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by Horst Siebert

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How Global Rules are established and stabilized*

Horst Siebert

Abstract: This paper analyzes how international rules are established and stabilized, i.e. how an international institutional order develops. Rules emerge mainly through learning from negative experience and serve to reduce transaction costs. The paper looks at mechanisms that stabilize rule systems, at bargaining procedures for cooperation gains, dispute settlement, sanctions, side payments, self-enforcing contracts, waivers and regional integrations within a multilateral order. In addition it analyzes the prevention of negative spillovers, international courts and global public goods.

Keywords: International rules, transaction costs, institutional competition, gains from cooperation, bargaining for cooperation gains, positive mechanisms, dispute settlement, sanctions, side payments, self-enforcing contracts, negative spillovers, international courts, global public goods.

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How Global Rules are established and stabilized

Horst Siebert

Institutional rules have developed in an evolutionary process. They emerge in many ways: learning from experience and searching explicitly for lower transaction costs, relying on institutional competition, agreeing on markets as a mechanism of allocation, securing cooperation gains, internalizing border crossing externalities and dealing with global public goods.

Learning from negative experience and searching for lower transaction costs

One way to explain the emergence of rules is to interpret them as the result of learning from experience. Most importantly, a negative experience that inflicts severe hardship on people becomes the underlying origin of a new rule. In such cases, rules are established ex post, after the negative experience has been made. They represent the ex-post result of preventing human tragedies in the future and may be regarded as the outcome of pathological learning.

A historic case in point is when a negative experience served as a starting point for new rules is the principle "*cujus regio, ejus religio",* agreed upon in the Westphalian Peace of Münster, Germany, in 1648. It came to life at the end of the Thirty Years War, mainly caused by a religious split in the European continent. According to this new principle, the religion of the ruling prince or king determined the religion of the region's inhabitants. In this way, religious wars could be prevented. The Second World War and the disintegration of the world economy in the 1930s led to the founding of today's most important global rule systems, namely for the trade order – represented by GATT and its successor, the WTO– and for monetary-financial stability - represented by the IMF. The World Bank, also founded after World War II and an important organization, does not represent a rule system in the strict interpretation of rules used throughout this book. It is instrumental to make it possible for developing countries to participate in the international division of labor, i.e. to accept the rule system for trade.

In contrast to disasters, a milder negative experience may also be at the origin of rules, for instance the insight that existing procedures are inadequate, too costly or that they can be improved considerably. When dissatisfied with a given situation, people actively search for new rules. Unlike the ex-post approach after a devastating experience, an ex ante element becomes visible. A significant example is the evolution of the GATT into the WTO, i.e. the advancement into a better, more comprehensive institutional set-up. Another case is dissatisfaction with a given situation as the poverty and poor health in Africa which is the origin of many private foundations as the Gates Foundation. Also, immanent dangers such as global warming may entice people to become active to

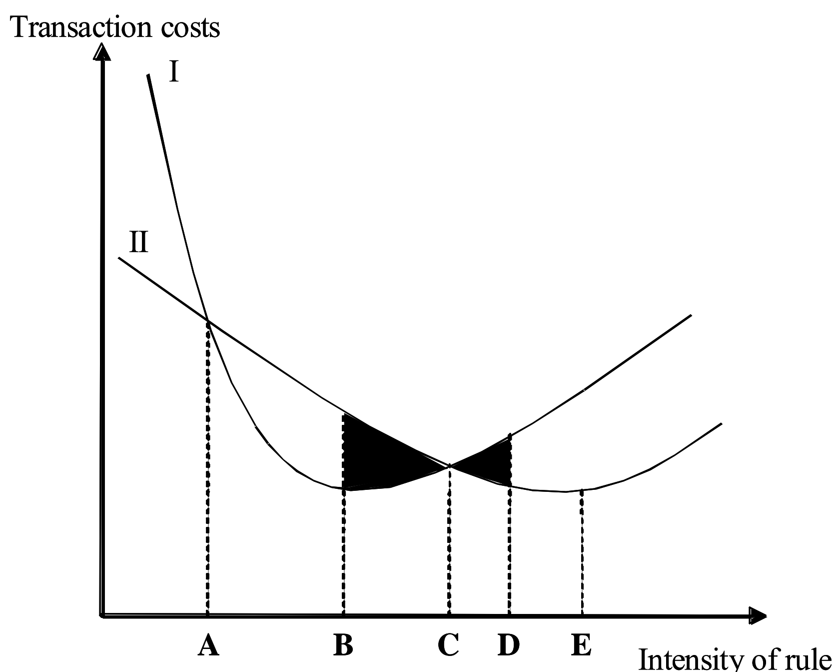
change the rule system. Alternatively, new rules may pop up in a flash, similarly to an inventor's bright idea.

It is difficult to draw the line between an ex-post approach in response to a negative experience and an explicit search effort - rules may evolve in a slow process in which ex post and ex ante are barely distinguishable. An example from the distant past is that people eventually accepted a good – for instance shells or precious metals – as a unit of value and as a means of payment. The acceptance of such a rule, i.e. the invention of money, can be considered as an essential technological innovation. Another historic illustration of a major organizational improvement is the invention of a bourse for freight in transatlantic shipping in the 19th century, allowing a better use of the existing shipping capacity. Further examples abound: claim staking of land eventually established a procedure through which the claims were respected, for instance through titles; merchants agree on procedures and standards for products or for accounting; industries concur on norms for measurement. A further example is that email addresses are offered by private companies (GMX, Yahoo, Google, Microsoft et al), and the internet domains on which they work are assigned and supervised by the group of organizations that go under the banner of the "Internet Society".

In all the above cases, the decentralized agreement of economic agents on "how things are done" is pivotal to the particular development of international rules. This process does not necessarily involve the government, even if the rules are international. Implicitly agreeing on markets for allocating goods and resources may very well be a decision of private agents. Governments may also agree on international procedures for using natural resources. Thus, the Kyoto Protocol opened the option to introduce markets for CO_2-licences in the European Union.

All these arrangements can be viewed as generating benefits to individuals and countries and lowering transaction costs. In economic terms, the phenomenon can be explained as follows. Take two countries I and II in which transaction costs fall after the introduction of a rule, and where, for the sake of the argument, the rule may be represented by different degrees, i.e. a different intensity meaning more precision or greater comprehensiveness (Figure 1). Since we are interested in the welfare of a country, we consider the total transaction costs of each country. In the area of the two curves where total transaction costs fall for both countries, both countries are interested in having a more comprehensive rule. When the transaction costs of one country start to rise whereas the costs of the other still fall, there are gains for both as long as the fall in costs of one country outweighs the cost increase of the other. In this case, total transaction costs for both countries still decrease. Then, one country may be willing to share part of its gains with the other country, and both may end up agreeing on the rule.

Figure 1: Falling transactions costs and intensity of rule



In Figure 1, an intensity of the rule at point A (the two transaction curves cross) is not optimal since to the right of A the transaction costs curves for both countries continue to fall. Both countries gain until point B where Country I reaches its lowest cost. From B to C and even beyond C, there are gains for both countries together if the cost reduction in Country II outweighs the cost increase in Country I. Let point D represent the lowest point of the total cost curve. Then, in the area between B and D, both countries can negotiate on the rule.

Under more realistic conditions of the real world, aspects other than compensation may lead to an agreement on rules. For instance, a country may accept a rule even if it is already on the rising branch of the transaction cost curve. It is likely to do this if it expects a downward shift in its transaction costs curve in the future or if it has an advantage from a package of rules where it pays to accept lower gains or even losses from one rule because there are greater benefits from other rules.

Institutional competition

A specific avenue towards finding new rules is institutional competition, in which established national rules stand side by side and compete with each other. The market decisions of economic agents or political decisions highlight over time which rules produce unsatisfactory results and which perform best. Such competition of rules leads to a discovery process in the sense of Hayek (1968). Competing for mobile factors puts pressure on countries to find new solutions, for instance

by implementing new institutional arrangements or by exploring new technological horizons. It stimulates the imagination and intensifies search effort to find solutions. Moreover, in this view, the technological or institutional solutions employed in the different locations can be explicitly compared. Seeing positive or negative examples from elsewhere, may encourage a country to do better than it actually performs. Thus, the analysis of "best practice" - or "benchmarking" - is an explicit attempt by firms and politicians to learn how things are done elsewhere, for instance in subunits of multinationals, in the organization of different firms or in the policy approaches of different governments. As Mark Twain once remarked, "There is nothing as annoying as a good example." Institutional competition can be interpreted as a useful mechanism to control the efficiency of governments. In a globalizing world, where the media report all remarkable events in all countries of the earth, this demonstration effect is intensified. In contrast to an explicit search in which rules are established ex ante and evolve in an evolutionary process, they are established ex post.

This institutional competition method encompasses taxation, regulations of product and factor markets, delineation of the private sector versus the public sector and the organization of the state. It also includes complete economic policy concepts and philosophies such as central planning versus the market approach.

Examples for institutional competition are, for instance, institutional arrangements that a country chooses for its corporate governance, rules for the banking sector, accounting rules, business or other taxes, the set-up of the labor market, arrangements for social security and welfare and environmental regulation. Interdependence among national regulation systems stems from the fact that people and factors of production can avoid national regulations by moving to another, more favorable region or country. Most importantly, capital has the exit-option and can locate where conditions are most encouraging. Labor and residents can migrate as well (Siebert 2006).

A key example of the competition between economic policy concepts is the competition between the economic philosophies applied in Latin America from 1950 to about 1985 (import substitution) and Asia (export diversification). Also relevant is the hidden rivalry between China and the former Soviet Union in from the 1960s on until the 1980s. A historically outstanding case was the contest between Communist central planning in Central and Eastern Europe and the market economies of the West prior to the fall of the Iron Curtain. In this Tiebout (1956) competition, the citizens of Central and Eastern Europe eventually voted with their feet and the Communist systems finally collapsed when the East Germans fled from the Eastern Bloc on August 19, 1989. They made their escape through Sopron in Hungary whose borders with Austria were no longer sealed.

Institutional competition cannot be applied in the case of border-crossing externalities and global public goods. It also finds its limit if a multilateral rule system has been developed, having the property of a public good. An example is the WTO. Besides these clear points, when rules are needed to keep transaction costs low, a major concern is the fear that institutional competition may end up in a race to bottom, meaning that business taxes in a country will be reduced if other countries lower their tax rates for businesses or that the protection of a nation's environmental quality will decrease if other countries place a low value on their environment. Similarly it is feared that other regulations, for instance in the banking sector, may be watered down. Although the answer to this issue is complex, the choice of a national policy instrument is derived in benefit-cost calculus. Thus, if citizens attach a high value to environmental protection and if this preference is expressed in their voting behavior, the political process will evaluate environmental protection accordingly and will protect the environment. Admittedly, if a goal conflict exists between environmental protection and keeping capital and jobs at home, a loose approach to the environment elsewhere will increase the opportunity costs of environmental protection. However, if the citizens of countries have a strong preference for environmental protection, this preference outweighs the higher opportunity costs in terms of goal losses in other areas. If the reasons for regulation are sufficiently tailored to the preference function of the country's citizens, regulations will be upheld. With respect to infrastructure and business taxation, firms remain willing to pay taxes if sufficiently attractive public goods are supplied. Moreover, the state can adjust the financing of its location factors, for instance by introducing user charges for infrastructure such as roads, ports and airports. Additionally, it is possible to privatize parts of a previously publicly owned infrastructure in order to set scarcity prices for infrastructure. Or, the government can switch to benefit taxation, which means that taxes are equivalent to the benefits received by users and not to the ability to pay. For all these reasons, it is not correct to argue that benefit cost analysis will lead to the conclusion that the environment need not be protected at all (Siebert 2006).

In evaluating institutional competition, it should be taken into consideration that it is a natural reaction of governments to strive for intergovernmental cooperation and institutional harmonization if this strengthens their position at home, for instance with respect to taxation. To form a cartel of institutional rules, restraining the mobility of factors of production and of residents, makes the life of governments much easier. Care should be taken that this does not happen. There is also the risk that standardization, while able to lower transaction costs, can be used to define an important economic position by firms or countries by throwing out other standards. It then becomes a weapon in their hands of a technological hegemon or a trade barrier.

Institutional Competition in the European Union

The European Union has a rich experience in institutional competition and in rule setting. It can be considered as a laboratory for global governance, from which the world can learn. The EU has made the principle of mutual recognition an important element of its integration policy. Since it proved impossible to harmonize *ex ante* the different legal systems, among them the logically constructed French law based on Roman law, the German law with its own tradition and the pragmatic British common law or case law, it was thought best to let the legal systems stand side by side, mutually recognizing the national rules. The path breaking Cassis-de-Dijon verdict of the European Court of Justice in 1979 ruled that a product legally brought to market in one of the member countries of the European Union was automatically admitted in other countries as well. The verdict dealt with Cassis-de-Dijon, a fruit liqueur, widely in use in France and especially in Burgundy to make Kir Royale (with champaigne), Kir Cardinal (with red wine or rosé) and Kir Bourgeois or Kir Ordinaire (with white wine). Before the ruling, Cassis-de-Dijon could legally be imported into Germany but it was not allowed to be marketed there. German regulation, the monopoly law on spirits (*Branntweinmonopolgesetz*) of 1922, required fruit liqueurs to have an alcohol content of at least 32 percent; thus the alcohol content of 17 percent in the Cassis-de-Dijon was ‘verboten’, forbidden.

The verdict of the European Court of Justice established the country-of-origin principle according to which the rules of the country of origin, i.e. the home country, and not the rules of the country of destination, are to be applied in a transaction. This principle holds not only for products, allowing for instance the export of beer from Belgium to Germany even if it is not brewed in accordance with the German beer purity regulations of 1516, but also for services, allowing a British bank product to be marketed in Germany or a company incorporated according to Irish law to operate plants on the continent. Following this principle, the different national regulations are de facto mutually recognized and coexist. This principle of respecting the home rule has proven to open the lid on national regulations in Europe. Only in cases in which products are hazardous or damaging to health, safety or the environment does the principle not apply (Article 30 of the EC Treaty).

Agreeing on markets in order to decentralize economic decisions

Another viable path to reducing transaction costs is to accept markets as an institutional arrangement for the allocation of a specific group of goods, i.e. the private goods. For these goods, market participants have no interest not to reveal their true willingness to pay - a condition that is not satisfied for public goods. As a consequence, economic decisions for private goods are decentralized. Individual households and firms enjoy the benefits of their decisions in terms of utility and profits, but they also carry the opportunity costs of these decisions. In this way, benefits

and opportunity costs of economic decisions are assigned to individual units of society. Given a framework for markets, economic decisions occur more or less automatically, independently of governments and political activity. They are de-politicized. Governments only come in when they define the institutional setting for markets. Thus, markets represent a decentralized mechanism of coordinating human actions.

In the world economy, markets allocate the gains from trade to countries, inducing countries to specialize in those areas of production that generate gains from trade for them. In this process, markets also allocate scarce goods and resources to the use with the highest reward. Markets thus are an instrument that selects the best use of such scarce resources among competing options. This becomes all the more apparent in a world economy with strong economic growth in developing countries when nations compete for resources. The demand of newcomers (developing countries) drives out the demand of incumbents (industrial countries). This is done by making a good or a resource scarcer and by rising prices.

There are several concerns with markets. A first concern is that markets can lead to monopoly power. In such a case, one agent can dominate demand or supply and influence prices. Supply monopolies may be organized horizontally, extending over one product and its substitutes, or vertically, comprising several stages of production in backward or forward linkages. One consequence of monopoly power is the necessity of competition policy in the market approach. Another approach is the correct definition of property rights so that monopolies disappear. Networks, for instance power lines or telephone lines, used to be considered as a major cause of natural monopolies. With new property rights for networks, i.e. the right of transmission, the natural monopolies disappeared. In the oil industry, vertical integration or hierarchies were replaced by spot markets and future markets after extraction rights were passed to the resource countries in the 1970s. Nevertheless, the correct definition of property rights will not be sufficient to undo monopolies. Competition policy is also needed. The difficulty consists in organizing an international competition policy.

A second concern relates to the observation that monopolistic positions do not only arise because the private sector attempts to attain them. Governments may also try to influence market results strategically and pay subsidies to allow their firms to establish themselves early in the market (rent creation) or to enable them to conquer favorable market positions and thus shift rents from other countries to national champions (rent shifting). Therefore rules on subsidies to prevent distortions are needed. Such rules should also stop strategic trade policy. Since an under-valuation of a currency represents a general subsidy to the export sectors, rules to avoid under-valuation are required.

A third concern is that information is not evenly spread on both sides of the market and that information asymmetries exist. This means that one side of the market may have information advantages. Moreover, information, for instance on product quality, is incomplete and it is costly to collect information. The answer to this problem is twofold. It is in the self-interest of each market participant to obtain as much information as possible, for instance on the competence and the service quality of a physician. In addition, competition of the sellers will be an incentive to improve the information provided by the market.

A fourth concern is whether markets are fair. The advantage of markets is that they are efficient, making sure that resources are used where they yield the best results, that goods are produced with least costs and that new products are developed. However, the ensuing income distribution may be thought of as unjust. It would be unrealistic to expect the equality of market results. Indeed, the international rule system affects the international distribution of income and also the distribution of benefits. Nationally, one answer is to change the income distribution through a tax-transfer mechanism; internationally this approach is not doable since the right to tax rests with the nation state. A more realistic approach is to look for equal starting conditions. Thus, the World Bank can be help developing countries so that they can enjoy the gains from trade.

A fifth concern is that markets produce results that are not politically acceptable. This is, for instance, a prevalent attitude in France. Until the 1970s, France adhered to *planification,* a combination of the government's will and markets, especially with respect to investment. Meanwhile, it has become somewhat taciturn about *planification*. In the same spirit of governmental influence, France relied on long-term contracts for crude oil in the two oil crises of the 1970s, in which France as a resource importer negotiated directly with resource-exporting countries, attempting to reduce resource uncertainty. These contracts specified oil quantities to be supplied by the resource countries and prices to be paid by the resource importer. As soon as spot and future markets for crude oil developed in the late 1970s and early 1980s, supply and price risks were considerably reduced and long-term contracts were no longer attractive. As for another non-market approach, the Communist countries applied a centrally planned international division of labor "from above" in the pre-1989 COMECON, of course with a strong influence by the Soviet Union: Instead of letting markets decide which goods to produce in which country, this decision was made politically. The Hungarians produced autobuses, the Czechs streetcars and the East Germans wagons for the Trans-Siberian Railroad. It is apparent that this system failed.

A sixth concern is market failures. One such failure arises, when markets do not exist. For instance, capital markets may not have enough time depth to cover intertemporal risks. The solution here would consist in establishing such markets where possible. A more important failure is that

monopolies come into being through an endogenous market process or that cartels are formed with the implication that market processes are distorted. Then competition policy is required. Another major market failure exists when technological externalities prevail and public goods are involved. In the case of externalities, the divergence between social and private costs has to be reduced, and in the case of public goods the willingness to pay cannot be aggregated via the market. Then institutional rules are required.

Securing gains from cooperation

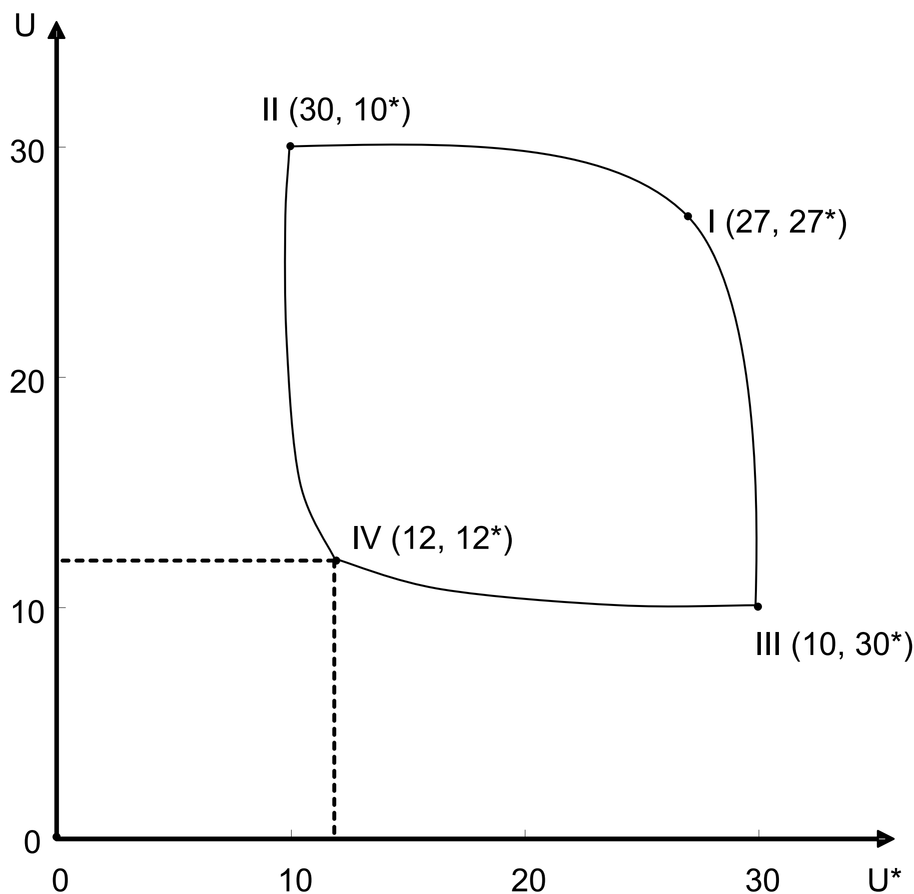
Cooperation gains are possible in cases where mutual benefits are feasible in a positive sum game. An important case in point is the international division of labor in which all participants can gain. However, in this area a country may behave strategically (or opportunistically) in international affairs in order to maximize its benefit by reducing the benefit of others. For instance, a dominant country can levy an import duty or intervene in other ways in order to maximize its benefits even if this means that the gains of the other country decrease. Another case is strategic trade policy through subsidies.

Consider a two-country-case in which the free trade solution generates benefits of 27 units to each country relative to autarky. Point I (27, 27*) in Figure 2 is the free trade solution, where the first number refers to the home country and where an asterisks (*) characterizes the foreign country. Assume the home country can push up its trade benefit to a value of 30 and reduce the foreign country's benefit to 10 by strategic measures. Point II (30,10*) in Figure 2 then denotes the home country's gains from trade relative to autarky. Alternatively, the foreign country can raise an optimal tariff in order to increase its gains from trade, which causes the domestic gains from trade to decrease. Then point III with bundle (10,30*) characterizes another solution. In an initial situation IV (12,12*) both countries are implementing a tariff policy. Finally, in the extreme case in which both countries take protection to the limit and in which they are in the autarky situation, the gains from trade are zero in the origin (0,0*).

Starting from an initial position with some trade (point IV), the area above point IV up to the curve II-I-III defines the potential area of trade benefits for both countries. They both can benefit from the transition to free trade. If they cooperate, they proceed to situation I, where the two of them reach a welfare maximum of 54 utility units, if we assume for simplicity that utility units can be aggregated. Agreement is needed on how to maximize benefits. Such an agreement can exist in accepting free trade, i.e. through decentralization via markets and accepting the distribution of total benefits through markets. The two countries then jointly maximize their benefit. However, in the case of non-cooperative behavior, they cannot reach the optimal situation I. Then each country wants to realize its favorite position with larger individual gains (II or III), but total utility is lower with 40

utility units. Such a situation is not sustainable, unless one of the two countries can enforce its conditions. If one of the countries does not dominate, both remain in situation IV in which non-cooperative behavior of both countries prevails. This is a typical prisoner's dilemma. They cannot agree, because one country expects that it will have greater benefits in a situation different from point I.

Figure 2: Trade benefits area



The situation considered above corresponds to a game with four possible outcomes. In Table 1, the gains from trade are represented in a pay-off matrix for the players. The first row and the first column indicate cooperative behavior, in which both countries benefit (box I). Box II indicates a cooperative strategy by the foreign country following the dominating domestic country. Box III characterizes a situation in which the domestic country is cooperative. Box IV indicates the case in which both countries do not cooperate. Note that the game presented here is a single round game. In a repeated game with many periods, the reputation of the two players comes into play, making a cooperative solution more likely.

Table 1: The prisoners' dilemma: welfare levels with cooperative and non-cooperative behavior

Foreign country / *Domestic country*	*Cooperative Strategy (Free Trade)*		*Non-cooperative Strategy (Tariff Policy)*	
Cooperative Strategy (Free Trade)	I	(27,27*)	III	(10,30*)
Non-cooperative Strategy (Tariff Policy)	II	(30,10*)	IV	(12,12*)

World gains resulting from lower tariffs have been estimated empirically. For example, Brown et al (2003) calculate in an applied general equilibrium model that a complete removal of all tariffs and other barriers would increase world GNP by US$ 2.1 trillion, boosting the GNP of all economies, for instance for the US by 5.5 percent, Europe by 6.3 percent, China by 7.75 percent and even 16.4 percent for the Philippines.

Principles in bargaining for cooperation gains in trade

Given such conditions, it needs an understanding between countries that cooperation gains exist and that it pays to introduce rules in order to prevent strategic behavior. Thus, a rational analysis by the participants may show the prospect of gains that can be reaped by all even if the degree of gains differs. A large body of institutional experience relates to the international division of labor, especially trade.

An important issue is who gains most and who gains relatively more. This is an emotional and a sensitive question. In principle, it is possible to supplement a rule system by redistribution measures. However, to explicitly introduce redistribution between countries gives rise to many debates, for instance how to determine the benefits of individual countries relative to the situation before the introduction of the rule. This makes it nearly impossible to implement a system redistributing the benefits of countries. Therefore it is most helpful for a rule system to develop that benefits accrue to all and that they are more or less not too disproportionate. Then the topic of relative benefits moves to the background. This seems to be the case in the trade area.

Several mechanisms are instrumental in establishing an international rule system: reciprocity of concessions, the principle of equal opportunity, equivalence to national treatment and the principle of mutual recognition.

The principle of equal opportunity means that each country can play according to the same rules. Tariffs and other obstacles to the international division of labor, including national regulations, stand in the way of equal opportunity. Liberalization can be viewed as a method through which equal opportunity is obtained. Distortions, for instance through subsidies on agriculture in the industrial countries, violate the principle of equal opportunity.

Non-discrimination through rules can be interpreted as an expression of the principle of equal opportunity or as a method not to violate the principle of equal opportunity. Non-discrimination is a necessary condition for equal opportunity, but not a sufficient one. In the world trade order, trade policy measures should not discriminate against countries; all countries should be treated equally. In particular, there must be no discrimination between domestic and foreign products. This principle can be explained very well with Thailand's cigarette case, decided by GATT in 1990. Thailand had raised a tariff on imported cigarettes, referring to health policy reasons, but without taxing domestically manufactured cigarettes. In the Thailand cigarette case, it was ruled that it is consistent with the world trade order for a country to take measures for health reasons (Article XX), but it must not make a difference between domestic and foreign products and it should not discriminate against imports.

The demand for avoiding discrimination differs from the desire for a level playing field. It is the core of the international division of labor to exploit differences in preferences and in endowment, relating to labor, capital and technology. Only then are gains between countries possible. Endowment conditions are given by nature, but they are also acquired through countries' effort such as accumulating the capital stock through investment, building human capital through learning and improving the technology through invention and innovation. For these reasons, asking for a level playing field cannot mean that countries should not exploit differences in endowment and preferences.

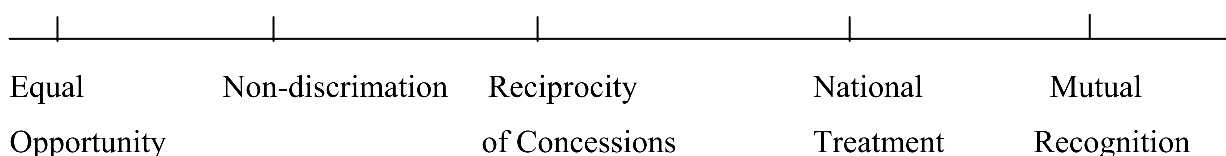
Reciprocity of concessions is an often-used procedure to obtain common rules. In the WTO, a traditional approach is the reciprocity of tariff concessions in the trade of goods, requiring that the tariff cut of one country must be matched by an equivalent reduction of another country. One country offers a concession in one area if another country has agreed to a concession in another area. The procedure of mutual concessions is important in liberalization rounds. It also is most relevant in the issue of market access and the cutback of distortions, for instance subsidies. This approach has been formalized in the rule system for trade by a bilateral demand-supply system. Only if a country is in the position of the principle supplier, i.e. if it provides the main part of the imports of the partner country, it can ask for a concession for a specific product (principal supplier rule). It is amazing that the concept of reciprocity is used because it has its roots in a mercantilist

philosophy that is inconsistent with a free international division of labor. According to the free-trade-for one theorem, a country can gain from free trade even if the other countries are protectionist; albeit it gains less. Only if the protectionism of the protectionist country is too strong will the other country find itself in the autarky position and gain nothing. The *do ut des* of concession seems to appeal to the idea of fairness, softly defined. Moreover, it may be politically easier to agree on a tariff reduction with a foreign country than in a redistribution of the gains from trade among groups of society at home.

In cross-border services and in the location of foreign firms, the rule of national treatment establishes the option for non-nationals to do business in a foreign country. It can be seen as a form of non-discrimination and allowing equal opportunity in the specific area of services and foreign direct investment. √

Finally, the principle of mutual recognition is a far-reaching way to accept the rule system of other countries. This can mean different things. With respect to the production of traded products, the rules of the country of origin are applied for imports, and not the regulation of the country importing the product. The country of origin rule takes precedence over the country of destination principle. With respect to services, the home rule of a service provider applies in the country importing the service. In reality, the principle of mutual recognition entails much more than simply allowing national treatment or granting a concession. The principles discussed so far can be arranged in a continuum of intensity of impact (Figure 3).

Figure 3: Continuum of procedures



Stabilizing rules for cooperation gains: Positive mechanisms

International rule systems contain mechanisms that play a stabilizing role in the institutional arrangement. Such mechanisms are needed in order to prevent countries from defecting from agreed upon procedures and to induce them to abide by multilateral rules. They become particularly necessary when the real world is in a flux, i.e. when the conditions to which the rules apply change quickly and markedly. The richest experience of this is available in the WTO. The questions to ask are: How do these mechanisms function and how they can be improved? √

Compared to negative constraints such as banning discrimination, positive mechanisms are superior since they include a constructive motivation and represent a procedure that strengthens the institutional arrangement and helps to expand the rule system. In the world trading order, one such mechanism is the "Most-Favored-Nation" clause, representing a positive manifestation of the principle of non-discrimination, ruling out differential treatment. The obligation towards a general, positive and unconditional most-favored treatment, which is included in Article I of the GATT treaty, implies that a tariff reduction that is granted to one country has to be granted to all countries ("favor one, favor all"). In this way bilateral tariff reductions are multilateralized. While the non-discrimination principle is a negative mechanism prohibiting discriminatory behavior, the most-favored-nation principle is a positive mechanism strengthening free trade.

An essential condition for an international economic order is that it generates visible and direct benefits for each of its members. For each country, the advantages of membership must exceed the advantages of non-membership. Visible and direct benefits should bring the support of the private sector; they also induce the support of NGOs. This helps to restrain national interest groups.

Another crucial stabilizing condition is that each country expects an increase in visible and direct benefits in the future. It then pays to stick to the rules, because there will be a reward later on. This aspect of future direct benefits reinforces the repeated game nature of the rule system and gives stability to the system. The individual country's benefit-cost calculations should not shift asymmetrically over time, i.e. the net advantage for each country should increase and in no case worsen. If this condition is not fulfilled, there will be an incentive to renege on the contract. From hindsight, the institutional arrangement for the world trade order has been attractive for the world community. It has been successful in raising the interest in ownership of its members by increasing its membership from 23 in 1947, when the GATT was founded, to 151 in the WTO in October 2007, by opening markets in eight tariff rounds[1] and also extending the rule system beyond trade. Important countries who are not yet members are: Algeria, Iran, Kazakhstan, Russia and the Ukraine.

Compared to the trade order, institutional arrangements in other areas face less favorable conditions in generating visible and direct benefits. Thus, global environmental protection signals a restraint and only generates the benefit of a global public good, whose advantages are diffused and less direct than those from trade.[2] Environmental policy for global public environmental systems is about burden-sharing; it is about allocating the costs of abatement and emission prevention. In a

[1] The Doha round is not concluded when the piece is written.

[2] Or competition policy limits the maneuvering space of large firms; competition policy requires the insight of governments that the control of excessive market power is to the benefit of consumers.

similar way, IMF policy imposes an often detested conditionality for the country in a currency crisis; the IMF is experienced as a restraint.

To interpret a rule system extending to several areas (the WTO covers trade in commodities, services and investment) as a single undertaking increases the incentive to accept rules in a specific area even if a country dislikes these specific rules. This is because rules of different areas are packaged. The distaste of one rule is compensated by the advantage in other areas. The single undertaking also enables participants to develop the rule system further, when new issues in the international division of labor have to be dealt with. The approach of packaging is also helpful in focusing the bargaining process when a liberalization round is being concluded.

In the past, plurilateral agreements, introduced in the Tokyo Round, allowed a subset of GATT members to sign contracts for specific areas, for instance the Agreement on Civil Aircraft and the Agreement on Government Procurement. Such a procedure, though easing a contract among at least some GATT members, represents an *à la carte* approach and entails the risk of fragmentation of the multilateral trading system (on waivers see below).

In spite of the advantages of a single undertaking, the ‘offsetting’ between the advantages of suborders should not be carried too far. If in the course of time the advantages of countries shift asymmetrically in the individual suborders, a fragile structure of acceptance could collapse like a house of cards. To avoid domino effects, it makes sense that the suborders should basically legitimize themselves on their own and not be conditionally accepted.

Acceptance of rules is essential. Besides visible and direct benefits, rule-making with the “one country- one vote” principle as in the WTO, requiring unanimity, assures that a country’s preferences are not overruled.
Yet another mechanism is to make sure that nations keep their promise. They have to commit themselves by excluding future actions or credibly promising future actions. This aspect has been analyzed for national monetary policy (Kydland and Prescott 1977). One mechanism is that countries shift policy instruments to a higher level, for instance in the European Union. Another avenue is that countries lock themselves in, for instance by putting up capital for operating a rule system (as in the case of the IMF) or contributing to the operating costs on a regular basis. Yet a further approach is to bind tariffs. A country that wants to raise the bound tariff has to negotiate with the countries most concerned; it has to compensate for the trading partners’ loss of trade. Binding tariffs means hardening a country’s promise. Thus, binding creates opportunity costs of non-compliance. In this way, the results of liberalization rounds are ‘chiseled in stone’; countries cannot easily walk away from agreements that have been reached. Not all commitments hold;

witness the US abandoning the gold standard in 1933 (Barro 1986) and from the Bretton Woods System in 1971.

Taking advantage of mutual recognition within a well-defined multilateral approach may strengthen the international institutional set-up. It decentralizes rule-finding processes and makes the discovery of new rules more or less automatic. Thus, the world trade order aims to accept the product standards of the country of origin exporting a product (country of origin principle). The world would be an economic mess if each country applied its own product standards to its imports (country of destination principle). However, in order to protect its citizens' health and life and to conserve natural resources, a country may choose its own measures (Article XX of the GATT Treaty). These measures must be non-discriminatory. Note that the approach of mutual recognition leads to institutional competition.

Non-discrimination requires that if market entry restrictions are applied, regulations through production permits, facility permits and product norms must not give preference to domestic producers and domestic goods. This also applies to taxation. The same measures should be applied as to similar domestic goods (see Thailand cigarette case below). Non-discrimination should also satisfy the condition that policy instruments should accord to the proportionality principle. Measures must accordingly be necessary in the sense that otherwise environmental policy aims or the protection of natural resources could not be achieved. As a rule, these aims are, however, achieved in a better way through specific environmental policy measures rather than through trade policy.

It is debated in determining the potential harmful health and environmental effects of similar goods how the similarity of products should be defined, from the demand side or from the production side. We have two different verdicts of the Appeleate Body. In the Mexican–American tuna fish case (1991), the principle of similarity was applied to the production methods (in the tuna case, methods of fishing which do not sufficiently protect dolphins). This means that the country-of-origin principle was used. In the Shrimp-Turtle case India et al vs the US decided in 1998 however (2007a), a different ruling came out. The general line of this ruling is that trade policy instruments can be used to enforce environmental standards even in other nations. The substance of the case consisted in Sea turtles being killed in shrimp trawl nets by trawlers, for instance Indian trawlers, and the US wanted to prohibit the import of shrimps from countries which do not require shrimp boats to be equipped with turtle-excluding devices. The US argued that their trade measure was covered by Article XX of the GATT, exempting WTO members from their trade obligations in order to protect human, animal and plant life. While the US lost the case, it only lost it because it discriminated and gave countries not enough time to change their production method.

As a precondition for these positive mechanisms, it is self-evident that clarity of the rules is a vital prerequisite. International rules cause national sovereignty to be ceded making it necessary to specify the exact conditions under which the international rule system takes precedence over the nation state's prerogatives.

Stabilizing rules for cooperation gains: Side payments

Side payments can be used as an incentive to get countries interested in a rule system. Such side payments can be interpreted as helping to establish preconditions so that a country can join a rule system. For instance, the European Union has used and still uses structural funds to allow countries to catch-up in a speedier development. Thus, Ireland has received 5.0 percent of its GDP in the period 1990-2000 from the EU's structural fund in order to be able to increase its GDP per capita, with transfers down to 2.5 percent in 2000; it is now at 128 percent of the EU-15 level (2005). Development aid can be interpreted as a side payment to make it possible for developing counties to participate in the international division of labor and join the WTO. Credits by the IMF for a country in a currency crisis can also be regarded as side payments (On side payments in the case of burden sharing see below).

Stabilizing rules for cooperation gains: Restraints and sanctions

An alternative to positive mechanisms for stabilizing a rule system is to impose bans and "to forbid", i.e. to use negative rules. Such constraints are agreed upon ex ante and are part of international agreements. The principle of non-discrimination in the trade order is such a restraint. Other restraints are ecological, for instance to ban fluorocarbons or to restrict trade in ivory. Further restraints relate to macroeconomic aspects, for instance the conditionality stipulations of the IMF for countries in a currency crisis or the limits that forbid nations from exceeding a budget deficit of 3 percent of GDP as in the Growth and Stability Pact of the European Monetary Union. A necessary condition for bans is that deviating behavior can be effectively monitored and that fines, withdrawal of benefits and some type of sanctions can be applied.

To enforce a desired international behavior, sanctions can be applied if a country deviates from agreed upon norms of behavior. Sanctions take different forms: banning exports of military weapons; outlawing the export of strategic products, for instance products needed to produce military weapons; prohibiting the export of investment goods essential for the development of a county; forbidding intermediate inputs for production and preventing the export of luxury consumption goods, disturbing the political elite. As a very last measure, bans on the export of consumption goods may be applied, affecting the day-to-day goods used by the general population. The level of sanctions is determined *ex post* when the deviating behavior of a country becomes apparent. They impose a cost on a country thus introducing an incentive to accept the rules. It is

hoped that sanctions are anticipated by the agents and thus steer the agents' behavior *ex ante*. Sanctions are used in such issues as ethnic conflict, human rights violations, the narcotics trade and nuclear proliferation.

Sanctions are arranged for in international agreements or are imposed unilaterally by a single state or by states in cooperation. For instance, retaliations – a form of sanction – are allowed in the WTO if a retaliation is the result of rulings of the WTO dispute settlement procedure. Or sanctions are imposed by the UN Security Council. Prior to 1990, the UN Security Council approved just two mandatory sanctions, against the white minority regime in Rhodesia and an arms embargo against South Africa (other anti-apartheid actions were voluntary). From 1990 to 2007, it has mandated sanctions against eleven states: Iraq, the former Yugoslavia, Libya, Haiti, Somalia, Liberia, the UNITA faction in Angola, Rwanda, Sierra Leone, North Korea and Iran. Out of 50 new sanction cases, launched in the 1990's, 24 of these were launched by the US in cooperation with other nations. Twelve of these were launched by the US unilaterally (Elliott et al 1999).

The end of the Cold War altered the political chessboard for sanctions. There are new centers of influence over sanctions besides Washington, like Beijing, Moscow or Brussels. International organizations (NGO's) also have more sway. NGO's are linked to the changing targets of sanctions. In addition, US private business has been increasingly vocal in its objections to sanctions. This is now a politically acceptable objection, whereas it was not during the Cold War.

Increased use of sanctions by the UN has provoked concern in two areas: the humanitarian consequences for women, children, and the elderly under comprehensive sanctions (as in Iraq) and the costs of enforcing sanctions for front-line states, such as the Balkan neighbors of the former Republic of Yugoslavia during the Bosnian conflict. Both concerns have contributed to growing opposition against the imposition of broad sanctions and have stirred interest in analyzing targeted sanctions (in particular, freezing the personal assets of political, military, and economic leaders in rogue states) to see whether that offers a path toward more effective sanctions that are less blunt in their effects (Elliott et al. 1999). According to Elliott (2006), sanctions are more likely to be effective when goals are limited and clearly defined, the target is small and vulnerable, and when sanctions are imposed quickly and decisively. Following Hufbauer, Schott and Elliot (1990), roughly 25 percent of sanctions can be considered successful according to the criteria whether the objective was achieved, at least in part, and how much did the sanctions contribute to a positive outcome.

Globalization has played an important role regarding the effectiveness of unilateral sanctions. Since target countries are more engaged in international markets, they are now better positioned to replace trade and financial flows. This, however, does not imply that multilateral sanctions are an easy

panacea: International cooperation is often costly to generate, creates delays and the potential for competing objectives as – for example – in the case of the UN Security Council Resolution No. 1737 against Iran's nuclear program in December 2006 which passed only after two months of intense negotiations and several amendments to please the Russians and Chinese (Elliott 2006).

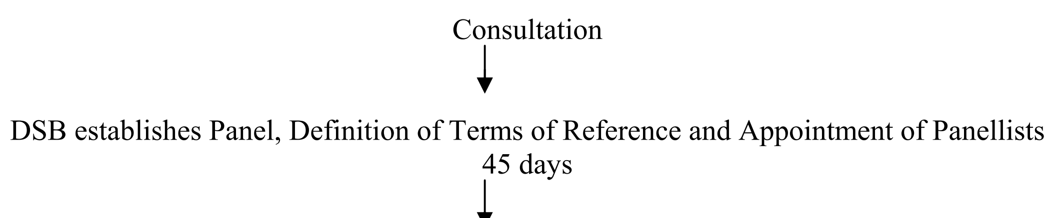
Blockades undertaken in times of peace are a specific form of sanctions. They have been used in unusual circumstances, for instance during the Cuban missile crisis in 1962, the Soviet land blockade of Berlin in 1948-49 or during the NATO blockade of the Yugoslavia (1993-1996).

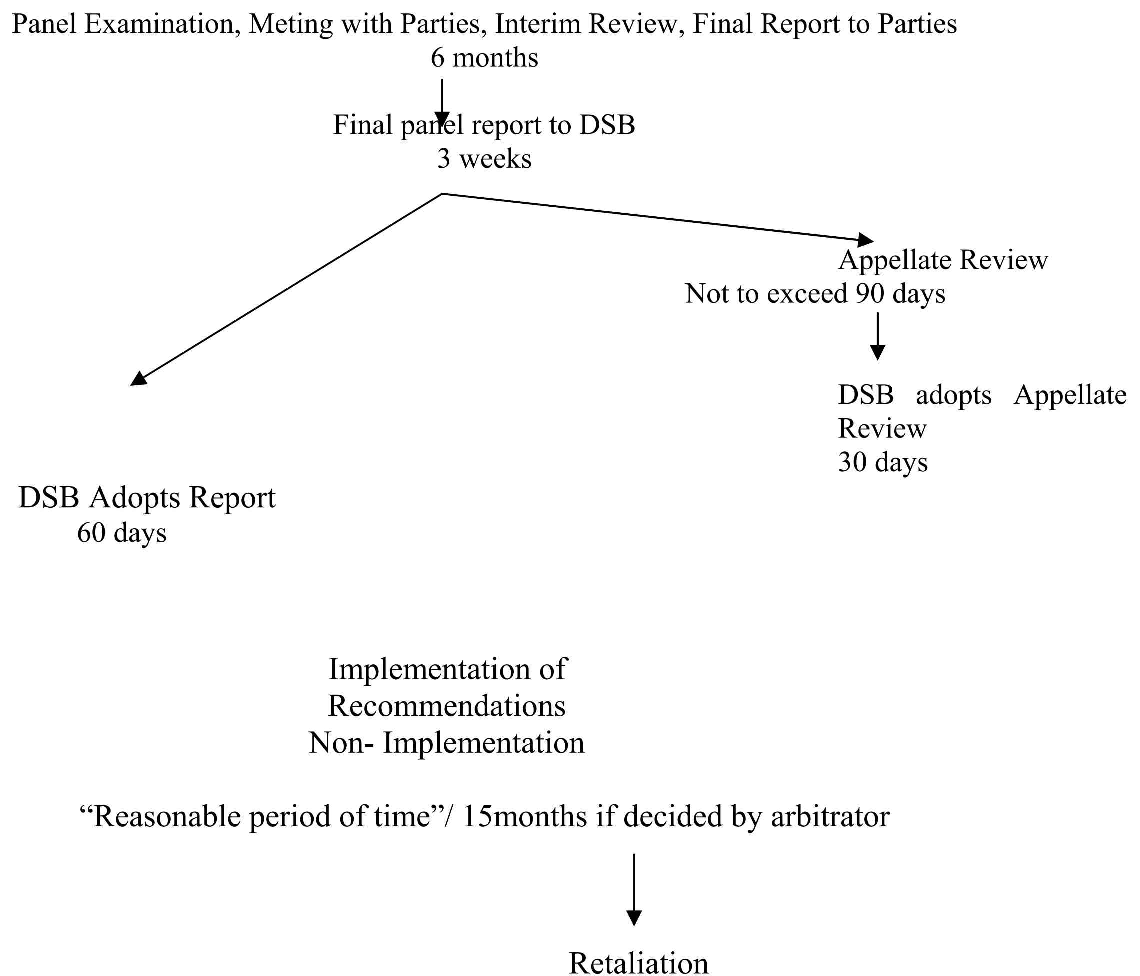
Stabilizing rules for cooperation gains: Dispute settlement mechanism

A dispute settlement mechanism is instrumental in solving conflicts that arise in the interpretation and the implementation of rules. To some extent, it may also help to develop a rule system further when the rules have to be applied to border line cases. Such a mechanism must be objective and fair. It should not be dominated by the large economies. Moreover, large countries should accept the rulings reached in the settlement procedure. Then the settlement mechanism is instrumental in improving acceptance by the member states.

A major example is the dispute settling of the WTO that was agreed upon in the Uruguay Round. In this institutional arrangement, the General Council, i.e. all the members of the WTO, meet as the Dispute Settlement Body (DSB). The procedure works by "negative consensus". Once parties have been unsuccessful in attempting to resolve their dispute through consultation, the General Council establishes a Panel, except when the General Council decides by consensus not to allow the establishment of a Panel. This means a high degree of automaticity. Members nominate the panellists that serve the Dispute Settlement Mechanism; the approval of disputants is needed on the composition of each panel. The steps of the procedure include an Appellate procedure (Figure 4). The DSB can adopt the Appellate Report, unless it is rejected by unanimity. Appellate review is limited to three months. The DSB monitors whether recommendations are implemented. If an offending party fails to adopt corrective measures within a reasonable period of time, compensation has to be negotiated. In the case of non-implementation, the DSB has the authority to allow retaliations. Time limits are set for each step. Total time until the Final Report is adopted by DSB is one year without appeal and one year and three months with appeal.

Figure 4: Stages in the Dispute Settlement Process





Source: WTO (2007 b)

356 cases were brought for settlement in the period 1995-2006, of which 142 were brought from developing countries, 84 from the US and 76 from the EU. Addressees of the complaints were the US (97 cases) and the EU (58 cases); China received eight complaints. This mechanism is quite an improvement compared to GATT. The overwhelming part of complaints from developing countries came from Latin America, mostly on agricultural issues. Other issues refer to dumping, steel and intellectual property rights. There was no complaint from an African country. Most cases result in compliance; only two have resulted in retaliation to date. √

As a major decision, Brazil and Thailand have won the cotton case against the US before the WTO Dispute Settlement Body in 2005, after demonstrating that US subsidies to American cotton farmers did damage to Brazil. In the equally important sugar case, it was decided in 2005, that the EU has to change its sugar regime. This indicates that developed nations, the US as well as the EU in particular, have less scope to impose unilateral punishments to other nations over trade disputes. Developing nations are potentially better able to defend their case. Admittedly, some developing countries have difficulty with the dispute settlement mechanism, since the costs of bringing a case

can be prohibitively high and since developing nations' ability to punish larger nations in the case of retaliation is limited. It therefore has been suggested that they receive administrative support from the WTO and that smaller nations should be allowed to band together in applying retaliatory measures. Moreover, developing countries tend to enter on specific issues only, not on precedent setting cases – i.e. they have minimal opportunity to shape the system to their advantage. Also they fear retaliation by stronger nations outside of the bounds of the WTO.

Retaliation involves raising tariffs against the respondent. These can take various forms. For instance, a 'carousel approach' is permitted in which tariffs are raised on a different set of EU imports every six months. Moreover, in exceptional cases when the claimant does not import much with the respondent, cross-retaliation is permitted, for instance to limit the application of retaliatory measures of TRIPs on the products of a region such as the EU.
Another example of dispute settlement, albeit with less teeth, is the system for the settlement of disputes that might arise in the use of the Sea. This mechanism is layed down in Part XV of the Convention UN Convention on the Law of the Sea with currently 155 members. It requires States Parties to settle their disputes concerning the interpretation or application of the Convention by peaceful means indicated in the Charter of the United Nations. However, if parties to a dispute fail to reach a settlement by peaceful means of their own choice, they are obliged to resort to the compulsory dispute settlement procedures entailing binding decisions, subject to limitations and exceptions contained in the Convention. The mechanism established by the Convention provides for four alternative means for the settlement of disputes: the International Tribunal for the Law of the Sea (see below), the International Court of Justice, an arbitral tribunal constituted in accordance with Annex VII (Arbitration) to the Convention, and a special arbitral tribunal constituted in accordance with Annex VIII (Special Arbitration) to the Convention. A State Party is free to choose one or more of these means. However, if the parties to a dispute have not accepted the same settlement procedure, the dispute may be submitted only to arbitration in accordance with Annex VII.

Stabilizing rules for cooperation gains: Arbitration

Conflicts between states can be assigned to international arbitration panels, agreed upon by states on an ad hoc basis to solve conflicts or being incorporated in international treaties between individual states or more generally in the international community. Nations submit to the verdict of the panel. An example is commissions to solve border line disputes. Arbitration is similar to the dispute settlement mechanism, albeit with less formal structure.

A more formal mechanism is international courts, such as the International Court of Justice, the International Criminal Court, the International Maritime Court and the European Court of Human Rights.

Waivers – A Stabilizing or destabilizing mechanism?

A highly controversial issue is whether a waiver to a rule system can stabilize the institutional arrangement or whether it will actually destabilize the set-up. It can be argued that exceptions to one or some of the rules of an international rule system allow countries to join a multilateral arrangement even if they do not accept the given rules for a specific area. Then a waiver increases the acceptance of an international order. It is apparent that a waiver is a contradiction to a single undertaking. Both positions, i.e. pro a single undertaking and pro waivers, cannot hold simultaneously.

In order to bring some light into this debate, we have to distinguish between four different phenomena: First, is the rule from which the exemption is granted a contradiction to the international rule system, i.e. is the waiver inconsistent with the rule international system? Second, is the rule from which the exemption is granted, essential for the international rule system or is it peripheral? A peripheral rule is not at the core of the rule system, i.e. the rule system can exist without this specific rule. Such a peripheral waiver may be acceptable. Third, is the rule for which the exemption is granted an add-on through which the existing rule system may be further developed in the future, without being essential for the actual rule system? An add-on may become an essential part of the rule system in the future. In this case, the exemption may be acceptable. Fourth, if an exemption is granted, even it is essential, will the waiver start or allow a process by which eventually the rule system is improved in the long run?

In terms of practical experience, these issues can be discussed with respect to the European Union. The core target of the European Union is to establish a single market with four freedoms: the free movement of goods, of capital, services and people (including the free movement of labor). In these essential areas, no exemption can be made. Apparently, interim solutions for a limited time period do not violate this condition, for instance restraining temporarily the free movement of labor for the new members in Central and Eastern Europe which joined the EU in 2004. Admittedly, some of these freedoms are not perfectly accepted in the EU, witness the service directive, which restricts the free mobility of service personnel and consequently of services. In less essential areas, such as border controls of persons within the EU or monetary policy, a subset of the EU members can go ahead further in ceding sovereignty. In such areas, the European Union has applied the philosophy of “variable geography” or “two speeds”, allowing member countries to advance in integration areas in which not all the members want to engage.

In the world trade order, a waiver for agriculture, obtained by the US in 1955, became an invitation for the EU's agricultural policy. It now severely hurts the developing countries and was an obstacle to get their agreement to the Doha-Round. A similar argument applies to the Short Term Arrangement on Cotton Textiles introduced in 1961 during the Dillon Round. It took nearly 50 years for it to be discontinued.

Regionalism versus multilateralism

Whereas the experience of a waiver inside the European Union is positive in peripheral areas, it is doubtful whether the waiver for deviation from the international trade order in favor of regional integrations will strengthen or weaken it. The waiver for the trade order is defined in three provisions: in Article XXIV of the GATT Treaty, allowing customs unions and free trade areas ("…the provisions of this Agreement shall not prevent, as between the territories of contracting parties, the formation of a customs union or of a free-trade area…"); in Article V of GATS, allowing service agreements; and in the enabling clause for developing countries, allowing preferential treatment.

The most important regional integrations are the European Union, NAFTA, AFTA and Mercosur. Besides these four major regional integrations, many bilateral free trade areas between only two states or selective free trade areas among several states have gained importance, outweighing meanwhile regional integrations by far in number. These bilateral or selective free trade areas do not necessarily include geographically neighboring states as in regional integrations, but embrace countries that are far apart, for instance Singapore and the United States. Meanwhile, some 368 regional trade agreements have been notified to the GATT/WTO up to December 2006. Of these, 292 were notified under Article XXIV of the GATT 1947 or GATT 1994, 22 under the Enabling Clause and 54 under Article V of the GATS. At that same date, 215 agreements were in force. Including regional trade agreements which are in force but have not been notified, those signed but not yet in force, those currently being negotiated and those in the proposal stage, a figure of close to 400 is likely to be implemented by 2010 (WTO home page July 18, 2007). Out of these, customs unions account for less than 10 percent. In comparison, the GATT received 124 notifications of regional trade agreements in the period 1948-1994.

The issue is whether these waivers will prove to be a building block for the multilateral trade order, permitting liberalizations between countries and in regions that would be impossible multilaterally or whether they will prove to be a stumbling block, eventually leading to erosion and even a collapse of the multilateral order for the international division of labor.

Whereas customs unions and free trade agreements, i.e. economic integrations, have to satisfy the condition that they shall not have a more restrictive effect on third countries than existed prior to

their formation, the waiver of Article XXIV of the GATT Treaty clearly contradicts the principle of non-discrimination. It excludes outsiders. The “most favored nation” clause, a principle at the core of the WTO, is not applied. Regional liberalizations are not multilateralized. And of course, the waiver also contradicts the WTO’s single-undertaking nature. Politically, the US and the EU as major players have used the waiver to build up their own hub-and-spoke system in which they can extend favors to the members of the network, for instance the EU having free trade arrangements with, among others, the EFTA countries, Croatia, Morocco, Turkey, Israel, Egypt, Syria, Mexico and Chile. Furthermore, the EU has included *de facto* many developing countries through a set of preferential agreements in its trade area, most importantly 71 developing economies in Africa, the Pacific and the Caribbean – the APC countries - through the Lomé-Convention. The EU and the US have a set of concentric rings around themselves.

The reasons why regional integrations are accepted nevertheless in the international trade order are manifold. Whereas it is not doubted that trade is diverted through regional integrations, it is expected that trade-creation will dominate trade-diversion not only for the members of a regional integration but also for the world economy as a whole. The main reason for this is that a regional integration will stimulate not only the economic activity of its members, but also of the countries outside. It has dynamic effects for third countries through growth. Moreover, regional integrations extend in differentiated forms to other countries. Furthermore, regional integrations, if successful, attract additional members over time. Again, European integration has been attractive for outsiders, expanding from an arrangement of six to 27 members. In addition, it is expected that in a regional integration free trade can be extended more easily to services and investment flows and that market access becomes easier. It is also hoped that some of the rules will eventually be generalized in a multilateral order. The Kemp-Wan existence theorem (Kemp and Wan 1976) has established conditions under which a customs union is Pareto-optimal for all its members. Most importantly, a regional integration can have a deeper form of interaction. Definitely, the European Union has reached a much deeper form of integration than would be possible in a multilateral world-wide approach. As a practical reason it is impossible to ban a deeper approach of regional integration in which countries cede national sovereignty and to hinder a whole continent such as Europe to establish a common economic - and to some extent - political union. In this interpretation, regional integrations may prove to be a vehicle to organize a multipolar world. Thus, regional governance is justified as a means to reach global governance.

In spite of these advantages, the WTO loses importance due to the waivers for regional integrations. The interest to strengthen the WTO is reduced. For instance, the WTO most-favored nation tariffs of the EU apply to only nine countries of the world, albeit including the US and Japan (WTO 2004

b). Regional integrations and bilateral agreements take the place of a multilateral order, if countries agree on the reduction of trade impediments in regional integrations and bilateral agreements only. It is much easier to conclude regional deals than multilateral arrangements. This holds most specifically for bilateral agreements where consensus is only required between two states instead of a complex arrangement among 151 WTO members. The same arguments hold for free trade agreements with only a few countries. The consequence is that countries are not willing to invest political energy in highly complex negotiations as the Doha round. The institutional arrangement becomes fragmented and looks like a spaghetti bowl - a term first used by Baghwati (1995). It turns out to be easier for politically powerful countries and regions with leverage to get their will, and it will be more difficult for smaller countries to obtain institutional rules that take into account their concerns.

A way out of this conundrum is to require more open customs unions, free trade areas and preferential agreements. This concept of "open regionalism" means that members of a regional integration voluntarily decide to keep the integration open in specific areas, such as trade, services, market access and possibly regulation. Other countries are invited to join and to implement the rules of a regional integration. They can opt to adopt one, some or even all rules of integration. This calls for part or all of the rules of regional integration to be open to be multilateralized. An important aspect is that "best practices" in regionalism are applied in order to bridge the gap between the multilateral approach and the regional approach (Plummer 2007). This includes a comprehensive coverage of goods and services, a low level of rules of origin, WTO consistent customs procedures, intellectual property protection and minimal technical barriers. Since regional integrations represent a deeper form of integration, multilateralization does not have to apply to all forms of integration. Countries outside the regional integration realistically will only apply some of the rules in the international division of labor and not all. Deeper forms of integration such as monetary union, abolishing border controls or political union could end up as being specific to a regional integration without being multilaterilized.

A Transatlantic Free Trade Area

TAFTA, a Transatlantic Free Trade Area, represents a concept to integrate the US, or possibly NAFTA, with the EU in major economic areas. Both regions are interlinked through trade, accounting for about 20 percent of each other's imports, and through foreign direct investment, with about half of the investment outflows of each region being invested on the other side of the Atlantic. In trade itself, the obstacles between both regions have been reduced to a very low level so that further reductions do not promise great additional gains. Moreover, agriculture does not seem to be a promising area for lowering trade barriers. In energy and environmental policy, the policy

concepts diverge considerably (Siebert 2005). In contrast, transatlantic cooperation is more promising in standard and rule setting. The existing Transatlantic Business Dialogue represents a meeting place for business leaders and government officials and can attempt to reduce transaction costs by setting common standards and working towards mutual recognition. This can be used for business, the financial sector, market access and competition policy. With the transatlantic region representing about 60 percent of world output, such cooperation might well be a trend setter in international rules. And of course, it would have some leverage in establishing global rules. A necessary condition, however, is that such an approach does not discriminate, i.e. that it is an open club. Openness for other regions and major players would help to counteract the impression of other countries that a western club wants to determine the rules of the game in its favor, attempting to exclude the new players in the international division of labor, among them Brazil, China and India.

Destabilization by large players

Another threat to the multilateral system is that large countries and regional blocs behave strategically. Thus, the US introduced the 'Omnibus Trade and Competitiveness Act' (Super 301) in 1988 and created the legal possibility of retaliating in the event of trade-restricting measures by other countries. The European Union developed its 'Trade Defence Instrument' in 1994. Moreover, both blocs have established their hub-and-spokes system around them. Although both blocs do have to respect the WTO rules, they can use their economic power to defend their interest, for instance in anti-dumping cases. There is the risk that they defy the international institutional arrangement. An Asian bloc around China is likely to evolve in the future. When these blocks pursue an aggressive trade policy, they endanger the multilateral system.

Preventing negative spillovers I: The territorial principle

One modus operandi to prevent excessive disturbances between nation states is to respect the other country's territory and not to intervene in its affairs. Territoriality, this old principle of diplomacy, for instance applied, at least partly, by the Viennese Congress in 1815 in rearranging the political landscape of Europe, is an essential approach to keep transaction costs low. Whereas it relates more to foreign policy and wars, it is also basic to economic relations. States respect the other states' autonomy and their legal authority; we can also say that states accept each other's property rights. √

The principle of territoriality is given up when states cede sovereignty to a supra-regional level (like the EU) or in international treatises like the Kyoto Protocol. It is restraint by international public law, especially in the violation of basic principles. Most specifically, the violation of "natural" law and human rights is not covered by the principle of territoriality. Another exemption to the territorial principle applies in the case of national defense.

Preventing negative spillovers II: Conflict management and mechanisms to internalize negative externalities

Border-crossing negative externalities, linking countries through technological systems such as groundwater conditions or an atmospheric setting, distort the market allocation and the competitive process. Cross-border environmental pollution such as acid rain is an example of such a negative externality. There are gains to be made by cooperation in order to internalise these externalities. By definition, this type of cooperation means reducing the externality by internalising the social costs. The polluter-pays principle where the polluter, for instance the upwind country, carries the abatement costs to cut emissions, is unlikely to be applied since the polluter is in a strong bargaining position. Therefore, the victim-pays principle is the more typical solution in which the pollute pays a compensation in order to induce the polluter to undertake abatement. The cost arrangement found will depend on other types of interdependencies promising benefits which may make countries ready to take over costs of abatement. For instance, within the European Union the bargaining position of the polluter is weaker because EU member states are interlinked in many ways and compromising in one area brings benefits in other fields.

Negative spillovers go beyond environmental negative externalities. Thus, an upstream country may use the water of a river that is also exploited by its downstream neighbor. It may change the direction of a river. Last but not least, hostilities and warfare fall into this category.

Limits of coordination

Cooperation is required if in the case of externalities running through technological systems the benefits from cooperation outweigh the costs of living with the technological externality. Otherwise, one has to live with the externality. In addition to health hazards, this principle requires some qualification.

An important condition is that the costs of cooperation do not involve costs of reducing competition between countries. If they do, such costs represent long-run opportunity costs because innovative pressure is taken out of the system. Then, the opportunity costs of reducing competition represent part of the costs for finding a solution and it is required to include the costs of reducing competition in a benefit-cost analysis. The gains from cooperation must more than compensate for the costs of reducing competition. Correcting externalities running though technological systems usually apply to allocation; therefore one normally does not expect that competition between countries is reduced. However, solutions may be chosen that reduce competition and that have a distorting impact on market positions of firms and countries and consequently on the intensity of competition.

In contrast to technological externalities, pecuniary externalities are interdependencies between market variables such as prices and incomes, running through the market mechanism. Such market

interdependencies are desired, and they give no justification for cooperation. Cooperation between governments in the case of market externalities always implies that competition is reduced.

As another aspect, market failures become relevant in this context. Competition between governments involves the functioning of many markets, especially goods and labor markets. Ideally, these markets function well. If market failures exist, national and international policy failures have to be distinguished. National failures have to be solved at the national level. International market failures require coordination. The costs of international policy failures should not outweigh the costs of market failures.

Coordination should never be seen as legitimate if it is undertaken for the single purpose of keeping governments, or the existing parties, in power. This is collusion among governments. In no case should governments be allowed to cooperate in limiting the exit option of residents, for instance by detaining a country's inhabitants behind walls. This limits freedom and runs counter to an open society in the spirit of Popper (1945).

Preventing negative spillovers III: International courts

International courts represent an institutional arrangement to solve disputes between states. In that function, courts are similar to the dispute settlement mechanism of the WTO, albeit in a less formalized way, and as a rule, with little or nearly no power to implement a verdict.

The International Court of Justice is the main legal organ of the UN. It was established by the UN Charter in 1945 and has its seat in The Hague, Netherlands. Its role is to solve disputes between states. Whereas UN membership makes a state fall within the jurisdiction of the court, the court may entertain a case only in specific circumstances, for instance when the states conclude a specific agreement to submit the dispute to the court, if both states have signed appropriate clauses in international treaties (there are about 300 of them) or if they have signed a declaration to accept the jurisdiction of the court as have done 67 states. A specific environmental chamber was established in 1993. The implementation of a verdict is in the hand of the UN Security Council. In its most famous case, Nicaragua vs United States of America, the Court, in 1986, judged the US to have violated international law by supporting the guerrillas and mining Nicaragua's harbors, and ordered them to pay reparations.

The International Tribunal for the Law of the Sea, based in Hamburg, deals with disputes regulated in the UN Convention on the Law of the Sea, which entered into force in November 1994. The Convention with currently 155 members ('States Parties') establishes a comprehensive legal framework to regulate all ocean space, its uses and resources. It contains, among other things, provisions relating to the territorial sea, the contiguous zone, the continental shelf, the exclusive

economic zone and the high seas. It also provides for the protection and preservation of the marine environment, for marine scientific research and for the development and transfer of marine technology. One of the most important parts of the Convention concerns the exploration for and exploitation of the resources of the seabed and ocean floor and subsoil thereof, beyond the limits of national jurisdiction.

In contrast to these international courts, the European Court of Justice, agreed upon by the EU member states, has more teeth. It has the power to interpret the international treaties, in its latest version the basic treaty of 2007 (not yet ratified in November 2007). The courts decisions are binding. Whereas the European Court of Justice cannot create "original" law which is the privilege of the European Council, i.e. the council of heads of state or ministers, the court has an important function in interpreting law. More specifically, the court can clarify whether national law is inconsistant with rules pertaining to the EU, for instance with the four freedoms of the single market. Thus, the court can influence the rules.

In order to ensure the effective and uniform application of Community legislation and to prevent divergent interpretations, the national courts may, and sometimes must, refer to the Court of Justice and ask it to clarify a point concerning the interpretation of Community law. The Court of Justice's reply is not merely an opinion, but takes the form of a judgment or reasoned order. The national court to which it is addressed is, in deciding the dispute before it, bound by the interpretation given. The Court of Justice's judgment likewise binds other national courts before which the same problem is raised.

In addition, 'actions for failure to fulfill obligations' enable the Court of Justice to determine whether a member state has fulfilled its obligations under Community law. Before bringing the case before the Court of Justice, the Commission conducts a preliminary procedure in which the member state is given the opportunity to reply to the complaints against it. If that procedure does not result in the member state terminating the failure, an action for infringement of Community law may be brought before the Court of Justice. The action may be brought by the Commission — as, in practice, is usually the case — or by a member state. If the Court finds that an obligation has not been fulfilled, the State must bring the failure to an end without delay. If, after a further action is brought by the Commission, the Court of Justice finds that the Member State concerned has not complied with its judgment, it may impose on it a fixed or periodic financial penalty. Regarding 'actions for annulment' the Court of Justice has exclusive jurisdiction over these type of actions when brought by a Member State against the European Parliament and/or against the Council (apart from Council measures with respect of State aid, dumping and implementing powers) or brought by one Community institution against another.

An unsolved problem exists when issues are decided differently by the European Court of Justice and by national constitutional courts. A related question is whether the EU needs a competence court that can decide where the competence lies for specific policy questions, i.e. which competence the different layers of decision making in the EU have, including the competence of the European Court of Justice relative to the national constitutional courts.

Other international courts such as the International Criminal Court and the European Court of Human Rights address specifically issues of crime and human rights.

Honoring positive spillovers

In contrast to negative externalities, positive spillovers represent an interdependence that is beneficial. A case in point is the equatorial rain forest in Brazil having a positive effect in allowing biodiversity. The country making the positive externality possible has to be compensated.

Dealing with public goods

Global public goods having a global dimension such as the ozone layer and the earth's atmosphere cannot be allocated by competitive processes. For instance, because of greenhouse gases the concept of competition between countries cannot be used in global warming to determine the optimal quantity or quality of the environmental media at stake. International institutional arrangements of bargaining are needed to aggregate the countries' political preferences and to allocate the costs of abatement to the individual countries, to find the least-cost solution for the abatement of pollutants and to prevent free rider behavior. Another example of a public good is internal security. Due to organized crime and terrorism a threat to security has a global dimension. By definition, global goods do not involve costs of reducing competition, and there are gains from cooperation. In these cases, international cooperation and common rules are needed. If public goods only have a national dimension, they do not satisfy the property of a global public good and therefore fit the criteria for competition between countries. Note that merit goods, judged meritorious by some groups or even the aggregated preferences of society, are not public goods.

Stabilizing rules for burden sharing: Side payments

In contrast to positive sum games in which all participants can gain, burden sharing represents a different matter. In such a setting, a common goal is shared by many, often to different degrees, and it can only be achieved if the costs of reaching the goals are shared. With respect to the opportunity costs of reaching the goal, we have a negative sum game even if countries may have a benefit from the common goal. An example is the reduction of CO_2-emissions in order to help solving the global

warming. In this case, side payments can be used as an incentive to get countries interested in a rule system.

Side payments may also take place in form of technology transfers. Thus, the Clean Development Mechanism of the Kyoto Protocol applies to projects in developing countries, undertaken by firms of developed countries: The firms receive a credit for their abatement which they may sell on the market for CO_2 – emission rights.

Self-enforcing contracts

When international treaties deal with free-rider behavior and quickly varying problems instead of relatively stable issue patterns with direct benefits as in the international division of labor, self-enforcing contracts are an appropriate instrument. Then the contract contains mechanisms that stabilize it and make sure that the contract is honored if the states of nature vary. One aspect of such contracts is that information on future states of the world is not perfect, for instance if in international environmental problems new information is likely to show up, if preferences shift and if burden sharing is likely to be judged differently over time. Most importantly, the contract should hold if the internal situation of signatories varies. Fines for countries deviating, a membership fee or an initial capital endowment put up by individual members, side payments such as transfers to members in economic trouble and sanctions represent possible instruments. Self-enforced contracts have been especially proposed for environmental treaties.

Lessons from European integration

The European Union can be viewed as a laboratory experiment for nation states ceding sovereignty. In a long process now lasting for nearly sixty years, the countries of Europe have been prepared to shift a sizable amount of sovereignty to the EU level. Starting with the European Coal and Steel Community of the Six in 1951, a common market was established for all products which then extended in several enlargements to 27 members. In a mixture of a customs union, monetary union and elements of a political union, many policy decisions have shifted to the European level. These include trade policy, competition policy and subsidy control as essential elements of a single market. The four freedoms establish a single market with the free flow of goods, services, capital and people. The principle of mutual recognition allows different legal settings to coexist and compete with each other. The Union’s powers in judicial cooperation, the free movement of persons, foreign policy and public health have been strengthened. Political aspects of integration, namely European Citizenship, a common foreign and security policy and internal security are also on the agenda.

Decision making in the EU represents a complex matrix of centralization and of ceding nation sovereignty where decisions can be taken by the EU commission, the European Council (of heads of states or ministers) with unanimity or qualified majority and the nation state. Trade policy, competition policy and control of state subsidies are completely centralized and in the hands of the commission. Monetary policy in the euro area of thirteen member states is also compelety centralized and de-politicized. Monetary policy and competition policy have been unconditionally delegated to independent agents where the ECB is only checked by public opinion (Coeuré and Pisani-Ferry 2007, p. 29). Trade in goods uses a supervised delegation through the 133 Committee (ibid, p. 30) made up of trade officials nominated by the member states. It monitors the negotiation process. Agricultural policy, the single market, international agreements, regional and cohesion funds, and financial assistance in crisis are decisions of the European Council requiring qualified majority. Environment, consumer protection and transfrontier movement of labor are shared responsibilities between the commission and nation states; in these areas the EU Commission has quite an influence through its directives. Direct taxation and indirect taxation (except for minimum indirect tax rates) require unanimity. This also holds for immigration of non-EU citizens with, however, some influence of the EU Commission. Policies at the national level include taxation, wage policy in those countries where wages are not determined by the markets anyhow, i.e. where they are negotiated by the social partners, the organization of the health sector, education and culture and the social security systems including pensions and health and unemployment insurance.

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