, negotiating and concluding agreements, seek allies. Given that coordinated efforts are oftentimes more efficient than individual efforts, I argue that countries facing high transaction costs could benefit from joining political and/or economic entities with well developed, cooperative organizational structures.

Clearly, the level of transaction costs is important in determining which economic arrangement countries choose. If transaction costs are negligible, the organization of economic activities for efficiency reasons seems to be irrelevant. If transaction costs are low, I would expect countries to strive for greater freedom of action and, hence, to prefer a less binding economic arrangement. Yet, as the level of transaction costs increases, I hypothesize that the likelihood of a country preferring a confederation over a general trade treaty will also increase.

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[50] See Waltz, Theory of International Politics, p. 111.

Pulling together the different strands of my argument, I propose to combine two variables--level of threat (economic competition) and transaction costs--to explain the type of hierarchical economic structures countries choose. That is, first of all, I suggest that, the greater the level of competition, the greater the need for assurance and the greater the willingness to forgo some freedom of action, and hence, the greater the likelihood of a country to enter a binding arrangement, provided time constraints (as in situations of extreme threat) do not forclose this option. A high level of threat thus is assumed to be necessary for a confederation to come about. Secondly, I argue that, the higher the level of transaction costs, the greater the likelihood that a country will prefer a more binding arrangement. Hence, in situations characterized by high threat and high transaction costs a confederation should be most likely. If the level of threat is low, countries can be expected to choose less binding arrangements, even if transaction costs are high. Conversely, if the level of threat is high but transaction costs are low, I would expect countries to seek binding economic arrangements, yet not to confederate, since chances for opportunistic behavior are reduced so that the creation of a confederation is not essential. I therefore hypothesize that both a high level of threat and high transaction costs are necessary to bring about a confederation (they are separately necessary), but that neither is sufficient (only jointly are they sufficient)[51] (see figure 2).

## Assessing Threats And Transaction Costs In International Politics

Having laid out my argument, I now turn to the operationalization of my main variables. I begin by focusing on the level of economic competition in the international system, and then, discuss factors which are crucial in ascertaining the magnitude of transaction costs.

Unlike the security realm, where an assessment of threat has become fairly routine (scholars study military capability; geographic proximity; military reputation),[52] in the economic realm, a measure of threat is less straightforward. Not surprisingly, therefore, scholars oftentimes merely assert that economic competition exists rather than to examine its magnitude. And yet, it is possible to compile a list of factors that--depending on the case to be scrutinized--allow us to ascertain countries' economic competitiveness. For example, one could compare gross domestic product (GDP) and unemployment figures of

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[51] Note that the symmetric existence of high threat and high transaction costs is presumed for the creation of a very binding economic apparatus. Hence, truly binding arrangements are more likely to occur among weaker states and are less likely with a great power, if for no other reason than that the concern about opportunistic behavior is unlikely to be both high and symmetrical for a great power and its weaker allies.

[52] See Stephen Walt, The Origins of Alliances (Ithaca: Cornell Univ. Press, 1987), pp. 23-24.

various states.[53] Or, one could focus on Organization for Economic Cooperation and Development (OECD) statistics on high-technology trade; Research and Development expenditures as percentage of GDP; or the percentage of market share in electronics.[54]

Turning to a discussion of transaction costs, I now delineate analogues for the factors that generate transaction costs in the realm of international relations (international political economy). Four factors in particular, I suggest, are critical in determining the magnitude of transaction costs.

First of all, as Williamson shows for contractual relations in the economic realm, the degree of uncertainty under which transactions are executed appears to be crucial. The greater the uncertainty of transactions, the higher the transaction costs, and thus, the greater the need for institutional structures that facilitate communication and cooperation between the parties involved.

However, one needs to keep in mind that Williamson argues that an increase in the degree of uncertainty only seriously impacts transactions which entail specific assets. That is, for nonspecific transactions an increase in uncertainty has virtually no effect, since alternative trading partners can easily be

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[53] See Geoffrey Garrett, "International Cooperation and Institutional Choice: The European Community's Internal Market," International Organization 46, no.2 (1992): 539.

[54] For a more detailed discussion of these variables, see Timothy Devinney and William Hightower, European Markets After 1992 (Lexington: Heath & Co, 1991), chapter 4.

found. Yet, if transactions are specific, the greater the degree of uncertainty, the greater the need to create an institutional framework which is capable of dealing with contractual gaps, i.e., which can mediate between the parties, and thus, help to "work things out."[55]

An analogous argument can be made for cooperative economic arrangements in the international realm. If transactions are executed under a low degree of uncertainty, countries are expected to prefer greater freedom of action over more binding institutional arrangements. However, as the degree of uncertainty increases, so does the likelihood that countries will create more binding economic arrangements, since countries now have to fear opportunistic behavior on the part of their allies which could endanger their economic security.

To measure the degree of uncertainty in the international system I focus on the number of potential trading partners to deduce hypotheses concerning cooperative behavior. More specifically, I postulate that the larger the number of potential trading partners, the greater behavioral uncertainties (risk of defection), since other countries might be available which can make more attractive offers. Moreover, the larger the number of actors seeking cooperation, the greater the likelihood of incomplete information, and hence, the greater the need for

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[55] For a discussion of this interaction effect between uncertainty and asset specificity, see Williamson, The Economic Institutions of Capitalism, pp. 59-60.

institutionalization.[56]

Secondly, asset specificity influences states' behavior significantly. As Williamson argues, transactions which do not entail specific investments, i.e., which are easily transferable to other uses or users, pose few hazards, since both buyers and suppliers can redirect their investments to alternative sources.[57] However, as assets become more specific--i.e., impossible or very costly to redeploy--, economic agents have to fear opportunism by others (cheating or defecting), and thus, are likely to design specific governance structures with "good continuity properties."[58] Or, in other words, if--due to a high degree of asset specificity--transactional risks are high, economic agents are likely to move their relationship out of the market and into a hierarchical governance structure to obtain additional safeguards.

The same rationale can be applied to economic relations in the international realm. As assets become more specific, states have to fear opportunistic behavior on the part of their allies--i.e., that allies seek to cheat on previously negotiated agreements or defect from the economic arrangement--, and thus, are more likely to create more binding economic arrangements with

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[56] For a discussion of different types of uncertainty, see Williamson, The Economic Institutions of Capitalism, pp. 56-59. For an operationalization of uncertainty in the security realm, see Katja Weber, "Hierarchy Amidst Anarchy," pp. 34-38.

[57] See Williamson, "Transaction-Cost Economics," p. 239.

[58] See Williamson, "The Modern Corporation," p. 1546.

highly developed institutional structures. Conversely, if assets can be used in various ways, an elaborate institutional structure seems to be unnecessary, since states face fewer transactional risks. It can therefore be hypothesized that, the more specific the assets involved in a transaction, the greater the likelihood that countries will confederate rather than opt for a structurally less binding form of cooperation, since the chances of opportunistic behavior should be significantly reduced in a more binding arrangement, due to the high reputation and/or security costs defectors or cheaters are likely to incur.

For instance, if country A promises to aid country B by sending unskilled workers--rather than specialized equipment--, yet cheats (only partially fulfills its promise) or defects (reneges on its promise), in addition to hurting country B country A damages its reputation as a dependable partner, and thus, incurs reputation costs. But, provided the defector's (country A) reputation has not been damaged to the point where no one else would want to cooperate with it, the defector could conceivably redeploy its workers and country B might be able to fill the void brought about by country A's defection by allying with country C. On the other hand, if country A commits itself to contribute to a joint production process by providing highly specialized equipment, yet cheats or defects, in addition to leaving its ally (country B) in a very vulnerable position country A not only seriously damages its reputation, but also jeopardizes its own security (economic well-being), unless it can reequip itself and then join some other cooperative arrangement.

In sum I thus propose that--given high economic threat--the asset specificity component of my transaction costs argument implies that structurally less binding economic arrangements are most likely in those cases in which states do not feel the need to invest in specific assets. Or, in other words, states are likely to seek less rather than more binding economic arrangements if states can maintain the type of assets they had prior to their cooperation efforts. On the other hand, where economic arrangements require investing in highly trained men, specialized equipment, or specific sites that states otherwise would not invest in or could not readily shift to, then there is a desire for greater bindingness to reduce transactional risks.

Third, as Williamson correctly points out, the frequency of transactions factors into states' institutional choices. Countries with a need to interact frequently can be expected to seek a structurally more binding cooperative arrangement than countries which plan to interact only once or occasionally, since the former are likely to recover the high setup costs of a sophisticated institutional arrangement and then to economize on transaction costs in the long-run.[59]

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[59] Note that, in the security realm, the frequency of transactions is not an issue. Countries that are threatened are primarily interested in assuring their survival, rather than to contemplate whether--at a later point in time--they will be able to recover the costs of bringing about a binding security arrangement. Even if countries were to use a particular security arrangement only once, yet it could be responsible for the countries' survival, the arrangement more than would have paid for itself.

Fourth, the degree of homogeneity of states seeking to cooperate is crucial. That is, I postulate that, the greater the degree of heterogeneity between countries, the greater the likelihood of language problems, misunderstandings and disagreements,[60] and therefore, the greater the need for translation, arbitration and costly coordination which increases transaction costs significantly. Put differently, the more varied the language, cultural and political backgrounds of countries seeking to cooperate, the higher their transaction costs, and thus, the greater their need for political structures which can reduce these costs. It is important, however, to understand that a high degree of heterogeneity is neither a necessary nor a sufficient condition for the creation of a confederation. I merely argue that a study of the cost-benefit implications of homogeneity can explain why a low degree of homogeneity raises the transaction costs countries incur and thereby, contributes to our understanding of why states choose the cooperative arrangements they do.[61]

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[60] See Waltz, Theory of International Politics, p. 136, who claims that "the diversity of parties increases the difficulty of reaching agreements."

[61] For an argument that views confederations as rooted in culture rather than in terms of costs and benefits, see Harold Guetzkow, "Isolation and Collaboration: A Partial Theory of Inter-Nation Relations," Journal of Conflict Resolution 1 (1957): 158; and Karl Deutsch, et al., Political Community and the North Atlantic Area: International Organizations in the Light of Historical Experience (Princeton: Princeton Univ. Press, 1957). These scholars have claimed that states sharing the same religion, language, cultural, and political traits are more likely to ally than states which differ on those counts. Yet, these scholars have not told us how the degree of homogeneity

Transaction Costs And European Integration

To test the above propositions, I examine recent integrative moves within the European Community (since the Maastricht Treaty referred to as the European Union [E.U.]). I show that economies of scale arguments face problems explaining integrative developments like the Single European Act and the Maastricht Treaty and I sketch what additional insights we can gain from a transaction costs approach.

Typically, to account for integrative measures like the Single European Act in the mid-1980s, proponents of an optimal size approach focus on economic changes in the 1970s and 1980s (the rapid industrialization of Japan and several East-Asian countries) as well as an "unprecedented technological revolution" which brought about a need for change.[62] More specifically, we are told that the economies of scale for modern industrial high-tech firms require markets of a certain size. The United States--by virtue of its sheer size--has a built-in advantage and the Japanese have solved their market problem by functioning as an export platform to an open American economy. To remain competitive (avoid economic decline), the Europeans have to create comparable firms and a comparable market, i.e., they need

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affects a state's choice between a structurally less binding cooperative arrangement and a confederation, and their cultural explanation does not provide a causal logic.

[62] See Devinney and Hightower, European Markets After 1992, p. 5; also see Robert Keohane and Stanley Hoffmann, "Institutional Change in Europe in the 1980s," in Keohane and Hoffmann, eds., The New European Community: Decisionmaking and Institutional Change (Boulder: Westview Press, 1991), p. 22.

to coordinate their efforts.

Technically, European economic integration (the creation of a common external tariff and the reduction of internal tariffs) should have created an internal market and the institutional backdrop for the pursuit of the scale economies extant in modern production. However, what one finds in the European case is that the economies of scale were not realized because of the existence of transaction costs. In fact, the residue of incongruent domestic policies and practices (non-tariff barriers) still prevented European firms from making use of scale economies. For instance, the German government insisted on a long-established German beer purity law (Reinheitsgebot) which restricts the ingredients that can be used to make beer, and thus, prevents foreign beer from being sold on the German market. Similarly, Italy had instituted a pasta purity law, Spain enforced an aging period of three years before whiskey could be sold, etc.

To remedy this problem, i.e., to do away with transaction costs that obstruct the creation of a truly integrated market, the Europeans developed plans for "Europe 1992" which entail the harmonization of a range of practices that affect competitiveness and mobility. In a White Paper entitled "Completing the Internal Market" the European Commission identified close to 300 measures which would have to be taken to establish conditions in which "buying, selling, lending, borrowing, producing and spending" could be done as easily on a Community as on a national basis.[63]

Moreover, one can point to the fact that, since the founding of the European Economic Community in 1957,[64] with each new member--Britain, Denmark, and Ireland were added in 1973; Greece in 1981; Portugal and Spain in 1986; and Austria, Finland and Sweden in 1995--and every new task, cooperation costs increased. As the European Union's institutional machinery proves less and less capable of coping with the numerous demands placed upon it--i.e., as an ever greater amount of information needs to be processed; as frequent disputes between members require more sophisticated arbitration mechanisms; as new voting procedures become necessary to prevent stalemate--, greater centralization has to be achieved to internalize transaction costs.[65] Or, put differently, I argue that a transaction costs approach can explain why getting rid of internal tariffs and establishing a common external tariff was not enough to realize economies of scale in Europe, and hence, why the elimination of non-tariff barriers (as specified in the White Paper) was so important.

To be able to account for the specific type of cooperation chosen by the E.U. members a careful empirical test is needed.

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[63] See Devinney and Hightower, European Markets After 1992, p. 40; and John Rourke, International Politics on the World Stage (Guilford: The Dushkin Publishing Group, 1993), p. 534.

[64] Note that, in 1967, the European Economic Community, the European Atomic Energy Community, and the European Coal and Steel Community were merged into a single organization, the European Community (EC).

[65] See Douglas North, Institutions, Institutional Change and Economic Performance (Cambridge Univ. Press, 1990), p. 127.

If one systematically were to examine the degree of threat and the magnitude of transaction costs the individual E.U. members were exposed to in the 1980s and early 1990s, one should be able to explain which country (countries) initiated the move toward greater integration and why the E.U. took the specific structural form it did. This then suggests that a transaction costs approach can be seen as an alternative to bargaining arguments which focus on the interests and relative power of states to account for cooperative behavior in the international system.[66]

Without actually conducting a case study of the E.U. one might speculate that, as more and more countries seek E.U. membership and place additional demands on the Union's institutions, the Europeans will curtail their freedom of action

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[66] Note that Garrett in "International Cooperation and Institutional Choice" criticizes transaction costs arguments for ignoring "bargaining over institutional designs" (pp. 541; 559). In fact, he stresses that occasionally situations arise where "it is difficult to discriminate between different potential outcomes in terms of their efficiency" (p. 534) and that therefore an examination of interstate bargains would be beneficial. Yet, just as the preferences of powerful states can shed light on the specific cooperative paths chosen by these actors, I maintain that a careful analysis of transaction costs fares equally well in accounting for the exact nature of structural commitments. Hence, I do not see the need to supplement transaction costs arguments with bargaining arguments, but rather, view the former as competing in explanatory power with the latter.
For further explanations focusing on the interests of states to account for integrative moves within the E.U., see Geoffrey Garrett and Barry Weingast, "Ideas, Interests, and Institutions: Constructing the European Community's Internal Market," in Judith Goldstein and Robert Keohane, eds., Ideas and Foreign Policy: Beliefs, Institutions, and Political Change (Ithaca: Cornell Univ. Press, 1993); and Andrew Moravcsik, "Negotiating the Single European Act: National Interests and Conventional Statecraft in the European Community," International Organization 45, no.1 (1991): 19-56.

even further to cope with the high transaction costs they are likely to confront in the not so distant future.[67] Or, in other words, one might speculate that the E.U. will continue to become stronger and more centralized so that it can internalize its rapidly growing transaction costs.

Yet, recently, we have also been reminded that countries treasure their sovereignty and do not curtail their freedom of action easily. The reaction to the Maastricht Treaty, calling for the further integration of macro-economic policies in Europe (a single European currency; a common foreign and security policy; the abolition of frontier controls; a common immigration policy), is a clear affirmation of the importance of sovereignty. In this case, the proponents of greater European institutionalization (France, Italy, and the Benelux countries) suffered a major setback. In a first referendum, Denmark refused to ratify the treaty. Then, voting for a second time, the Danes decided to ratify parts of the treaty, yet, together with the British, exempted themselves from the adoption of other parts.

It is clear that progress towards greater European

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[67] Clearly, members of the European Free Trade Area (EFTA) are interested in E.U. membership and so are the newly created East European democracies. In fact, as Keohane and Hoffmann suggest, "a Community of twenty-four rather than twelve [now fifteen] members is a distinct possibility by the end of the century," see "Institutional Change in Europe in the 1980s," p. 8. For a more detailed account of the debate between proponents of "widening" versus "deepening," see Jacques Delors, "Europe's Ambitions," Foreign Policy no.80 (Fall 1990); Paolo Liebl, "The Illusions of 'Euro-Optimism,'" The American Enterprise (March/April 1991); Angelo Codevilla, "The Euromess," Commentary (Feb. 1993); and Walter Goldstein, "Europe After Maastricht," Foreign Affairs 72, no.5 (Winter 1992/93).

integration in the political/security realm, presently, is stalled. Since, due to the reduction in threat brought about by the end of the Cold War, there is no security basis for further integration, there is no movement toward a common foreign policy -as could be witnessed in the case of the former Yugoslavia. Hence, Europe is not a "superpower in the making," the individual members of the E.U. maintain a substantial amount of their sovereignty, and there is no widespread desire for a United States of Europe.

While excessively ambitious visions of some integrationists are being left behind, those elements of European integration promising a reduction in transaction costs are still being pursued vigorously. That is, although the deadline for the creation of a single European currency (1999) will not be met,[68] remarkable progress toward greater integration has been achieved Since the formulation of the White Paper, the majority of the directives (70-75%) outlined has been implemented so that much fewer non-tariff barriers to trade exist. Aside from that we find that decisionmaking is increasingly being pooled and transferred to the E.U. level.[69]

These recent developments within the European Union have important implications for our understanding of international institutions and of a transaction costs model of international

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[68] The only country which currently meets the conversion criteria specified in the Maastricht Treaty is Luxembourg.

[69] See Martin Holland, European Community Integration (New York: St. Martin's Press, 1993), pp. 87-88.

hierarchy. The latest integrative moves lend support to the position that institutions are developed at the level of the transaction costs problem. Thus, states can create or intensify organizational ties in one issue area (for instance economics), while leaving other domains (such as security) untouched.

On a theoretical level this suggests that we need to rethink "spillover" arguments of integrationists and functionalists. Whereas scholars like David Mitrany, for instance, claim that--once "habits of cooperation" have been formed--economic and political integration will eventually lead to greater cohesion in the security realm,[70] I argue that this should only be the case if integrated institutions are issue-specific, i.e., if it is impossible for institutional benefits from one domain (for instance the economic realm) to spill over into a second domain (security realm). Conversely, if the existence of institutional structures in one area also lowers states' transaction costs in another area, then there should be no need to create yet another binding arrangement. This is not to say that a "spillover" will hardly ever occur, but that it is much less automatic than integrationists and functionalists lead us to believe.

## Hierarchy Amidst Anarchy: A Final Thought

As I have discussed above, realists tell us that, in an anarchic world, self-interested states act to assure their

[70] See David Mitrany, A Working Peace System (Chicago: Quadrangle Press, [1943] 1966).

survival. If all states pursued their self-interest, cooperation--presuming the existence of convergent interests--would be unlikely. Yet, as I have shown, situations do arise in which unilateral action cannot assure the survival (economic well-being) of states so that self-interested actors voluntarily curtail their autonomy to obtain necessary assurances. Or, in other words, in an anarchic environment, self-interested states not only eye each other, but their very self-interest leads them to accept some degree of hierarchy amidst anarchy.

Since cooperation is costly, hierarchical governance structures do not only come about because they promise greater security or economic benefits, but also because they can reduce transaction costs. Or, put differently, self-interested actors create large-scale organizations to internalize transaction costs that otherwise would plague their exchanges.

Given that the international system currently is in a state of flux and that numerous countries are reevaluating their security provisions as well as their economic competitiveness, we are likely to see the adjustment or replacement of extant security and/or economic arrangements. Certainly, there are a number of conceivable developments. Whether we will see cooperation or conflict, and the magnitude of either, only time will tell. In the end, all we can hope for is that the self-interest of states will lead them towards a cooperative path, i.e., that states will continue to create international institutions to mitigate the effects of anarchy.

Figure 1: Continuum of Cooperative Economic Arrangements

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<------------------------------------------------------------------>
 general      free trade        customs    common     economic
 trade        area              union      market     confederation
 agreement    (EFTA)    (NAFTA)          (EC---->)


           --------> freedom of action, sovereignty,
                     autonomy, maneuverability
                     decrease
           --------> costs of exiting the arrangement
                     increase
           --------> likelihood of defection decreases

           ========> arrangements become more binding
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Figure 2: Summary of the Determinants of States' Choices in the Economic Realm

| | | Level of Competition | |
|---|---|---|---|
| | | Low | High |
| Trans-action Costs | Low | No cooperation; or free trade | Customs Union |
| | High | no cooperation | economic confederation |