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## Economic approaches to global regulation: expanding the international law and economics paradigm

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## ECONOMIC APPROACHES TO GLOBAL REGULATION: EXPANDING THE INTERNATIONAL LAW AND ECONOMICS PARADIGM+

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### ABSTRACT

The recent economic crisis has demonstrated with startling clarity the importance of developing a more robust framework for assessing the effects of national rules on global welfare. For more than fifty years, law and economics scholars have examined the effects of domestic legal rules on economic activity and general welfare in the United States. More recently, international law scholars have begun to use economic methods to analyze the international legal order. In this article I survey this evolving body of “international law and economics scholarship” with a view to articulating its principle methodological innovations as well as assessing its contributions to our substantive understanding of the global order. I conclude that while the accomplishments of international law and economics scholars have been substantial, their focus on sovereignty and their commitment to a particular set of analytic assumptions borrowed from “new institutional economics” limits their ability to capture the “real world” complexity and diversity of the global legal order. I suggest that we must expand our analytic methods to take up more directly the inherently political and normative character of our analytic assumptions. Doing so might lead us to more normative and less theoretically certain accounts of the global order in which we live, while pointing us toward the more just, equitable and prosperous order we might create.

### 1. INTRODUCTION

The recent economic crisis demonstrated the need to assess the countless legal rules and institutions that affect global economic life from the perspective of their impact on global welfare as a whole. On the one hand, economic globalization has increased prosperity for billions of people in the developing world.<sup>1</sup> At the same time, global economic interdependence has increased the vulnerability of people everywhere to volatility in the global econ-

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\* Associate Professor of Law, Northeastern University School of Law. This article would not have been possible without the faith, encouragement and support of people too numerous to mention here. Nevertheless, I would like to express my particular gratitude to a few colleagues who continued to believe in my scholarly capacity to say something useful and perhaps transformative in a well-developed field populated with numerous able scholars even when I sometimes feared that I could not. Those colleagues include David Kennedy, James Rowan, Malcolm Owen Slavin and Emily Spieler.

<sup>1</sup> See, JAMES M. CYPHER & JAMES L. DIETZ, *THE PROCESS OF ECONOMIC DEVELOPMENT* 6 (3d ed. 2009) (citing World Bank statistics). See also, DANI RODRIK, *ONE ECONOMICS MANY RECIPES: GLOBALIZATION, INSTITUTIONS AND ECONOMIC GROWTH* 13 (2007) (Real per capita income in the developing world grew at an average rate of 2.1 percent per annum compared to 1.3 percent per annum in the developed world between 1960 and 2004); JEFFREY D. SACHS, *THE END OF POVERTY: ECONOMIC POSSIBILITIES FOR OUR TIME* 51 (2005) (noting during the period between 1980 and 2004, there was a significant reduction in persons living in extreme poverty and a significant increase in the number of people living in countries that experienced growth in average income per capita and in average life expectancy).

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omy, increased income inequality in both the developed and the developing worlds, and left a large proportion of the global population in abject poverty.<sup>2</sup> The legal rules structuring economic activity both nationally and trans-nationally are a crucial component in this story. It is imperative that we develop the political and intellectual capabilities to analyze legal rules by reference to their economic effects on the lives of people around the world.

Legal scholars have long recognized the role of law and legal institutions in the allocation of resources in social and economic systems.<sup>3</sup> Where rules produce significant global economic effects, refining our capacity to assess their impact on global welfare is an important step in the broader political project of creating more just, equitable, inclusive and welfare-enhancing regimes of regulation and governance for the globe as a whole. However we may want to define and measure “global welfare,” we will want to be able to assess whether specific rules adopted locally, nationally or internationally, increase or diminish it.<sup>4</sup> As a legal scholar interested in the effect of legal rules on economic growth and distributional equity, I have frequently turned to the discipline of economics for methodological innovation and analytic insight. In this respect, I am hardly alone. For many years, legal scholars in the United States have been mining economic theory to improve their understanding of the impact of domestic rules and regulation on economic activity and general welfare.<sup>5</sup> More recently, a number of international law scholars have sought to use economic analytic methods to explore

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<sup>2</sup> For a sobering discussion of trends regarding global income inequality both within countries and between countries from 1970 through 2001, see, U.N. DEVELOPMENT PROGRAMME, HUMAN DEVELOPMENT REPORT 2002: DEEPENING DEMOCRACY IN A FRAGMENTED WORLD 19 (2002). For a more recent snapshot of inequities in the distribution of wealth globally, see CYPHER & DIETZ, *supra* note 1 at 49 (compiling comparative data on income distribution for the poorest and the richest twenty percent of the populations of 27 geographically diverse developing countries and the U.S. and Japan based on World Bank statistics from 2007). For an informative discussion of the persistence of poverty despite significant global economic growth since 1950, see CYPHER & DIETZ, *supra* note 1, at 6-18. For an interesting analysis of some of structural and institutional causes of the tremendous variability in economic growth among countries over the last fifty years, see, RODRIK, *supra* note 1, at 13-55.

<sup>3</sup> For an intellectual history of American “legal-economic theory” from the eighteenth century to the present, see, JAMES R. HACKNEY, JR., UNDER COVER OF SCIENCE: AMERICAN LEGAL-ECONOMIC THEORY AND THE QUEST FOR OBJECTIVITY (2006). There is a well-developed tradition, building out of the early twentieth century Progressive critique of legal formalism known as Legal Realism, focused on the significance of legal rules to the distribution of economic welfare. See, e.g., Robert Hale, *Coercion and Distribution in a Supposedly Noncoercive State*, 38 POL. SCI. Q. 470 (1923); Robert Hale, *Bargaining, Duress, and Economic Liberty*, 43 COLUM. L. REV. 603 (1943); Morris Cohen, *Property and Sovereignty*, XIII CORN. L. Q. 8 (1927-28); Marc Galanter, *Why the “Haves” Come Out Ahead: Speculations on the Limits of Legal Change*, 9 LAW & SOC’Y REV. 95 (1974); Duncan Kennedy, *The Stakes of Law, or Hale and Foucault!*, in SEXY DRESSING ETC. 83-125 (1993) [hereinafter KENNEDY, SEXY DRESSING].

<sup>4</sup> In the domestic context, many scholars associated with the “law and economics” tradition have developed methods for assessing the efficiency and welfare impact of legal rules and institutions. For a brief history of the “law and economics” movement, see RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 23-28 (7th ed. 2007). Among economists, it has been those most associated with “institutional economics” traditions who have contributed to our understanding of the welfare effects of law. For a history of the significance of law in the work of institutional economists, see HEATH PEARSON, ORIGINS OF LAW AND ECONOMICS: THE ECONOMISTS’ NEW SCIENCE OF LAW 1830-1930 (1997) [hereinafter PEARSON, ORIGINS OF LAW AND ECONOMICS].

<sup>5</sup> See, e.g., HACKNEY, *supra* note 3; BARBARA H. FRIED, THE PROGRESSIVE ASSAULT ON LAISSEZ FAIRE: ROBERT HALE AND THE FIRST LAW AND ECONOMICS MOVEMENT (1998). The emergence of “law and economics” as a systematic jurisprudential approach to legal analysis is frequently tied to the publication to two seminal articles: R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960), and Guido Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499 (1961). See also POSNER, *supra* note 3, at 23.

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the global legal and economic order and its effects on global welfare.<sup>6</sup> Although these scholars differ both in their approach to “global welfare” and in the economic tools upon which they rely, all seek to improve our ability to understand, from a global point of view, when international law makes things better and when it make things worse.<sup>7</sup>

In Part 2 of this article, I examine the central substantive and methodological preoccupations of scholars working in the emerging field of international law and economics, with a view to articulating the “state of the art” vis-à-vis economic approaches to the analysis of international law.<sup>8</sup> This exploration reveals some shared attributes as well as some significant differences in the work of international law and economics scholars. International law and economics scholars bring economic approaches to bear on issues of concern to international law scholars generally—such as the sources and legitimacy of international legal rules and norms, whether, when and how international law effects the behavior of nation-states and other international actors, how inter-state cooperation contributes to global order, when international institutions or organizations are necessary or appropriate mechanisms for global or-

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<sup>6</sup> See, e.g., William J. Aceves, *The Economic Analysis of International Law: Transaction Cost Economics and the Concept of State Practice*, 17 U. PA. J. INT'L ECON. L. 995 (1996) [hereinafter Aceves, *Transaction Cost Economics and State Practice*]; Eyal Benvenisti, *Collective Action in the Utilization of Fresh Water: The Challenges of International Water Resources Law*, 90 AM. J. INT'L L. 384 (1996); Robert D. Cooter, *Structural Adjudication in the New Law Merchant: A Model of Decentralized Law*, 14 INT'L REV. L. & ECON. 215 (1994) [hereinafter Cooter, *New Law Merchant*]; Jeffrey Dunoff & Joel Trachtman, *Economic Analysis of International Law*, 24 YALE J. INT'L L. 1 (1999) (Appendix B contains a selected bibliography of scholarship applying economic approaches to international legal issues) [hereinafter Dunoff & Trachtman, *Economic Analysis of Law*]; ANDREW T. GUZMAN, *HOW INTERNATIONAL LAW WORKS: A RATIONAL CHOICE THEORY* (2008) [hereinafter GUZMAN, *HOW INTERNATIONAL LAW WORKS*]; Gillian Hadfield, *Law for a Flat World: Legal Infrastructure and the New Economy* (USC Center in Law, Econ. and Org. Research Paper No. C10-7, 2010), <http://ssrn.com/abstract=1567712>; William B.T. Mock, *Game Theory, Signaling and International Legal Relations*, 26 GEO. WASH. J. INT'L L. & ECON. 33 (1992) [hereinafter Mock, *Game Theory and International Relations*]; Joel R. Paul, *New Movements in International Economic Law*, 10 AM. U. J. INT'L L. & POL'Y 607 (1995); Eric A. Posner & Alan O. Sykes, *Economic Foundations of the Law of the Sea* (U. Chi. Law Sch., John M. Olin Law & Econ Working Paper No. 504, 2009), <http://ssrn.com/abstract=1524274>; Paul B. Stephan, *Barbarians Inside the Gate: Public Choice Theory and International Economic Law*, 10 AM. U. J. INT'L L. & POL'Y 745 (1995) [hereinafter Stephan, *Barbarians*]; Paul B. Stephan, *Accountability and International Lawmaking: Rules, Rents, and Legitimacy*, 17 NW. J. INT'L L. & BUS. 681 (1996-1997) [hereinafter Stephan, *Accountability and International Lawmaking*]; Alan O. Sykes, *The Economics of Injury in Antidumping and Countervailing Duty Cases*, 16 INT'L REV. L. & ECON. 5 (1996); JOEL P. TRACHTMAN, *THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW* (2008) [hereinafter TRACHTMAN, *THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW*]; Joel P. Trachtman, *The Theory of the Firm and the Theory of the International Economic Organization: Toward Comparative Institutional Analysis*, 17 NW. J. INT'L L. & BUS. 470 (1996-1997) [hereinafter Trachtman, *The Firm and International Economic Organization*]. An early precursor to this emerging field of international law and economics scholarship is Wilhelm Roëpke, *Economic Order and International Law*, 86 RECUEIL DES COURS 203 (1954).

<sup>7</sup> For a survey of the main contours of this scholarship, see *infra* Part 2.

<sup>8</sup> For general discussions of the principal analytic questions and preoccupations of the much larger and more developed field of domestic law and economics, see JEFFREY L. HARRISON, *LAW AND ECONOMICS: POSITIVE, NORMATIVE AND BEHAVIORAL ASPECTS* (2d ed. 2002); POSNER, *ECONOMIC ANALYSIS OF LAW*, *supra* note 3; A. MITCHELL POLINSKY, *AN INTRODUCTION TO LAW AND ECONOMICS* (3rd ed. 2003); and STEVEN SHAVELL, *FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW* (2004). For a critique of domestic law and economics from the perspective of critical legal studies, see Duncan Kennedy, *Law-and-Economics from the Perspective of Critical Legal Studies*, in *THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW*, VOL. 2, (Peter Newman, ed., 1998) 465-474. [hereinafter Kennedy, *Law-and-Economics from the Perspective of Critical Legal Studies*] (also contains useful short bibliography of important works of domestic law and economics scholarship).

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dering, and how international law might be deployed most effectively to encourage welfare-enhancing inter-state cooperation while preserving sovereign autonomy and minimizing conflict.<sup>9</sup> Moreover, when international law and economics scholars shift their analytic attention from the structure of the international legal system to its impact on transnational economic activity, they often focus on exploring the economic effects of particular institutional forms of transnational rule-making or particular allocations of regulatory authority among sovereign states.<sup>10</sup> Finally, and perhaps as a result of their focus on jurisdictional and institutional questions, international law and economics scholars have drawn their inspiration largely from theories and methods associated with “new institutional economics,” with a particular focus on transaction cost economics, firm theory, comparative institutional analysis, game theory, rational choice theory and public choice theory.<sup>11</sup>

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<sup>9</sup> See, e.g., Aceves, *Transaction Cost Economics and State Practice*, *supra* note 6 (seeking to bring together insights from international law, international relations and economics for the interdisciplinary study of international cooperation); GUZMAN, *HOW INTERNATIONAL LAW WORKS*, *supra* note 6, at 23 (“This book is interested in questions relating to compliance with international law and cooperation in international affairs.”); TRACHTMAN, *THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW*, *supra* note 6, at ix (seeking to elaborate a law and economics-based account of the structure of the international legal system “including the rise, stability and efficiency of custom; compliance with treaty; the establishment of international organizations; the use of dispute settlement in international treaty structures; and host of other topics). Compare LORI F. DAMROSCH ET AL., *Chapter 1. The Nature of International Law*, in *INTERNATIONAL LAW CASES AND MATERIALS 1-55* (4th ed. 2001) (providing an introduction to the central concerns of the discipline of international law including the structure and organization of the international political system, sovereignty and the inter-state relations, the binding character of international law, enforcement of and compliance with international law, among others).

<sup>10</sup> See, e.g., Steven J. Choi & Andrew T. Guzman, *National Laws, International Money: Regulation in a Global Capital Market*, 65 *FORDHAM L. REV.* 1855 (1996-1997) [hereinafter Choi & Guzman, *National Laws, International Money*] (arguing that regulatory competition between national securities regimes supported by a “territorialist” conception of national jurisdiction and beneficial forms of inter-state cooperation that facilitate information sharing and greater capital mobility will result in more efficient functioning of international securities markets than either the extraterritorial application of national securities laws or attempts to harmonize substantive legal standards internationally); Cooter, *New Law Merchant*, *supra* note 6 (arguing that decentralized lawmaking based on an economic methodology for assessing the efficiency of the incentive structure contained in actual customary business norms in diverse business communities supplemented by formal legal enforcement and sanctions will lead to more efficient regulation of business transactions than more traditional “command and control” regulatory approaches); Joel P. Trachtman, *Unilateralism, Bilateralism, Regionalism, Multilateralism and Functionalism: A Comparison with Reference to Securities Regulation*, 4 *TRANSNAT’L L. & CONTEMP. PROBS.* 69, 74-75 (1994) [hereinafter, Trachtman, *Unilateralism, Bilateralism, Regionalism*] (considering a methodology for analyzing three questions with respect to the regulation of securities transactions, “First, why do countries begin to defer to other countries, or cooperate with other countries in [the area] of securities regulation? . . . Second, what methods of deference or cooperation are available in the securities sector? . . . Finally, and intertwined with the previous questions, how do countries determine the appropriate scope of deference or cooperation: autarky, bilateralism, regionalism, or multilateralism?”).

<sup>11</sup> The term “new institutional economics” was first coined by Oliver Williamson in *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* (1975). While Williamson has on several occasions sought to characterize what constitutes “the field,” his description in 2000 still seems apt: “[T]he new institutional economics is a boiling cauldron of ideas. Not only are there many institutional research programs in progress, but there are competing ideas within many of them.” Oliver E. Williamson, *The New Institutional Economics: Taking Stock, Looking Ahead*, 38 *J. ECON. LIT.* 595, 610 (2000) [hereinafter Williamson, *Taking Stock*]; see also Oliver E. Williamson, *Reflections on the New Institutional Economics*, 141 *J. INST’L & THEORETICAL ECON.* 187 (1985); Oliver E. Williamson, *Forward: The New Institutional Economics Guidebook*, in *NEW INSTITUTIONAL ECONOMICS: A GUIDEBOOK*, xxiii (Éric Brousseau & Jean-Michel Glachant, eds., 2008) [hereinafter *NEW INSTITUTIONAL GUIDEBOOK*]. In many ways, “new institutional economics” comes to have

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Despite these general similarities, the work of international law and economics scholars can be divided into two related but distinct strands, each of which focuses on an important group of global regulatory issues. The first strand uses economic methods to suggest the most appropriate institutional level for making the rules (or regimes) that shape global economic activity and sometimes what form those rules (or regimes) should take.<sup>12</sup> Scholars working in this strand focus on such questions as when and under what circumstances national rules and regulatory competition among nation-states will be most likely to increase global welfare and when it might be more appropriate to turn to other institutional forms, such as private ordering, informal inter-state cooperation, formal agreements among states, harmonized or universal legal norms or international organizations to maximize global welfare. The second strand focuses on the allocation of jurisdictional authority among nation states and mechanisms for resolving situations in which more than one sovereign has an interest in regulating the same economic activity.<sup>13</sup> Scholars working in this strand use economic analysis to develop a welfare-maximizing system of jurisdictional rules among nation-states that would permit states to protect their legitimate sovereign interests both within and outside their territories without unduly hindering globally beneficial private economic activity or impinging on the legitimate interests of other sovereign states.

Both strands address important questions of sovereign power in the global economy. How strong should national sovereign regulatory authority be vis-à-vis that of other sovereigns and other institutional rule-makers and vis-à-vis private economic actors in the global legal and economic order? As one might expect, there has been a robust debate among scholars both within and between strands of international law and economics scholarship about how to resolve these important issues. Throughout, the focus is on the welfare effects of various institutional structures and arrangements of rule-making authority rather than on the global welfare effects of the substantive rule schemes themselves. To a certain extent, the welfare effects of various systems for allocating authority to make rules might serve as a proxy for assessing the welfare consequences of the rules themselves. This would not be the case, however, where the economic impact of the rules is independent of the institutional arrangements controlling their adoption or implementation.

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shape as a field in part in relation to its focus on “institutions” in dynamic economic processes and in part in relation to the methods of institutional economic analysis it leaves behind. As to the analytic focus of the field, Claude Ménard and Mary Shirley offer a useful description: “For new institutionalists the performance of a market economy depends upon the formal and informal institutions and modes of organization that facilitate private transactions and cooperative behavior. NIE [New Institutional Economics] focuses on how such institutions emerge, operate, and evolve, how they shape different arrangements that support production and exchange, as well as how these arrangements act in turn to change the rules of the game.” Claude Ménard & Mary M. Shelly, *Introduction*, in *HANDBOOK OF NEW INSTITUTIONAL ECONOMICS*, 1-2 (Claude Ménard & Mary M. Shelly, eds., 2008). For a very interesting genealogy of the relationship and continuing interaction and dialogue between “new” and “old” institutional economics, see MALCOLM RUTHERFORD, *INSTITUTIONS IN ECONOMICS: THE OLD AND THE NEW INSTITUTIONALISM* (1996) [hereinafter RUTHERFORD, *INSTITUTIONS IN ECONOMICS*]; see also OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 1-14 (1985) (offering an alternative genealogy of the field). For a discussion of the methodological eclecticism of “new institutional economics” see RUTHERFORD, *INSTITUTIONS IN ECONOMICS*, at 2-3; see also Williamson, *Taking Stock*, at 596-600.

<sup>12</sup> For a discussion of this first strand of international law and economics scholarship, see *infra* Part 2, Section A.

<sup>13</sup> For a discussion of this second strand of international law and economics scholarship, see *infra* Part 2, Section B.

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In Part 3 of this article, I explore the global economic significance of an issue that has not captured the analytic attention of international law and economics scholars focused on questions of institutional structure and sovereign authority: the ubiquitous transnational economic impact of *domestic* rules. Some examples of domestic rules with transnational economic effects include Chinese currency regulations regarding exchange rates, Colombian or Afghan rule regarding the production and distribution of coca or opium, Delaware corporate law and its impact on the decision-making and business practices of multinational corporations, and Vietnamese, Cambodian or Bangladeshi wage regulations and their impact on Chinese and other wage rates around the world. These rules seem interesting and important to understand precisely because their economic effects do not result from extra-territorial sovereign application. Rather, the effects of these rules are transnationalized through private economic activity sometimes undertaken in reaction or in relation to the rules.

Moreover, the magnitude of the transnational economic effects of these rules often do not easily correlate with traditional sources of international sovereign authority such as political or military power or market size. Some of the sovereign rule-makers in the examples just described are, by international economic and political standards, weak players in the global system. Nevertheless, in some circumstances, their rule-making produces significant economic effects that even the world's most powerful states have difficulty combating or containing.

From a political perspective, these rules evidence a disjuncture between the political constituencies responsible for the adoption or implementation of the rules and the economic constituencies affected by them. This disjuncture between economic effects and the political and institutional mechanisms for addressing them poses complex challenges for the legitimacy and functioning of the global legal and economic order that cannot easily be addressed through traditional conceptions of territorial sovereignty or consensual sovereign deference to international norms or institutions. This disjuncture seems particularly important in circumstances where the economic benefits of the global order are so inequitably distributed and when the presumption of formal sovereign equality is belied by significant differences in the abilities of states to shape their economic destinies through regulation.

There is no question that economic analytic methods should be useful in helping to explicate the global welfare effects of domestic rules. I have suggested elsewhere that the work of R.H. Coase establishing a framework for analyzing the relative effects of legal rules on economic welfare might be a good place to begin.<sup>14</sup> Coase's analytic approach seems particularly promising because it encourages us to shift our analytic focus from assessing the impact of rules by reference to sovereign territory, national policy intentions and the legitimacy of jurisdictional authority to identifying the economic interests implicated by a legal rule, interpreting the effects of the rule for those economic interests and modeling how bar-

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<sup>14</sup> See generally Dan Danielsen, *Local Rules and a Global Economy: An Economic Policy Perspective*, 1 TRANSNAT'L LEGAL THEORY 49 (2010) [hereinafter Danielsen, *Local Rules*] (arguing that a "global welfare perspective" on the transnational economic effects of local rules is needed and that Coase's framework for economic policy analysis of legal rules provides a useful and provocative starting point for developing such a perspective). Coase's economic policy framework for assessing the economic effects of legal rules was first articulated in R.H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960) and later elaborated in R.H. COASE, *THE FIRM, THE MARKET, AND THE LAW* (paperback ed. 1990).

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gaining by affected interests in the shadow of the rule can shape the economic significance of the rule for the interests themselves and for total welfare.<sup>15</sup>

In Part 4 of this article, I use Coase's framework as a starting point to explore what would be involved if we analyzed the global welfare effects of domestic rules by focusing on the economic interests affected by the rules and the ways in which we might anticipate dynamic adjustments in the shadow of the rules. My objective is to endeavor to think about the relationship between legal rules and global welfare *directly* rather than as an *effect* of the structure of the rule-making process or the structural relations among rule-makers. As we might anticipate, however, this is no easy task.

Each level of the analysis presents difficult challenges that require normative and political judgment and that take us back to questions of institutional structure and jurisdictional authority. Which interests do matter? How might cultural and political differences impact our understanding of the meaning of rules for economic interests? How should we consider the dynamic adjustments made by public as well as private actors on the global stage once a rule has been adopted? Each of these issues presents formidable problems of scale and complexity—there simply are more interests, more diverse cultural and political environments, and more complex and multi-level adjustments by diverse public and private actors alike when we are dealing with a global economy. From this perspective, it may seem justifiable both analytically and practically to treat sovereignty, national territory or legal jurisdiction as proxies for such difficult normative choices. At the same time, however, each of these challenges also raises questions about the costs and consequences of deploying these simplifying notions for the usefulness of an analysis of the global welfare effects of rules. I conclude that our current analytic approaches are not yet capable of assessing the global welfare effects of rules. We will need to expand both our analytic methods and our substantive foci of analysis if we are to begin to capture the complexity and diversity of global economic life.

In this article, I hope to build on the contributions and evolving work of international law and economics scholars toward a more comprehensive approach to assessing the welfare effects of rules in the global economy. First, through an exploration of the central methodological preoccupations and substantive insights of international law and economics scholarship to date, I suggest some important gaps in the work that come to light when analytic attention is focused on the economic significance of the domestic application of national rules for global economic welfare. Second, using R.H. Coase's economic policy framework for assessing the welfare effects of legal rules as a point of departure, I examine some of the most difficult challenges for expanding our economic methods to enable a more satisfying understanding of the economic interests affected by rules and the meaning of rules in a complex and diverse global economy, as well as the difficulty in conceptualizing the ways in which public and private actors are simultaneously involved in the process of rule-making and in adjusting the economic effects of the rules which they have all had a hand in making. I conclude by suggesting that in order to construct a more comprehensive assessment of rules in a global economic order, we may be required to interrogate more deeply the consequences of the assumptions that pervade our analytic methods even if that means taking up more directly the normative, ethical and distributional questions those assumptions seek to exclude in the pursuit of theoretical coherence or scientific rigor. A search for new analytic approaches may require us to reacquaint ourselves with the work of some of the early forebears of institutional

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<sup>15</sup> See Danielsen, *Local Rules*, *supra* note 14, at 57-59.

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economics who sought to develop a science of economics capable of analyzing and explaining economic life in all of its normative complexity and cultural diversity, as well as more recent work within new institutional economics that seems to be leading us toward more complex and inclusive analytic models. Doing so might lead us to more normative and less theoretically certain accounts of the global order in which we live, while pointing us toward the more just, equitable and prosperous order we might create.

## 2. ASSESSING THE INTERNATIONAL LAW AND ECONOMICS LITERATURE

Over the last years, a growing number of scholars from the American legal academy have sought to bring analytic methods and theoretical insights from economics to bear on issues of international law, regulation and governance.<sup>16</sup> To a large extent, these scholars have focused on the questions of institutional arrangement that are most central to the broader field of international law: who should make the rules in the global order and whose rules ought to apply in a complex global economy. Perhaps as a result, the economic approaches used by these scholars reflect methodological innovations and approaches from within what economists might describe as “the new institutional economics.”<sup>17</sup> Most international law and economics scholarship employs analytic methods from one of three strands of “new institutional economics”—transaction cost economics, public choice theory or game theory.<sup>18</sup> In a few cases, scholars have sought to combine methods and insights from more than one of these traditions in an attempt to articulate a more comprehensive theoretical approach to the international legal order.<sup>19</sup> By and large, international law and economic scholars have *not* focused on assessing the global welfare impact of substantive rules or rule systems in the global economy. Perhaps as a result, they have generally not relied as heavily as their domestic colleagues on the intellectual tradition of attempting to assess the relative efficiency and welfare effects of substantive legal rules initiated by the work of Ronald Coase. In Part 3 of this article, I suggest ways in which we might build on insights drawn from Coasean economic policy analysis to expand our analytic capabilities for assessing the global economic significance of domestic rules. But, before doing so, I will offer a thematic sketch of the types

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<sup>16</sup> For a list of representative examples of this work, *see supra* note 6.

<sup>17</sup> For a description of “new institutional economics” and its analytic and methodological concerns, *see supra* note 11.

<sup>18</sup> For scholarship using transaction cost economics, *see, e.g.*, Aceves, *Transaction Cost Economics and State Practice*, *supra* note 6; Choi & Guzman, *National Laws, International Money*, *supra* note 10; Trachtman, *The Firm and International Economic Organization*, *supra* note 6. For scholarship using public choice theory, *see, e.g.*, Erin Ann O’Hara, *Economics, Public Choice and the Perennial Conflict of Laws*, 90 GEO. L.J. 941 (2001-2002) [hereinafter O’Hara, *Economics, Public Choice*]; Stephan, *Barbarians*, *supra* note 6; Stephan, *Accountability and International Lawmaking*, *supra* note 6. For scholarship using game theory, *see, e.g.*, Cooter, *New Law Merchant*, *supra* note 6; GUZMAN, HOW INTERNATIONAL LAW WORKS, *supra* note 6; Mock, *Game Theory and International Relations*, *supra* note 6.

<sup>19</sup> For scholarship using hybrid or multiple institutional economic analytic methods, *see, e.g.*, Dunoff & Trachtman, *Economic Analysis of International Law*, *supra* note 6 (using transaction cost economics, game theory, property theory and organizational theory); Andrew T. Guzman, *Public Choice and International Regulatory Competition*, 90 GEO. L.J. 971 (2001-2002) [hereinafter Guzman, *Public Choice and International Regulatory Competition*] (seeking to reconcile transaction cost analysis with critiques based on public choice theory); TRACHTMAN, ECONOMIC STRUCTURE OF INTERNATIONAL LAW, *supra* note 6 (combining transaction cost economics, game theory and property theory); Joel P. Trachtman, *Economic Analysis of Prescriptive Jurisdiction*, 42 VA. J. INT’L L. 1 (2001) (using property theory, transaction cost economics, organizational theory).

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of projects and preoccupations that have been the focus of international law and economics scholarship to date and suggest some of the economic analytic methods most frequently used to pursue those projects.

The volume, range and creativity of international law and economics scholarship challenges any attempt at general characterization. Nevertheless this scholarly literature does seem to divide loosely into two related bodies of work with different areas of analytic focus. The first body of scholarship focuses on developing economic analytic models and methods for assessing which institutional levels, forms and regulatory frameworks are most conducive to increasing efficiency and/or welfare in the organization and operation of the global legal and economic order.<sup>20</sup> The second body of scholarship uses economic models and methods to explore the allocation of jurisdictional authority in the global legal and economic order with a view to defining a system of international jurisdictional rules and incentives that will enhance global efficiency and welfare.<sup>21</sup> Perhaps most significantly, both traditions focus primarily on

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<sup>20</sup> I will hereafter refer to this body of work as “First Strand scholarship” and to scholars producing this work as “First Strand scholars.” For examples of First Strand scholarship, *see, e.g.*, GUZMAN, HOW INTERNATIONAL LAW WORKS, *supra* note 6 (analyzing the impact of international law on inter-state cooperation and bargaining in the global order); Aceves, *Transaction Cost Economics and State Practice*, *supra* note 6 (discussed *infra* Part 2, Section A); Choi & Guzman, *National Laws, International Money*, *supra* note 10 (focusing on the superiority of national regulatory competition over international or coordinated rules for the regulation of international securities transactions); Cooter, *New Law Merchant*, *supra* note 6 (discussed *infra* Part 2, Section A); Andrew T. Guzman, *Why LDCs Sign Treaties That Hurt Them: Explaining the Popularity of Bilateral Investment Treaties*, 38 VA. J. INT’L L. 639 (1997-1998) [hereinafter Guzman, *Why LDCs Sign Treaties that Hurt Them*] (arguing that bilateral investment treaties that create a framework for the negotiation of binding investment agreements between host countries and foreign investors increase efficiency and reduce the cost of foreign investment even if they may not increase welfare for developing countries as a group); Stephan, *Barbarians*, *supra* note 6 (using public choice analysis to highlight the policy stakes of various regulatory choices in four areas of international economic law); Stephan, *Accountability and International Lawmaking*, *supra* note 6 (discuss *infra* Part 2, Section A); Trachtman, *Unilateralism, Bilateralism, Regionalism*, *supra* note 10 (analyzing reasons for cooperation and deference among states with respect to the regulation of international securities transactions).

<sup>21</sup> I will hereafter refer to this body of scholarship as “Second Strand scholarship” and to scholars producing this work as “Second Strand scholars.” For examples of Second Strand scholarship, *see, e.g.*, TRACHTMAN, THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW, *supra* note 6 (discussed *infra* Part 2, Section B); Stephen J. Choi & Andrew T. Guzman, *The Dangerous Extraterritoriality of American Securities Law*, 17 NW. J. INT’L L. & BUS. 207 (1996-1997) [hereinafter Choi & Guzman, *Dangerous Extraterritoriality*] (arguing that territorial limitations on the scope of application of securities laws and vigorous regulatory competition promotes efficient capital markets based on issuer choice of law and improves the quality of regulation by reducing the likelihood of interest group capture of regulatory processes); Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Laws*, 71 S. CAL. L. REV. 903 (1997-1998) [hereinafter Choi & Guzman, *Portable Reciprocity*] (advocating a international system of securities regulation made up of diverse and competitive national rule schemes reciprocally and trans-nationally enforced in every country based on the security issuer’s choice of national law); Andrew T. Guzman, *Choice of Law: New Foundations*, 90 GEO. L.J. 883 (2001-2002) (discussed *infra* Part 2, Section B) [hereinafter Guzman, *Choice of Law*]; O’Hara, *Economics, Public Choice*, *supra* note 18 (using public choice analysis to challenge the determinacy of “efficiency” as a criterion for selection of choice of law rules and to suggest limits to the choice of law paradigm as a mechanism for managing conflict among states); Paul B. Stephan, *Institutions and Élités: Property, Contract, the State, and Rights in Information in the Global Economy*, 10 CARDOZO J. INT’L & COMP. L. 305, 306-307 (2002) [hereinafter Stephan, *Institutions and Élités*] (arguing “that investments in harmonizing those rules that allocate jurisdiction for local lawmaking may lead to more useful responses to the information revolution and globalization than would further efforts to unify the substantive law governing rights in information, whether through institutionalized lawmaking or the common law process.”); Michael J. Whincop, *Conflicts in the Cathedral: Towards a Theory of Property Rights for Private International Law*, 50 U. TORONTO L.J. 41 (2000)

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the welfare implications of the *structure* of rule-making institutions and regulatory systems in the global legal and economic order and on the *structure* of relationships between rule-makers (particularly states). By contrast, they have been much less interested in the *substantive* content or the global welfare effects of different *substantive* rules or regulatory regimes.

**A. Tradition 1—Levels, forms, regulatory regimes and governance mechanisms**

One area of analytic focus among First Strand international law and economics scholars has been the use of economic methods to explore the “institutions” (including both institutional actors like firms, states and international organizations and institutional frameworks in the form of rules, regulatory regimes and normative orders) comprising the international legal and economic order with a view to discerning which institutions might be most appropriate to handle which aspects of global regulation and governance. The relevant institutional actors in the global order for First Strand scholars are multiple, diverse and all competing (or cooperating) in the interested pursuit of their respective preferences, be they productive efficiency, political power, or institutional dominance. Such institutional actors range from individuals to firms to bureaucracies to nation-states, to bilateral and regional institutions to special purpose international regulatory institutions to large, multilateral institutions. Moreover, while the motivations for activity and bargaining among these diverse institutional actors may differ, all are imagined to behave in ways that are explicable and predictable in economic terms using economic choice models, whether focused on transaction costs, game theory or public choice theory.

In addition to a diversity of institutional actors, First Strand scholars imagine the international legal order to be comprised of multiple, overlapping and often conflicting legal and normative frameworks emanating from multiple public and private institutional sources. Such frameworks and sources include private contract and dispute resolution, local or national rules, the extra-territorial application of national rules, bilateral or regional legal regimes, international private norms derived from business practices or the work of private regulatory institutions, and international customary and treaty-based norms and legal rules. When situating the international actors in the context of the international legal order, First Strand scholars generally distinguish between public and private interests and institutions. Public institutions (both national and international) are thought to focus on the maximization (or preservation) of national interests, prestige, regulatory jurisdiction and political power while private economic actors focus on arbitrating the opportunities and obstacles presented by the international legal order in an effort to maximize their respective economic returns.

With this background context, the two-fold goals of First Strand scholarship become more legible. As an initial matter, First Strand scholars seek to establish that the international legal and economic order (or a particular aspect of it) is both amenable to and explicable through economic analysis. Then First Strand scholars deploy economic analytic methods to assess and compare different institutions, or combinations of institutional arrangements, with a view to identifying more efficient and welfare-enhancing institutional levels, forms, regulatory structures and/or governance mechanisms for rule making. The impact of institutional reforms undertaken as a result of this analysis on global welfare would be indirect – if very

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(suggesting a crucial link between conflict of laws rules and the meaning and stability of property entitlements and arguing that appropriate international conflict rules can assist parties to increase welfare-maximizing cooperation and reduce sub-optimal competition).

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important. The analysis is designed to improve our ability to identify situations in which rule making at one rather than another level would improve the international legal and economic order as a whole. In a sense, First Strand scholars seem to view the international legal and economic order as a great multi-dimensional puzzle. From this perspective, the task for international law and economic analysis is to provide theoretical and methodological frameworks for identifying and promoting the arrangements of institutional actors and processes through which more efficient institutions, regulatory regimes and governance mechanisms for the global legal and economic order can be made and/or administered.

Within these broad parameters—first using economic analytic methods to explicate an aspect, issue or problem in the international legal and economic order, and then using such methods to suggest when and why particular institutional actors, regulatory regimes or governance mechanisms will increase efficiency—the scholarship comprising this literature is quite diverse. To provide a better sense of the contours of First Strand scholarship, I will focus on three examples from which I will draw parallels to the broader body of work in the First Strand.

In the first example, Professor William Aceves brings an economic analytic approach to exploring how the efficiency of inter-state cooperation can be shaped by the structure of international law and institutions.<sup>22</sup> International relations studies indicate that in a decentralized, non-hierarchical global order comprised of self-interested, egoistic states engaged in the maximization of their own utility often at the expense of the global good, international institutions can facilitate welfare-enhancing inter-state cooperation.<sup>23</sup> Aceves refines and enriches this insight using a transaction cost economics approach. Aceves argues that when the transaction costs of arranging, monitoring and enforcing cooperation through an international institution (usually established through a long-term, complex contract in the form of a treaty), two significant issues characteristically arise for states—costly adjustments to unforeseen contingencies and controlling attempts by states parties to extract unfair advantage from an institutional relationship through opportunistic rent-seeking behavior.<sup>24</sup> He asserts that states generally try to address these two complex issues by incorporating either “exogenous” or “endogenous governance mechanisms” into their relationship.<sup>25</sup> When “exogenous governance mechanisms” are used, the problems of unforeseen contingencies and opportunistic rent-seeking behavior are generally managed through the mechanism of a third-party adjudicator who is empowered by the parties to adapt the original agreement between the parties through interpretation and impose binding dispute resolution on the parties.<sup>26</sup>

In contrast to the typical “exogenous governance mechanism” of third-party dispute resolution, Aceves argues that state cooperation could be increased and transaction costs re-

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<sup>22</sup> Aceves, *Transaction Cost Economics and State Practice*, *supra* note 6.

<sup>23</sup> *Id.* at 999-1002.

<sup>24</sup> *Id.* at 1016-18.

<sup>25</sup> *Id.* at 1017-19, 1022 (“Exogenous governance structures address the problems raised by transaction costs by authorizing a third party to address any disputes or unforeseen developments that may arise in the course of a relationship. . . . Exogenous structures can take several forms, including arbitration and judicial settlement.” “In contrast to exogenous governance structures, endogenous structures allow states to address the problems raised by transaction costs within the context of their relationship. Unlike exogenous structures, endogenous structures do not rely upon a third party or other outside mechanism to resolve disputes. Rather, disputes are resolved by the parties within the course of their relationship.”) (citations omitted).

<sup>26</sup> *Id.*

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duced by “endogenous governance mechanisms.”<sup>27</sup> In particular, Aceves asserts that the iterative process of state practice helps to facilitate “endogenous governance mechanisms” that foreground state/party autonomy and flexibility over formalism, cooperation over conflict and informal governance and private ordering over what Aceves calls “legal centrism.” In Aceves’ view, state practice can allow states to interpret and/or modify their original agreements through subsequent actions, thereby increasing institutional flexibility while reducing the need for the costly negotiation of complex treaty contingencies up front as well as the need for external adjudicators to resolve disputes.<sup>28</sup> He further suggests that over time, consistent state practice can develop into customary international law, allowing states to establish norms and modes of cooperation without resort to formal agreements or rigid institutional structures.<sup>29</sup> While Aceves sees a place for both “exogenous” and “endogenous” governance mechanisms in international institutions and the global economic order, he uses insights drawn from his transaction costs analysis to suggest a preference for institutional forms built around “endogenous governance mechanisms,” such as state practice, as a means for generating increased cooperation and efficiency (in the form of reduced transaction costs) among states.<sup>30</sup>

In a second example, Professor Robert Cooter uses economic theory to explore the merits of decentralized party-generated legal ordering in the context of what he terms “the new law merchant.”<sup>31</sup> Cooter describes “the new law merchant” as the rules, norms and guidelines generated and administered by discrete business communities to govern their business affairs. Cooter focuses on business norms that, like customary international law, develop through the passage of time and repeated usage into obligations as opposed to mere voluntary practices, and suggests that such norms could be the basis for an efficient system of decentralized and custom-based law if subjected to a form of economic analysis he terms the “structural approach to adjudicating social norms.”<sup>32</sup> Using models derived from game theory to explain the evolution and efficiency of certain customary business norms, Cooter’s “structural approach” suggests what he terms “the correct role for the state with respect to [business] custom.”<sup>33</sup> Specifically, Cooter argues that states should (i) identify operative customary business norms in particular business communities, (ii) identify the incentive structures within the relevant business community responsible for producing the norms, (iii) apply his economic analytic methods to evaluate the efficiency of the incentives structures identified, and, if a norm is determined to be “efficient” (because based on cooperative, internalized and repeated business practices developed in a business community in the absence of non-convexities and spillovers to other communities), (iv) formalize the applicable norm by elevating it into positive law and enforcing it through state police power.<sup>34</sup> In this way, Cooter argues that states can facilitate private ordering while avoiding the inefficiencies of “command-and-control” regulatory structures<sup>35</sup> as well as the costs of under-enforcement that often accompany infor-

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<sup>27</sup> *Id.* at 1022-32.

<sup>28</sup> *Id.* at 1056-67.

<sup>29</sup> *Id.* at 1060-64.

<sup>30</sup> *Id.* at 1064-67.

<sup>31</sup> Cooter, *New Law Merchant*, *supra* note 6.

<sup>32</sup> *Id.* at 216-17, 217.

<sup>33</sup> *Id.* at 226.

<sup>34</sup> *Id.*

<sup>35</sup> *Id.* at 215-16.

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mal enforcement of social norms.<sup>36</sup> Though Cooter's analysis is not addressed directly to the international context, neither is it limited in scope or application to a particular state. In fact, the logic of Cooter's "structural approach," seems to reject any coordinated international institutional approach to the creation of an "international law merchant." Rather, his analysis seems to suggest that if states were to adopt his "structural approach" to bottom-up lawmaking based on the identification and enforcement of efficient customary business norms, a decentralized and efficient global legal order for commercial transactions could be "found" in business practice rather than "made" through international planning or institutional design.<sup>37</sup>

In a third example of this strand of international law and economics scholarship, Professor Paul Stephan takes up the dramatic increase in the number and significance of legal rules made by international institutions and inquires: "What safeguards do we employ to increase the chances that [these legal rules] will do some good? More specifically, what processes hold international lawmakers accountable for their decisions?"<sup>38</sup> In particular, Stephan focuses on international laws that govern either the behavior of private actors or that limit the discretion of government organs in the type of rules they can adopt with respect to private actors.<sup>39</sup> He then uses an analytic model based on public choice theory to develop what he describes as "the political economy of international lawmaking" by examining the motivations and mechanisms of accountability for diverse institutional actors engaged in four types of international lawmaking: public legislating, private legislating, dispute resolution and administrative interpretation.<sup>40</sup> While recognizing that one reason for the high demand for international law is its usefulness in helping to solve collective action problems that may result in insufficient incentives for optimal levels of inter-state cooperation, Stephan challenges any assumption that inter-state cooperation is always or even often enhancing of the general welfare.<sup>41</sup> Rather, building on public choice theory, Stephan argues that before embracing international lawmaking as a global good in welfare terms one would need to account for the possibility that well-organized and cohesive minority interest groups may secure international laws promoting their particular interests to the detriment of less organized majorities and that rent-seeking by interest groups may sometimes swamp the global welfare gains of international rules.<sup>42</sup>

Stephan does not claim a firm empirical basis for his analysis or conclusions. Instead, he offers a number of anecdotal examples to support the suggestion that international lawmaking may be particularly susceptible to interest group capture and rent seeking while being less accountable to the types of democratic processes that might check these welfare-reducing tendencies. As a consequence, international rules may suffer from a deficit of legitimacy relative to national rules, even if some international rules do enhance general welfare.<sup>43</sup> From these tentative conclusions, Stephan offers three procedural methods for national governments (and governmental actors) to reduce the number and effects of international rules by (i) using what he terms "strategies for subversion" to make international rule-making more

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<sup>36</sup> *Id.* at 226.

<sup>37</sup> *See id.* at 227.

<sup>38</sup> Stephan, *Accountability and International Lawmaking*, *supra* note 6, at 681.

<sup>39</sup> *Id.* at 683.

<sup>40</sup> *See id.* at 685-95.

<sup>41</sup> *Id.* at 694.

<sup>42</sup> *Id.*

<sup>43</sup> *Id.* at 706-19.

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difficult, (ii) promoting efforts to improve the transparency of international rule-making processes, and (iii) adopting a posture of skepticism in respect to the legitimacy or validity of international rules by not deferring to international bodies in deciding what ambiguous (as opposed to clear) international rules mean or what impact international rules should have on domestic law.<sup>44</sup> While Stephan seems to support a reduction in international rules and rule-making that regulate private conduct or that circumscribe national jurisdiction to regulate private conduct, he does not advocate the abolition or rejection of international rules or rule-making *tout court*.<sup>45</sup> Rather, he suggests that subjecting international rules and rule-making to better democratic oversight by nation-states should result in more welfare-enhancing (if fewer) international rules in the global legal and economic order.<sup>46</sup>

While the subject matter and economic analytic methods of these three examples are quite different, they share some common themes that characterize them as a distinct tendency in international law and economics scholarship. The most important point is this: First Strand scholarship is more attentive to the arrangement of institutional forms and ordering mechanisms than to the substantive content of particular international legal regimes. Each project seeks to build an explanatory model for analysis of some aspect of the international legal and economic order based on economic theory. To the extent these scholars suggest policy implications from their models, they generally assert that a particular *institutional level* and/or *process* for international rule-making will result in increased efficiency or welfare without giving much attention to the specific content of the rules that would emerge from the prescribed institutional process.<sup>47</sup> Rather, these scholars predict that the prescribed institutional process will result in rules with certain general characteristics (e.g. flexible, derived from actual state or business practice, democratically accountable, facilitative of regulatory competition and party choice). These characteristics, in turn, are asserted to bring about more efficient or welfare-enhancing substantive results for the global legal and economic order. This general tendency seems applicable even when the scholarship is directed at the analysis of a particular substantive legal regime, such as securities law, commercial law or antitrust.<sup>48</sup>

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<sup>44</sup> *Id.* at 719-34.

<sup>45</sup> *Id.* at 734-35.

<sup>46</sup> *See id.* at 719-720.

<sup>47</sup> *See, e.g.,* Aceves, *Transaction Cost Economics and State Practice*, *supra* note 6 (focusing on the role of “state practice” in facilitating “endogenous governance structures” and the general positive attributes of such structures, including reduced transaction costs, party-negotiated solutions to problems and changed circumstances, informality, flexibility and adaptability, without specific attention to the substantive content or the welfare effects of the particular norms generated through “state practice”); Cooter, *New Law Merchant*, *supra* note 6 (focusing on the general superiority of decentralized lawmaking rather than “command-and-control” regulations and the potential efficiency gains to be had from deriving business norms from actual business practices, without attention to the specificity or welfare effects of the actual business norms that constitute the “new law merchant”); Stephan, *Accountability and International Lawmaking*, *supra* note 6 (focusing on a general difference in accountability between national and international lawmaking and inferring a higher likelihood of welfare-reducing rules at the international level without addressing the relative welfare effects of particular national and international rules, though he does use his framework to suggest how a more particularized welfare analysis might be done).

<sup>48</sup> *See, e.g.,* Choi & Guzman, *National Laws, International Money*, *supra* note 10 (focusing on the efficiency and welfare benefits of an international securities regimes based on the territorial application of national rules and issuer choice of law); Trachtman, *Unilateralism, Bilateralism, Regionalism*, *supra* note 10 (focusing on the structural rules and incentives for inter-state cooperation or deference in the area of securities regulation and the diversity of substantive policy objectives of various national regimes); Paul Stephan, *The Futility of Unification and Harmonization in International Commercial Law*, 39 VA. J. INT’L L. 743 (1999) [hereinafter Stephan,

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Second, consistent with mainstream international legal scholarship in general, First Strand scholarship places the nation-state at the center of the global legal and economic order, even as the scholarship aims to disaggregate the nation-state as a unified institutional actor or de-privilege the nation-state as the best or most appropriate source of normative authority or legal rules.<sup>49</sup> While many diverse sources of norms and rules are recognized and many possible modes of regulation and governance imagined, the state and state-interests remain the framework around which both international economic activity and international lawmaking are seen to coalesce.

Third, while First Strand scholars imagine the possibility of useful, efficient and/or welfare-enhancing lawmaking by organizations or institutions at the international level, their conclusions reflect a fairly consistent set of normative preferences with respect to the international legal and economic order—preferring decentralized, bottom-up normative frameworks over centralized, “command-and-control” legal regimes, “private” over “public” forms of international ordering, and “state” over “international” rule-making. To a certain extent, these preferences may reflect a bias within “new institutional economics” more broadly in favor of market-based ordering systems as opposed to institutional or planning-based systems.<sup>50</sup> At the same time, while First Strand scholars recognize that institutions are a necessary and inevitable part of any economic order, the more closely a particular institution can be analogized to an individual engaged in self-interested, arm’s-length commercial bargaining, the more comfortable these scholars seem to be with imagining efficient governance by that insti-

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*Futility*] (arguing for less scholarly attention to the substantive rights and duties of private parties in international commercial transactions and for more attention on how to encourage states to facilitate party choice and to reveal state intentions with respect to the resolution of international commercial disputes); Andrew T. Guzman, *Is International Antitrust Possible?*, 73 N.Y.U. L. REV. 1501 (1998) [hereinafter Guzman, *International Antitrust*] (focusing on the structural disincentives for states to arrive at efficient international antitrust regulation through national rules, the obstacles to achieving appropriate regulation through inter-state cooperation and some preconditions for increasing the likelihood of efficient cooperation at the international level).

<sup>49</sup> See, e.g., Aceves, *Transaction Cost Economics and State Practice*, *supra* note 6, at 999-1000 (“Two fundamental assumptions underlie most studies of international cooperation. First, states are the principal actors in international affairs. Second, the international system is characterized as a decentralized system that lacks a hierarchical enforcement mechanism. These two factors render cooperation difficult.”); Cooter, *New Law Merchant*, *supra* note 6 (arguing for decentralized lawmaking in the business area with norms generated by business actors being recognized and enforced by states); Stephan, *Accountability and International Lawmaking*, *supra* note 6 (comparing lawmaking by national governments and international lawmaking through state cooperation).

<sup>50</sup> Referring to critics of “the new institutional economics” from other strands of institutional economics, Rutherford states: “They argue that its theory is often too abstract and formal; that it sometimes adopts an extreme, reductionist, version of individualism; that the individual is seen as an overly rational and overly autonomous being, constrained, but not otherwise influenced by, his institutional and social setting; that orthodox welfare criteria are not appropriate for appraising institutional change, and that a complacent attitude prevails concerning the efficiency characteristics of markets and of institutions that emerge spontaneously. The NIE [New Institutional Economics] is thus portrayed as more formalist, (particularly in its neoclassical and game theoretic manifestations), individualist, reductionist, oriented toward rational choice and economizing models, and generally anti-interventionist. [T]hese labels apply to some more than others, but . . . they are labels that new institutionalists have willingly applied to themselves, in part in order to clearly distinguish themselves from [old institutional economics].” RUTHERFORD, *INSTITUTIONS IN ECONOMICS*, *supra* note 11, at 4 (citations omitted).

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tutional actor.<sup>51</sup> Conversely, the more distant or complex the analogy between institutional behavior and self-interested, private economic activity, the more these scholars seem to expect the institution will produce inefficient or welfare-reducing outcomes.<sup>52</sup>

From this vantage point, it becomes possible to understand both a preference for private ordering over public ordering at the state or the international level (due to the substantial likelihood of government or governance failure), on the one hand, and a preference for national over international regulatory institutions. As between the individual (or firm) and the nation-state, the individual/firm seems more likely to generate preferences and respond to market incentives in an economically rational manner than do nation-states.<sup>53</sup> And, as between nation-states and international institutions, nation-states seem relatively more capable of efficiently aggregating constituent preferences and more likely to respond like market ac-

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<sup>51</sup> See, e.g., GUZMAN, *HOW INTERNATIONAL LAW WORKS*, *supra* note 6, at 17 (“[T]he book adopts a set of rational choice assumptions. States are assumed to be rational, self-interested, and able to identify and pursue their interests. Those interests are a function of state preferences, which are assumed to be exogenous and fixed. States do not concern themselves with the welfare of other states but instead seek to maximize their own gains or payoffs. . . . These assumptions have at least two things to recommend them. First, they are standard assumptions among social scientists and many international law scholars, indicating that they are widely viewed as useful, though obviously imperfect, approximations of reality. Second, and more important, the assumptions are basically hostile to cooperation. . . . Because the model is built on assumptions that make cooperation difficult, we can have greater confidence when the results suggest ways that cooperation can come about.”) (citations omitted); Trachtman, *The Firm and International Economic Organization*, *supra* note 6, at 473-474 (“The main hypothesis of this paper suggests that states use and design international institutions to maximize the members’ net gains (NG), which equals the excess of transaction gains from engaging in intergovernmental transactions (TG), minus the sum of transaction losses from engaging in intergovernmental transactions (TL), and the transaction costs of intergovernmental transactions (including transaction costs of international agreement or of creating and running institutions, TC). Thus, stated mathematically, they maximize the present value of  $NG = TG - (TL+TC)$ . ‘Intergovernmental transaction’ is a kind of transaction in power, including prescriptive jurisdiction, between states.”) (citations omitted).

<sup>52</sup> See, e.g., Cooter, *New Law Merchant*, *supra* note 6, at 215-216 (suggesting that states will not behave in economically efficient ways when regulating, Cooter states: “Central planning is a way of making law, as well as commodities. To implement a central plan, officials must have the power to allocate resources. To possess this power, the orders issued by planning officials at the top must trump the rights of property and contract enjoyed by people and enterprises at the bottom. Thus, public law crowds out private law. . . . An advanced economy involves the production of too many commodities for anyone to manage or regulate. As the economy develops, the information and incentive constraints tighten upon public policy. These facts suggest that as economies become more complex, efficiency demands more decentralized lawmaking, not less.”); Paul B. Stephan, *The Political Economy of Choice of Law*, 90 *GEO. L.J.* 957, 960 (2001-2002) (discussing the appropriate framework for determining whether inter-state cooperation is likely to increase or decrease global welfare, Stephan states: “In any particular case, we must ask whether the benefits of a potentially desirable agreement, discounted by the likelihood of a particular institutional structure achieving it, is greater than the costs generated by a potentially undesirable agreement, discounted by the likelihood of that structure producing such an agreement. Rarely is the answer to this question obviously in the affirmative. There are two categories of reasons why international cooperation may produce undesirable outcomes. First, negotiators may give excessive weight to the preferences of private groups with unrepresentative preferences but especially low organizational costs. . . . Second, persons with an interest in the institutions established or promoted by international cooperation may seek the adoption of agreements that expand the competence, discretion and authority of those institutions at the expense of desirable regulatory outcomes.”).

<sup>53</sup> See, e.g., Cooter, *New Law Merchant*, *supra* note 6 (individual businesses and business groups will generate more efficient norms for business transactions than states); Choi & Guzman, *National Laws, International Money*, *supra* note 10 (allowing issuer choice among national securities law regimes is more likely to lead to efficient global capital markets than extraterritorial application of state securities regimes).

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tors to incentives and competitive pressures than complex international institutions.<sup>54</sup> It is perhaps for this reason that the nation-state remains so central in First Strand scholarship, serving as a kind of liminal institutional linchpin between the individual economic actor and the global economy, the local and the global, the economic and the political.

Finally, although First Strand scholars generally orient their economic analyses of diverse institutional arrangements toward maximizing some broad conceptions of efficiency and/or general welfare, their work seems to reflect a wide range of different ideas about precisely what is being economized or maximized, in whose interest and to what purpose, rather than a commonly shared notion of “efficiency” or “welfare.”<sup>55</sup> Once again, this aspect of First Strand scholarship may parallel a tendency in “new institutional economics” away from Pareto optimality as the main reference point for analysis to “a comparative institutional approach.”<sup>56</sup> What counts are institutional arrangements, in the sense of who has authority over what, rather than the substantive content of rules, the effects they produce or the outcomes which are generated by institutional decision making. Yet, as Professor Louis De Alessi suggests, “Regardless of approach, the description of one contractual or institutional arrangement as more efficient than another typically involves alternatives with different (implicit) distributions of welfare,” when what is needed is some “. . . set of value judgments to provide a frame of reference, why one system is better than another.”<sup>57</sup> By and large, the articulation of how a particular gain in “efficiency” (however defined) leads to increased “welfare” and for whom is not a major focus of attention in this work. Rather, in First Strand scholarship, “efficiency” and “welfare” are generally thought to follow from an appropriate arrangement of institutional authorities, whether public or private, exercising authority within appropriate jurisdictional

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<sup>54</sup> See, e.g., Stephan, *Accountability in International Lawmaking*, *supra* note 6 (nation-states are subject to more effective accountability mechanisms and are therefore more likely to produce welfare-enhancing regulation than international lawmakers); Choi & Guzman, *National Laws, International Money*, *supra* note 10 (a combination of the territorial application of national securities regulations, regulatory competition between states and issuer choice of regulatory regime is more likely to lead to efficient global capital markets than international cooperative agreements or a supra-national regulatory institution).

<sup>55</sup> See, e.g., Aceves, *Transaction Cost Economics and State Practice*, *supra* note 6 (seeking to facilitate through “state practice” the development of endogenous governance mechanisms that minimize transaction costs as impediments to optimal levels of inter-state cooperation); Cooter, *New Law Merchant*, *supra* note 6, at 226 (reaching a tentative conclusion that social norms that evolve in a free business community “will be efficient in the absence of nonconvexities or spillovers to other communities[,]” but that self-interest within business communities will result in the under-enforcement of norms requiring the supplementation of informal business community sanctions with formal legal ones enforced by states through courts); Stephan, *Accountability and International Lawmaking*, *supra* note 6, at 695 (asserting that weak mechanisms for accountability in international lawmaking increases the likelihood that “interest groups may induce countries to engage in international lawmaking that disserves the populations of the nations promoting the legislation.”); Trachtman, *The Firm and International Economic Organization*, *supra* note 6, at 473, 473-74, 475 (applying the theoretical perspective of “transaction cost economizing” to suggest “that states use and design international institutions to maximize the members’ net gains” and that the maximization of net gains requires a comparative institutional analysis involving “positive evaluation of various forms of organization and indicat[ing] normative choice of the form of organization that maximizes the positive sum of [relevant] factors.”).

<sup>56</sup> See RUTHERFORD, *INSTITUTIONS IN ECONOMICS*, *supra* note 11, at 159-60, 160 (“To the extent that criteria for judgment can be found in the comparative institutional approach, they tend to consist of productive or dynamic efficiency. Many references to improved ‘economic efficiency’ in this literature refer to reductions in production or transactions costs, increases in economic growth, or increased institutional flexibility. How these are related to welfare is, however, often left very vague.”)

<sup>57</sup> Louis De Alessi, *Form, Substance, and Welfare Comparisons in the Analysis of Institutions*, 146 J. INST’L & THEORETICAL ECON. 14-15 (1990).

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limits. The precise contours of “efficiency” and “welfare” as concepts are left vague or loosely defined.

**B. Tradition 2—Scope of jurisdictional authority and conflicts**

The second body of international law and economics scholarship primarily focuses on defining and managing the jurisdictional authority of national institutional actors in the global legal and economic order. Second Strand scholarship relies much more explicitly than the First Strand work on an analogy between domestic society and international society, and perhaps more importantly, between the behavior of individual self-interested economic actors in markets for material resources and the behavior of self-interested institutions (most often nation-states) in international “markets” for regulatory power. The notion is that much as individual economic actors will cooperate with other economic actors when they are both able to receive a material advantage, so nation-states are imagined to engage in cooperative “transactions” for jurisdictional authority in order to maximize their respective preferences. A major concern for Second Strand scholars, however, is that for a variety of reasons—from a parochial lack of attention to or overt discrimination against the interests of foreigners in the creation and administration of national rules, to collective action problems that may result in sub-optimal levels of inter-state cooperation, to public choice problems that may lead nation-states to promote the interests of organized minorities at the expense of total welfare in both national and international rule-making—states are unlikely to exercise their regulatory authority over economic actors in ways that will maximize global welfare.

From this conceptualization of the global legal and economic order, Second Strand scholars focus their analytic attention on how best to structure the international system of rules and incentives to improve the likelihood that the self-interested behavior of states in the “market” for regulatory power will increase (rather than decrease) global welfare. Another way of characterizing the goal for these scholars would be to create international mechanisms for promoting welfare-enhancing behavior (whether cooperation or regulatory competition) among nation-states and discouraging welfare-reducing behavior (whether competitive distortions through monopoly-like extra-territorial assertions of regulatory power or strategic, predatory or “race-to-the-bottom” regulatory competition). From this perspective, determining the right rules and incentives regarding the scope of jurisdictional authority and the management of jurisdictional conflicts becomes central to promoting the welfare-enhancing functioning of the global legal and economic order as a whole. For this reason, issues of jurisdiction become the central preoccupation of the international law and economic scholars working in the Second Strand.

A brief exploration of two important examples from Second Strand scholarship will suggest the main contours of this literature as a whole. These two examples share a common conception of the crucial question at issue—what institutional control mechanism(s) for the allocation of jurisdictional authority among nation-states will maximize global welfare in the international legal and economic order?—as well as some common economic assumptions and analytic methods. However, the scholarly approaches used in these pieces also differ in important ways that are suggestive of more widely shared differences among scholars working within the Second Strand, though these may be more differences of degree than kind.

Perhaps the most comprehensively elaborated example of the Second Strand of scholarship is Professor Joel Trachtman’s book, “The Economic Structure of International

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Law.”<sup>58</sup> In this book, Trachtman brings together a range of economic theories and analytic methods, including price theory, transaction cost economics, game theory, public choice theory, comparative institutional analysis and others, to articulate what he terms “a law and economics-based theoretical understanding of the international legal system.”<sup>59</sup> While the book deploys economic analysis on a broad range of international legal topics, at the core of Trachtman’s theory about the structure of the international legal and economic order is the issue of jurisdiction. As he puts the point: “This book is based on the idea that international law is produced in order to allow states to achieve their preferences with greater effectiveness through exchanges of authority: through transactions in jurisdiction.”<sup>60</sup>

A significant analytic challenge for Trachtman is the need to link the classical economic premise that the self-interested pursuit by individuals of their respective preferences in competitive markets will increase total welfare to his assertion that the interested pursuit by nation-states of their respective preferences for jurisdictional authority in the international legal and economic order will similarly increase global welfare. In other words, a major hurdle for this work is to move beyond what seems to be an appealing analogy between markets for material resources and markets for jurisdiction, to establish a sound theoretical basis for treating the market analogy as apposite to or predictive of nation-state behavior in the real world.

Trachtman responds to this challenge in several related steps. First, he asserts that nation-states are, in effect, institutional aggregations of the individual preferences of their constituents.<sup>61</sup> Second, he asserts that nation-states express their preferences (and indirectly, the preferences of their constituents) through the adoption of legal rules and the assertion of jurisdictional authority.<sup>62</sup> Third, building on rational international relations theory, he argues that nation-states, no less than firms, can reasonably be assumed to rationally evaluate and seek to maximize their preferences.<sup>63</sup> Fourth, he argues that nation-states (as agents for their citizens) will seek to maximize their respective baskets of preferences in international society (the functional equivalent of a market for power) by engaging in transactions in power when such transactions are mutually beneficial. Finally, he asserts that, absent market failures, such transactions in jurisdiction should produce “gains from trade” in the form of net increases in both national and global public welfare through the maximization of the achievement of the regulatory preferences of states collectively.<sup>64</sup>

In reaching this conclusion, Trachtman

. . . recognizes that efficiency in the allocation of government authority may be inconsistent with efficiency in the allocation of individual authority: efficiency in the market. So it is important from a political

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<sup>58</sup> TRACHTMAN, *THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW*, *supra* note 6.

<sup>59</sup> *Id.* at ix.

<sup>60</sup> *Id.* at 11.

<sup>61</sup> *See id.* at 9 (“The state acts as agent of its citizens.”). *See also id.* at 34 (“While states and other social units exist to aggregate preferences, and to express them, we can speak of state preferences only as, and to the extent that, the state reflects the individual preferences of its constituents.”).

<sup>62</sup> *See id.* at 37. *See also id.* at 34 (“[F]or analytical purposes, I assume national laws to be perfect expressions of constituent preferences.”).

<sup>63</sup> *See id.* at 18 (“Rationalist international relations theory assumes that states are rational evaluative maximizers of their own preferences.”).

<sup>64</sup> *See id.* at 9-10.

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standpoint to recognize that the law and economics of international law may depart from concerns for market efficiency.<sup>65</sup>

However, he seems to minimize the possible significance of this divergence by suggesting that “Cost-benefit analysis would assume that individuals would seek to design governmental institutions, and their powers of intervention, so as to maximize the combined efficiency of market allocations and governmental allocations.”<sup>66</sup>

In his article “Choice of Law: New Foundations,” Professor Andrew Guzman begins his analysis of the issue of jurisdiction similarly focused on how to turn the economic preferences of individuals into a global legal and economic order that maximizes global welfare.<sup>67</sup> However, Guzman’s analysis starts by focusing on economic transactions between individuals and their national and transnational effects rather than transactions among states in jurisdictional authority.<sup>68</sup> He states:

Focusing on the wellbeing of individuals, of course, is equivalent to focusing on the effect actions have on individuals. In other words, the only basis of jurisdiction to be considered is “effects.” When an activity has no effect on any person within a jurisdiction, that jurisdiction has no reason to regulate the activity.<sup>69</sup>

From here, Guzman conceives of two classes of parties affected by a private transaction—“direct parties” defined as “consensual, informed parties to the transaction” and “third parties who are affected by the transaction but not party to it.”<sup>70</sup> He also imagines two classes of “effects”—“direct effects” defined as the benefits to the direct parties to the transaction (which are always assumed to be positive otherwise the parties would not transact) and “indirect effects” defined as those effects of the transaction felt by third parties (which might be positive or negative because they are, in effect, externalities of the transaction between the direct parties and not the result of bargaining among third parties).<sup>71</sup>

From this conceptual framework, the effects of a transaction on total welfare, whether national or global, is the sum of the direct and indirect effects of the transaction, and whether the effects will be positive or negative will depend on the magnitude of the direct effects for the parties to the transaction and the indirect effects for third parties.<sup>72</sup> Hence, for Guzman, the goal for the international regime of jurisdictional rules is clear:

In framing choice-of-law rules, the objective should be to identify and implement rules that will permit transactions to take place when the total impact on [global] welfare is positive, and prevent transactions from taking place when the total impact on [global] welfare is negative.<sup>73</sup>

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<sup>65</sup> *Id.* at 3.

<sup>66</sup> *See id.* at 3-4.

<sup>67</sup> Guzman, *Choice of Law: New Foundations*, *supra* note 21.

<sup>68</sup> *See id.* at 894.

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

<sup>71</sup> *See id.* at 896.

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

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For analytic purposes, Guzman, like Trachtman, assumes that nation-states maximize the local welfare of their constituents. Unlike Trachtman, however, Guzman sees no independent value to the maximization of state preferences. Rather, he suggests, “Traditional choice-of-law concepts such as national interests or comity are relevant only to the extent they affect global welfare.”<sup>74</sup> Since Guzman defines total welfare as the achievement of positive net effects of individual transactions, he asserts that the only legitimate exercise of jurisdiction (or expression of interest) by the nation-state would be regulating transactions that reduce net global welfare while permitting transactions that increase net global welfare to take place unimpeded.<sup>75</sup> In this, Guzman does focus attention on the global welfare effects of rules, although in an indirect way, mediated by the impact of one or another pattern of jurisdictional authority.

The remainder of Trachtman’s and Guzman’s analyses are devoted to explaining why and when nation-states will most likely *not* maximize global welfare through the exercise of their parochial regulatory choices, and what factors should be taken into account in devising an international system of jurisdictional rules and incentives to lead nation-states to exercise their jurisdictional/regulatory authority over individuals and economic actors in ways more conducive to the enhancement of global welfare.<sup>76</sup> Trachtman and Guzman each offers his own complex analytic framework and set of factors to guide policy-makers in the formulation of an international system of jurisdictional rules for nation-states—Trachtman’s centering on the elaboration of a modified international framework rooted in Brainerd Currie’s “state interest analysis” aimed at maximizing the ability of states to realize their regulatory preferences as a group,<sup>77</sup> while Guzman’s is more reflective of a kind of “modified territorialism” aimed at maximizing the ability of individuals to consummate net global welfare-enhancing

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<sup>74</sup> *Id.* at 894.

<sup>75</sup> *See id.*

<sup>76</sup> *See id.* at 886 (“The fact that global welfare represents the objective of policy analysis, however, does not imply that individual countries will or should pursue that same objective. Indeed, the challenge for choice of law is the fact that nations—the actors in the international arena—typically do not share this or any other common objective. Rather, each country determines its policies based on its own objectives. In contrast to the domestic context, there is no institution authorized to create a comprehensive set of binding rules at the international level. If the globally efficient result is to be achieved, therefore, it is necessary to find a way to align national interests with those of the global community. This alignment of incentives is at the heart of the theory developed herein.”). *See also* TRACHTMAN, *THE INTERNATIONAL STRUCTURE OF CHOICE OF LAW*, *supra* note 6, at 28-29 (“A primary goal of property rights is to match effects of ownership resulting in the internalization of externalities. A primary function of jurisdictional rules is similarly that of shaping governmental incentives to achieve greater internalization of externalities among political units: as [Harold] Demsetz states, ‘no harmful or beneficial effect is external to the world.’ On the other hand, transaction cost and strategic considerations may well cause us to decline to internalize in particular cases. . . . Thus, the question is what institutional structure maximizes the match between preferences and control.”) (citation omitted).

<sup>77</sup> *See* TRACHTMAN, *THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW*, *supra* note 6, at 34-71. Brainerd Currie is among the most influential theorists of conflict of laws of the last 60 years. He is perhaps best known for his analytic methodology for resolving conflicts of law by reference to an assessment of the interests of contending states in regulating the transaction or event at issue. *See* LEA BRILMAYER & JACK GOLDSMITH, *CONFLICT OF LAWS: CASES AND MATERIALS*, 215-219 (5th ed. 2002). For an articulation of Currie’s analytic framework, *see* Brainerd Currie, *Notes on Methods and Objectives in the Conflict of Laws*, 1959 *DUKE L.J.* 171 (1959). For a discussion of the influence of Currie’s work on Trachtman’s analysis, *see* TRACHTMAN, *THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW*, *supra* note 6, at 34-38.

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transactions.<sup>78</sup> However, for purposes of a general overview of Second Strand scholarship, the particulars of each author's proposal are less important than understanding the ways in which the convergence and divergence of views among these authors are reflective of the broader literature as a whole.

As to areas of convergence, Trachtman and Guzman, like international law and economics scholars in both Strands, focus on the nation-state as the institutional center of the global legal and economic order.<sup>79</sup> Second Strand scholars frame the issue of jurisdictional authority in the global order in terms of the appropriateness of the extra-territorial application of national laws to private actors or activities outside a sovereign's geographic territory.<sup>80</sup>

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<sup>78</sup> See Guzman, *Choice of Law*, *supra* note 21, at 904-940. In some respects, Guzman's conceptual framework seems to share a sympathetic connection with the work of Aaron Twerski who argued that in turning from territory to state interests as the focus of analysis in conflict of laws problems, conflicts theory had lost touch with the significance of physical territory in shaping human expectations about what law will govern their affairs and that fulfilling people's expectations should be an important value in any just system of choice of law. See Aaron Twerski, *Enlightened Territorialism and Professor Cavers – The Pennsylvania Method*, 9 DUQ. L. REV. 373 (1971). At the same time, while Guzman advocates a "presumption against extraterritoriality," he argues that sometimes extraterritoriality is required to achieve an efficient level of regulation and hence, no categorical position against extraterritoriality can be taken. See Guzman, *Choice of Law*, *supra* note 21, at 887, 909-913. He adds to this mix, a preference for "private ordering" through the enforcement of party choice of applicable law, but subject to regulatory oversight when the net effect of the parties' transaction would be a reduction in global welfare. See *id.* at 913-915, 896. Finally, he suggests that "it is impossible to achieve an efficient resolution of all choice-of-law questions without substantive international cooperation." *Id.* at 886. It is Guzman's advocacy for an international system for choice of law based on a combination of preferences for national rules territorially applied and the de-territorialization of private transactions based on the enforcement of party contractual choice of law that seems to reflect his "modified territorial" perspective.

<sup>79</sup> See, e.g. TRACHTMAN, *THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW*, *supra* note 6, at 11 ("This book is based on the idea that international law is produced in order to allow states to achieve their preferences with greater effectiveness through exchanges of authority: through transactions of jurisdiction."); Guzman, *Choice of Law*, *supra* note 21, at 886 ("Indeed, the challenge for choice of law is the fact that nations—the actors in the international arena—typically do not share this or any other objective."); Choi & Guzman, *Portable Reciprocity*, *supra* note 21 (advocating an international system of securities regulation made up of diverse and competitive national rule schemes reciprocally and trans-nationally enforced in every country based on the security issuer's choice of national law); Stephan, *Institutions and Elites*, *supra* note 21 (criticizing international institutional efforts to unify substantive intellectual property rules globally in favor of an effort to harmonize the rules for the allocation of jurisdiction among national rule-makers in a way that fosters national regulatory competition and innovation).

<sup>80</sup> See, e.g., Guzman, *Choice of Law*, *supra* note 21, at 894 ("When an activity has no effect on any person within a jurisdiction, that jurisdiction has no reason to regulate the activity. Similarly, if an activity has an effect on the residents of a jurisdiction, that jurisdiction has, at the very least, an interest in regulating the activity. Whether it should do so or not is the subject of the balance of this Article."); TRACHTMAN, *THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW*, *supra* note 6, at 27 ("The durable technical legal questions of choice of law and prescriptive jurisdiction resolve into a core normative public policy issue: how should authority be allocated within an interstate or international system? These questions grow increasingly pressing, as greater interstate and international commerce as well as technological advances increase the frequency and scope of conflict over the application of law. Recently, we have seen important international debates regarding the application of national law to the Internet, international mergers, securities regulation, export controls, environmental protection, and taxation. These questions are answered by legislatures, by executive branches, by courts, by treaty writers, and sometimes by international organizations, operating at different vertical levels. This [book] seeks to develop a framework by which to analyze the question of the allocation of authority among horizontally related units.") (citation omitted); Choi & Guzman, *Dangerous Extraterritoriality*, *supra* at note 21, at 208 ("This article calls into question the desirability of applying American securities laws extraterritorially.").

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While these scholars recognize that the exercise of extra-territorial jurisdiction is both permissible under current international law and sometimes necessary for the achievement of national as well as global policy and welfare objectives, it is generally disfavored.<sup>81</sup>

The extra-territorial application of national rules is potentially problematic for Second Strand scholars for several reasons. First, it raises the likelihood of inter-state conflicts of regulatory authority which may result in states over-enforcing their national rules and/or under-engaging in inter-state cooperation to the detriment of global welfare. Second, it may discourage potentially global welfare-enhancing economic activity either (i) through over-regulation to the extent the combined effects of the respective national regimes may result in higher regulation than any individual national regime would require on its own, or (ii) through increased transaction costs to the extent economic actors must attempt to comply with multiple, confusing or conflicting regulatory regimes. Third, as a result of the foregoing problems, the extra-territorial application of national rules may also increase the likelihood of welfare-reducing adverse economic effects for third-party states and/or economic actors as an indirect result of the effect of the combined regulation on the behavior of others. Nevertheless, as the extra-territorial application of national rules may appear to the states promulgating the rules to benefit national over foreign actors, states are likely to apply their national laws outside their territories all too frequently, or with insufficient regard for the effects of such applications on global welfare as a whole. Thus, these scholars assert that some international regime or mechanism is required to induce states to use their jurisdictional authority consistent with the maximization of global welfare.<sup>82</sup>

To the extent the views of Second Strand scholars diverge, they tend to do so primarily along three related continua. The first is the issue of the relative weight that should be accorded to party choice versus national regulatory preference in the international system of jurisdictional rules. While scholars working in this tradition seem to agree that party choice should determine the applicable regulatory regime under some circumstances, some scholars

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<sup>81</sup> See, e.g., Guzman, *Choice of Law*, *supra* note 6, at 907 (considering the effects of extraterritorial application of national laws on a transaction that should be permitted to occur because it would result in a net increase in global welfare, Guzman states: "If every country applies its laws extraterritorially, each country will have the ability to prevent the [efficient] transaction. A country will prevent the transaction if and only if the local sum of direct and indirect effects is negative. This means that for the transaction to be permitted, being globally efficient is not enough, it must improve the welfare of every country. Transactions that increase world welfare but that harm even a single country will be prevented. This implies that there will be too much regulation—globally efficient activities will be prevented."); TRACHTMAN, *THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW*, *supra* note 6, at 35 ("Even if a [national] law is mandatory, the degree of state interest in applying the law to particular circumstances may be attenuated to the extent that its violation has adverse effects on other jurisdictions, and lacks adverse effects in the regulating jurisdiction. . . . The question left open here is the core question of choice of law: assuming there is a state interest sufficient for a particular legal rule to be mandatory, when is that interest sufficiently attenuated by virtue of cross-border connections to justify its nonapplication?") (citations omitted); Choi & Guzman, *Dangerous Extraterritoriality*, *supra* note 21, at 208 (speaking with respect to the extraterritorial application of U.S. securities laws, the authors state: "Certainly the goals of protecting investors and ensuring capital market integrity are laudable. However, the use of extraterritoriality to accomplish these goals is both unnecessary and ineffective. Extraterritoriality results in frequent conflicts between the United States and other nations. Furthermore, the application of extraterritoriality limits the ability of investors and issuers to select the securities regime of their own choosing. As a result, countries applying extraterritorial rules are insulated from competitive pressures to tailor rules toward the joint interests of investors and issuers. Rather, countries so insulated may craft regulatory regimes that satisfy the interests of either government bureaucrats or special interest groups.") (citation omitted).

<sup>82</sup> See *supra* note 76.

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advocate a system wherein party choice is the primary determinate of applicable law.<sup>83</sup> In this regard, neither Trachtman nor Guzman would fall into the strict “party choice” camp. Both recognize a significant and legitimate role for the state in determining when to exercise its regulatory jurisdiction as well as when to cooperate with other states in creating an international system of jurisdictional rules. Nevertheless, Guzman seems closer to the “private ordering” end of this spectrum. His notion that the only legitimate basis for the exercise of national regulatory jurisdiction is the prohibition of private transactions with net welfare-reducing effects on national constituents implies that states should permit the remainder of transactions to be consummated in accordance with party choice, subject only to the legitimate regulatory authority of other states.<sup>84</sup> By contrast, Trachtman seems closer to the “state preferences” end of the continuum. Specifically, he asserts that state regulatory preferences are likely to be broader than, and distinct from, private preferences because they reflect an aggregation of individual interests. For this reason, he argues that state regulatory preferences will be more expressive of total welfare than private preferences and therefore a better foundation from which to build an international system of jurisdictional rules.<sup>85</sup>

The views of Second Strand scholars also diverge in how much analytic concern they give to whether state regulatory preferences will reflect welfare-enhancing aggregations of constituent preferences and whether inter-state cooperation will lead to global welfare-enhancing jurisdictional rules. For Second Strand public choice scholars, these issues are the main focus of their analytic attention and concern.<sup>86</sup> By contrast, Trachtman and Guzman both assume that states efficiently aggregate the interests of their national constituents, although Trachtman seems more comfortable with this assumption than Guzman who sees it

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<sup>83</sup> See, e.g., Erin A. O’Hara & Larry E. Ribstein, *From Politics to Efficiency in Choice of Law*, 67 U. CHI. L. REV. 1151 (2000) (“This Article proposes a comprehensive system of choice of law that is designed to enhance social wealth by focusing on individual rather than governmental interests. To the extent practicable, parties should be able to choose their governing law, subject to possible procedural protections to ensure that the choice is real. In the absence of an explicit agreement, courts should apply rules that facilitate party choice or that select the law the parties likely would have contracted for—that is, the law of the state with the comparative regulatory advantage. . . . State regulatory concerns are accounted for through explicit state legislation on choice of law rather than ad hoc judicial determination of the states’ interests.”); MICHAEL J. WHINCOP & MARY KEYES, *POLICY AND PRAGMATISM IN CONFLICT OF LAWS*, 26 Melbourne U. L.Rev. 236 (2001) (arguing that a regime of conflict of laws based on party choice can reduce transaction costs, increase private ordering and limit regulatory monopolies and cross-border spillovers).

<sup>84</sup> See Guzman, *Choice of Law*, *supra* note 21, at 894.

<sup>85</sup> See TRACHTMAN, *THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW*, *supra* note 6, at 37.

<sup>86</sup> For a clear and concise articulation of both concerns, see, e.g., Stephan, *Political Economy*, *supra* note 52, at 959-67 (2001-2002). See also Stephan, *Futility*, *supra* note 48, at 744 (challenging the usefulness of unification or harmonization of commercial law at the international level due to process concerns regarding the formulation of international agreements for national implementation that “results too often either in rules written for the benefit of particular industries or other interest groups, or in the suppression of conflict that in turn increases legal risk.”); Erin Ann O’Hara, *Opting Out of Regulation: A Public Choice Analysis of Contractual Choice of Law*, 53 Vand. L. Rev. 1551, 1555-58 (2000) [hereinafter O’Hara, *Opting Out of Regulation*] (arguing that a jurisdictional regime based on the enforcement of what appear to be efficient contractual choice of law provisions may permit parties to opt out of inefficient substantive regulation and produce the perverse effect of increasing the existence inefficient and welfare-reducing substantive rules by reducing the incentives of interested parties to pressure states to reject or revise inefficient substantive rules); O’Hara, *Economics, Public Choice*, *supra* note 18, at 943 (“If Pareto-superior contract provisions can lead to Pareto-inferior substantive laws, the efficiency of choice-of-law rules enforcing choice-of-law clauses is called into question.”).

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more as an analytic necessity than a reflection of reality.<sup>87</sup> With respect to the issue of inter-state cooperation, Guzman worries a great deal about addressing the concerns of his public choice colleagues by recognizing the need to create incentives to induce welfare-enhancing inter-state bargaining and suggesting that inter-state cooperation might be more desirable from a global welfare perspective in some substantive areas than in others.<sup>88</sup> Ultimately, however, Guzman argues that inter-state cooperation will more often enhance global welfare than reduce it.<sup>89</sup> By contrast, while Trachtman briefly engages the public choice challenge to the welfare benefits of inter-state cooperation, his analysis in this regard is directed much less to public choice concerns than game theoretic ones.<sup>90</sup>

Second Strand scholars also have a range of views as to the benefits versus the risks of regulatory competition. The regulatory competition issue arises in Second Strand scholarship because the level and scope of regulatory competition will be affected, if not determined in large part, by the applicable system for the allocation of regulatory jurisdictional authority.<sup>91</sup> Whether Second Strand scholars promote or discourage regulatory competition in particular substantive regulatory fields, such as securities law, bankruptcy law or antitrust law, tends to depend on their assessment of the likelihood and extent of adverse third-party effects or externalities and/or the likelihood of predatory or “race to the bottom” state behaviors resulting from regulatory competition in that field.<sup>92</sup> One important goal of the economic

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<sup>87</sup> See TRACHTMAN, *THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW*, *supra* note 6, at 19-20 (“The approach taken in this book ignores the possibility that government officials make decisions that maximize their own welfare, without focusing directly on the welfare of citizens. Where used, this is merely a simplifying assumption, and there are certainly circumstances where it would miss important detail.”); Guzman, *Choice of Law*, *supra* note 21, at 895 (“To proceed, it is necessary to make at least an initial assumption about how government policy is formed. In the interest of expositional ease, the paper begins with the most traditional and common assumption—that the government of each country maximizes the domestic welfare of its residents. This assumption is not made because it is realistic, but rather because it helps the presentation and because there is no consensus on what other assumption would be appropriate in this context.”).

<sup>88</sup> See Guzman, *Choice of Law*, at 900-4, 932-38.

<sup>89</sup> See Guzman, *Public Choice and International Regulatory Competition*, *supra* note 19, at 972 (“[L]et me say explicitly that I believe that international cooperation is likely to be welfare-improving in the majority of contexts, though the exact nature of that cooperation must vary from one subject to another.”).

<sup>90</sup> See TRACHTMAN, *THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW*, *supra* note 6, at 19-20, 72-149.

<sup>91</sup> See, e.g., TRACHTMAN, *THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW*, *supra* note 6, at 57 (“The question of whether regulatory competition should be increased cannot be answered separately from the broader inquiry into the optimal allocation of regulatory jurisdiction”); Guzman, *Choice of Law*, *supra* note 21, at 887-888 (“This Article seeks to bring together two previously independent lines of research. Choice-of-law scholars have long debated the question of how to allocate jurisdiction when activities cross borders. . . . The regulatory competition literature has produced useful analyses of several topics, most notably corporate law, securities regulation, antitrust, and bankruptcy. . . . Despite its success in those areas of law on which it has focused, however, the regulatory competition literature has failed to provide a general treatment of the jurisdictional question.”) (citations omitted).

<sup>92</sup> See, e.g., TRACHTMAN, *THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW*, *supra* note 6, at 59-68 (discussing the significance of third-party externalities and “race to the bottom” regulatory competition both generally and with specific reference to antitrust and securities regulation); Guzman, *Choice of Law*, *supra* note 21, at 932-938 (discussing the relative benefits of inter-state cooperation versus competition with respect to choice of law rules and substantive rules, with particular reference to bankruptcy, securities law and antitrust as substantive examples); Choi & Guzman, *Dangerous Extraterritoriality*, *supra* note 21, at 208 (arguing that regulatory competition and clear jurisdictional rules that strictly limit the extraterritorial application of securities laws will better protect investors and issuers as well as global capital markets than the extraterritorial application of national laws); Choi & Guzman, *Portable Reciprocity*, *supra* note 21, at 906 (while recognizing that regulatory competition “may theoretically result in either a race-to-the-bottom or a race-to-the-top,” neither

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analytic methodologies developed in Second Strand scholarship is to help guide choices as to when regulatory competition, some form of inter-state cooperation, or some international institutional arrangement is most likely to increase global efficiency and/or welfare. In this way, the work of First and Second Strand scholars overlap, combining analyses of institutional levels and regulatory regimes with analyses of the most global welfare-enhancing mechanisms for the international allocation of jurisdictional authority. In this respect, both Trachtman and Guzman seem to be trying to bring the concerns of First and Second Strand scholarship into a single frame of analysis.

In addition, it is important to note that Second Strand scholars, like their First Strand colleagues, do not share a common or consistent view of what constitutes “efficiency” or “welfare” in their work.<sup>93</sup> For example, Trachtman suggests that “efficiency in the allocation of governmental authority may be inconsistent with efficiency in the allocation of individual authority: efficiency in the market.”<sup>94</sup> By contrast, Guzman seeks to derive the scope of governmental authority by measuring the net welfare effects of market transactions, primarily by relying on the welfare enhancing effects of an optimal allocation of jurisdictional authority.<sup>95</sup> Further, Trachtman equates the maximization of global welfare with the “maximization of the achievement of regulatory concerns by states,”<sup>96</sup> while Guzman treats the maximization of global welfare as the maximization of the sum of the positive net effects of individual transactions worldwide.<sup>97</sup> Thus, like their counterparts in new institutional economics and their First Strand colleagues, Second Strand international law and economics scholars tend to be catholic in their definition and use of efficiency and welfare concepts depending on the context and purposes of their analysis.<sup>98</sup>

The international law and economics literature that has emerged over the last thirty years has made important contributions to our understanding of the ways in which regulatory authority is and ought to be organized within a global economy. There is no question that an optimal arrangement of sovereign powers – and limits on those powers – will be a significant component in any global regulatory scheme oriented to maximizing global welfare however defined. Nevertheless, this emerging field has by and large approached the welfare effect of rules in a global economy *indirectly*, by assessing the welfare impact of various arrangements

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is likely in the context of international securities transactions due to the existence of different types of issuers and investors looking for different combinations of regulatory protection and risk premiums); Guzman, *International Antitrust*, *supra* note 48, at 1503-1505 (arguing that while national antitrust regulation is likely to be suboptimal from the perspective of global welfare, the incentives facing individual countries with respect to substantive regulation at the international level make cooperation extremely difficult to achieve and suggesting ways the international community might maximize the likelihood of agreeing on welfare-enhancing international antitrust regulation) ; David E. Van Zandt, *The Regulatory and Institutional Conditions for an International Securities Market*, 32 VA. J. INT'L L. 47, 72-79 (1997) (differing national interests and the ability of some states to externalize the costs of weak regulation on others countries make inter-state cooperation over a regulatory regime for international securities transactions desirable if difficult to achieve).

<sup>93</sup> See, e.g., O'Hara & Ribstein, *From Politics to Efficiency*, *supra* note 83, at 1152 (equating efficiency in choice of law with maximal enforcement of individual choice rather than state interests and social welfare with wealth maximization); Guzman, *International Antitrust*, *supra* note 48, at 1511 (defining welfare in the antitrust context as the maximization of consumer and producer surplus). See also examples that follow *infra*.

<sup>94</sup> TRACHTMAN, *THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW*, *supra* note 6, at 3.

<sup>95</sup> See Guzman, *Choice of Law*, *supra* note 21, at 894.

<sup>96</sup> TRACHTMAN, *THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW*, *supra* note 6, at 10.

<sup>97</sup> See Guzman, *Choice of Law*, *supra* note 21, at 896.

<sup>98</sup> See *supra* notes 55, 56 and 57.

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of rule making and rule implementing authority. In the remainder of this article, I explore the kinds of questions that would need to be addressed in order to assess the global welfare impact of legal rules *directly* by exploring the behavior and bargaining of economic actors affected by those rules, in the spirit of R.H. Coase's "The Problem of Social Cost."<sup>99</sup>

### 3. DOMESTIC RULES AND GLOBAL WELFARE: EXPANDING THE SCOPE OF INQUIRY

International law and economic scholars have advanced our understanding of the global welfare implications of international legal arrangements. They have addressed the most significant questions of "institutional design" at the international level with a focus on the potential for maximizing efficiency and global welfare (however defined) in structuring the global legal and economic order. In pursuing this project, First Strand scholars have focused on assessing the most appropriate institutional level or form for rule-making and the optimal regulatory structure for one or another aspect of international economic activity. Second Strand scholars have focused on the challenge of devising the most appropriate international system for allocating jurisdictional authority among nation-states. The concerns of these two scholarly strands also overlap. An optimal allocation of jurisdictional authority may well implicate the appropriate level at which regulation is promulgated. Similarly, where states are unlikely to engage in welfare-optimizing regulatory behavior on their own and some international regulatory capacity is called for, this will have implications for the optimal allocation of jurisdictional authority among sovereigns.

Both strands of international law and economics scholarship focus on the appropriate role of the territorially sovereign nation-state in the structure of the international regulatory order. The goal of the inquiry is to ensure that sovereign states play the regulatory roles most appropriate for ensuring the maximization of overall global welfare. From another perspective, we might say that the literature, like much international legal scholarship, proceeds as if total global welfare were primarily a matter of arranging relations among sovereigns and between sovereigns and international collaborative institutions in the proper manner. These issues are important ones for global economic welfare and analytic attention to them can yield important insights into the structure and workings of the global legal and economic order.

Moreover, there is no question that this literature can sometimes also be helpful for thinking about the welfare implications of the substantive content of regulatory regimes. Although this is generally only an indirect or collateral result of studies aimed at ascertaining the most efficient allocation of jurisdictions and sovereign authorities, the literature has generated a number of sector specific hypotheses about the types of regulation which may be welfare enhancing at the global level. For example, important work has been done on analyzing whether regulatory oversight over international securities or financial transactions should be located at the national level and disciplined by regulatory competition, or regulated through

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<sup>99</sup> R.H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960), reprinted in R.H. COASE, *THE FIRM, THE MARKET, AND THE LAW*, 95 (paperback ed. 1990) [hereinafter Coase, *The Problem of Social Cost*].

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some form of inter-state cooperative arrangement.<sup>100</sup> Similar sorts of investigations have been made in with regard to bankruptcy,<sup>101</sup> commercial law<sup>102</sup> and antitrust.<sup>103</sup>

It is striking, however, that on the whole, international law and economics scholars have not been as aggressive in developing methods for evaluating the global welfare effects (or distributional consequences) of particular substantive rules or regulatory regimes as many of their law and economics colleagues have been with respect to the welfare effects of domestic legal rules or regimes. Although some important questions about the welfare effects of rules in a transnational economy can be usefully explored by reference to jurisdictional allocation and sovereign structure, others cannot. Difficult to capture through the paradigms informing international law and economics scholarship to date is the transnational economic impact of national rules that are adopted, enforced and applied domestically for domestic policy purposes as lawful exercises of domestic prescriptive jurisdiction under current international law.

I have argued elsewhere that numerous rules applied domestically, such as Brazilian rules regarding forest preservation, Bahamian rules regarding bank secrecy, California rules regarding auto emissions and Chinese rules regarding wage rates and worker safety, can and do produce significant transnational economic effects in the global economy and merit more economic policy attention and analysis.<sup>104</sup> When attention is focused on the transnational economic effects of these rules (rather than, as is traditional in public international law, on whether the adoption or formal application of the rules reflects a legitimate exercise of sovereign jurisdictional authority), a very different map of the global legal and economic order emerges.<sup>105</sup> In fact, one characteristic of this new map is that the scope of national rules measured in terms of economic effects in the global economy often does not coincide with either the territorial or political borders of the states adopting them or with formal attempts by such states to apply their rules beyond their territorial borders.<sup>106</sup>

The arrangement of sovereign powers may, of course, have an effect on the extent to that domestic rules of this type do, in the end, affect transnational economic flows. Moreover, international rules or harmonized national regulation certainly can influence the transnational economic impact of domestic rules. At the same time, an inherent aspect of an integrated and inter-dependent global economy is the fact that economic activities and resources flow across jurisdictional boundaries in ways that routinely cause local legal rules and cultural practices to influence economic conditions in far away places. Moreover, these effects are often not under the control of the sovereign making or enforcing the rule. Unlike the extra-territorial applica-

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<sup>100</sup> See, e.g., Choi & Guzman, *National Laws, International Money*, *supra* note 10; Choi & Guzman, *Dangerous Extraterritoriality*, *supra* note 21; Choi & Guzman, *Portable Reciprocity*, *supra* note 21; Merit B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom?*, 95 MICH. L. REV. 2498 (1997); Trachtman, *Unilateralism, Bilateralism, Regionalism*, *supra* note 10.

<sup>101</sup> See, e.g., Lucian A. Bebchuk & Andrew T. Guzman, *An Economic Analysis of Transnational Bankruptcies*, 42 J.L. & ECON. 775 (1999); Andrew T. Guzman, *International Bankruptcy: In Defense of Universalism*, 98 MICH. L. REV. 2177 (2000); Lynn M. LoPucki, *The Case for Cooperative Territoriality in International Bankruptcy*, 98 MICH. L. REV. 2216 (2000); Robert K. Rasmussen, *Resolving Transnational Insolvencies Through Private Ordering*, 98 MICH. L. REV. 2252 (2000); Jay Lawrence Westbrook, *Choice of Avoidance Law in Global Insolvencies*, 17 BROOK. J. INT'L L. 499 (1991).

<sup>102</sup> See, e.g., Cooter, *New Law Merchant*, *supra* note 6; Stephan, *Futility*, *supra* note 48.

<sup>103</sup> See, e.g., Guzman, *International Antitrust*, *supra* note 48; Andrew T. Guzman, *Antitrust and International Regulatory Federalism*, 76 N.Y.U. L. REV. 1142 (2001).

<sup>104</sup> Danielsen, *Local Rules*, *supra* note 14, at 49-68.

<sup>105</sup> See *id.* at 102-115.

<sup>106</sup> See *id.* at 107-111.

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tion of domestic rules, which at least both the state asserting extra-territorial jurisdiction and the state choosing to apply foreign law domestically have the ability to limit or control, the economic effects of the domestic application of domestic rules by states cannot be fully limited or internalized in an interdependent global economy. In fact, precisely because the domestic application of national rules in a global economy will inevitably produce transnational economic effects for both economic actors and for other states, what is needed is a method or approach to economic policy analysis that would assess and compare the transnational economic effects of such national rules to alternative institutional arrangements from the perspective of their relative impact on global welfare as a whole. To get a picture of how rules “travel” in the global economy, we need to understand not only where and when rules are made and formally applied but also what impact the rules have on the behavior of economic actors and the scope of economic effects they produce. From this perspective, it does not matter whether the rule is made by a private, local, national or international institution any more than it matters what the rule-maker intended the scope of the rule to be. What does matter are the effects the rule actually produces on the choices and activities of economic actors, and the way in which those effects play out dynamically in the global economy.

Among other things, analyzing the transnational effects of domestic rules would advance our understanding of the global economy by drawing our attention to power asymmetries among sovereign rule-makers in the global order. Such asymmetric power relations are less well analyzed by economic approaches that measure regulatory effects based on jurisdictional authority primarily because our international models of jurisdiction assume formal equality among sovereigns.<sup>107</sup> This background assumption, imported into international law and economics from the broader field of international law, makes it difficult to assess the quite different welfare consequences of similar rules adopted in different locations. To adequately assess these differences would require an analytic approach able to take into account the many factors that may contribute to the scope of effects resulting from a particular rule or rule-maker. We need only think of examples such as Bahamian bank secrecy rules or Delaware corporate law to observe that the magnitude or significance of effects are not wholly contingent on traditional indicia of sovereign power, such as market size, economic clout or military power. Under conditions of global economic interdependence, the domestic application of wage regulation by a large, powerful jurisdiction like China can shape the costs, conditions and competitiveness of production across the globe,<sup>108</sup> and the domestic application of bank secrecy rules by small and otherwise weak jurisdictions like Liechtenstein, Luxembourg or Switzerland can affect the ability of even the largest and most powerful nations to enforce effectively their tax and banking regulations.<sup>109</sup> In such circumstances, it seems very unlikely that any nation-state, no matter how powerful in traditional terms, could use national rules

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<sup>107</sup> See RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW §§ 402 & 403 (1987). See, also, Convention on the Rights and Duties of States, Art. 4, December 26, 1933, 49 Stat. 3097, T.S. 881, 165 L.N.T.S. 19, 3 Bevans 145 (“Article 4. States are juridically equal, enjoy the same rights, and have equal capacity in their exercise. The rights of each one do not depend on the power which it possesses to assure its exercise, but upon the simple fact of its existence as a person under international law.”).

<sup>108</sup> See, e.g., RAPHAEL KAPLINSKY, GLOBALIZATION, POVERTY AND INEQUALITY 132-135, 217-218 (2005) (noting the significance of China’s wage rates in creating its competitive advantage over the rest of the world in textiles manufacturing and shaping patterns of competitive behavior in respect to wages and production methods around the world).

<sup>109</sup> See, e.g., Robert T. Kudrle & Lorraine Eden, *The Campaign Against Tax Havens: Will it Last? Will it Work?*, 9 STAN. J.L. BUS. & FIN. 37, 40-43, 50-54 (discussing how countries through the passage of domestic

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either to defend successfully against all of the adverse economic effects of the domestic rules of other states or to control effectively all of the economic conditions within its own territory, let alone globally.<sup>110</sup> At the same time, it seems possible that alternatives to national sovereignty, such as inter-state cooperation, would not infrequently lead to international rules and institutions that merely replicate the adverse effects of national power asymmetries at the transnational level, or to harmonized or universal international rules that were no more likely than the existing legal and economic order to increase global welfare.<sup>111</sup>

Once we begin to think about measuring the overall welfare consequences of rules based on the various ways in which effect they economic actors, we are on the methodological terrain perhaps most famously explored by Ronald Coase in “The Problem of Social Cost.”<sup>112</sup> Coase began by examining the economic effects of rules—not their pedigree or origin or formal legal category—but the way in which they affected the costs and opportunities for economic actors. Moreover, Coase focused on the need to consider when economic actors would adjust their behavior through bargaining with one another in the shadow of a rule when attempting to measure the effects of a rule on the economy as a whole. In the years since Coase published “The Problem of Social Cost,” law and economics scholars have developed a rich literature for analyzing the efficiency and welfare consequences of rules in a national economy.<sup>113</sup> In law and economics scholarship of this type, the center of analytic focus has

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bank secrecy laws are able to become global tax havens and collect huge amounts of foreign bank deposits and the impact of such laws on the global financial system).

<sup>110</sup> JOHN H. JACKSON, ET AL., *LEGAL PROBLEMS OF INTERNATIONAL ECONOMIC RELATIONS: CASES, MATERIALS AND TEXT 1* (5th ed., 2008) (“‘Interdependence’ may be overused, but it accurately describes our world today. Economic forces flow with great rapidity from one country to the next. Despite all the talk of sovereignty and independence, these concepts can mislead when applied to today’s world economy. How ‘sovereign’ is a country with an economy so dependent on trade with other countries that its government cannot readily affect the real domestic interest rate, implement its preferred tax policy, or establish an effective program of incentives for business or talented individuals? Many governments face such constraints today including, increasingly and inevitably, the United States.”).

<sup>111</sup> See, e.g., ERIC A. POSNER, *THE PERILS OF GLOBAL LEGALISM* 94-99 (2009) (arguing that the proliferation of international legal norms reflects efforts by the most powerful states to maintain power in the face of increasing fragmentation of the sovereign order); ANTHONY ANGHIE, *IMPERIALISM, SOVEREIGNTY AND THE MAKING OF INTERNATIONAL LAW* (2005) (arguing that since its inception international law has consistently reflected the imperial power and ambitions of the colonizer (later the developed world) in subjugation of the colonized (later the developing world)); HA-JOON CHANG, *BAD SAMARITANS: THE MYTH OF FREE TRADE AND THE SECRET HISTORY OF CAPITALISM* 19-39 (2008) (arguing that the developed world has used trade agreements and international institutional arrangements to extract higher levels of growth and prosperity at the expense of the developing world). See also Guzman, *Why LDCs Sign Treaties that Hurt Them*, *supra* note 20, at 680-684 (arguing that while bilateral investment treaties will increase global efficiency, they will also reduce welfare for developing countries as a group); Stephan, *Accountability and International Lawmaking*, *supra* note 6, at 720 (arguing that obstacles to democratic accountability and decision-making at the international level make international rule-making particularly likely to reduce welfare); Stephan, *Political Economy*, *supra* note 52, at 960-964 (asserting a range of “costs” to international cooperation based on process concerns about the way international rules are produced and the limited interests they are likely to serve).

<sup>112</sup> See Coase, *The Problem of Social Cost*, *supra* note 99. See also R.H. COASE, *THE FIRM, THE MARKET, AND THE LAW*, 10-16 (paperback ed., 1990) [hereinafter COASE, *THE FIRM, THE MARKET, AND THE LAW*] (elaborating his analysis in *The Problem of Social Cost*).

<sup>113</sup> Works of law and economics scholarship using a cost/benefit model for assessing the efficiency and welfare effects of legal rules are too numerous to list. Some representative examples would include, BRUCE ACKERMAN, *RECONSTRUCTING AMERICAN LAW* (1984); Howard Beales *et al.*, *The Efficient Regulation of Consumer Information*, 24 J. L. & ECON. 491 (1981); John Prather Brown, *Toward an Economic Theory of Liability*, 2 J. LEGAL STUD. 323 (1973); Guido Calabresi & Jon T. Hirschoff, *Toward a Test for Strict Liability in*

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not been the scope of regulatory authority, the proper institutional level of regulation or the policy intentions of the regulatory institution adopting the rule. Rather, analysis has centered on the relative impact of particular rule choices on the efficiency of economic activity and welfare for the domestic economy as a whole, measured in terms of actual (or more often anticipated) economic effects. In developing an economic analytic approach to the issue of the transnational effects of domestic rules, it would seem to be similarly useful to articulate a method for assessing the net impact on global welfare of a domestic rule or rule scheme by tracing the economic effects of the rule(s) wherever they may be felt in the global economy.<sup>114</sup> Such a methodology would seem to require relaxing analytic attention, at least temporarily, to the important questions of the regulatory intention, geographic boundaries or scope of jurisdictional authority of the state adopting the rule(s)—questions that have been the primary focus of international law and economics scholarship thus far in its development.<sup>115</sup>

Of course, this entire analytic tradition for assessing the welfare effects of domestic rules has been the subject of much controversy. After all, in the U.S., the literature critical of a Coasean economic policy approach to analyzing the welfare effects of legal rules is nearly as vast as the literature seeking to deploy it.<sup>116</sup> Nevertheless, if we are to push the field of international law and economics scholarship past the important questions of sovereign authority and jurisdictional limits, it makes sense to begin by focusing on the issues on which Coase's original analysis turned—What economic interests are affected by the rules we would like to consider? What are the rules that govern the economic activity at issue and what do they mean for the behavior of these economic actors? How might economic actors adjust to such rules in the absence of transaction costs? And finally, in our own world of positive transaction costs, how can we use legal arrangements to encourage the allocation of resources as between economic constituencies that they might have selected through cost-free bargain-

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*Torts*, 81 YALE L.J. 1060 (1972); Guido Calabresi & A. Douglas Malamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972); Richard S. Markovits, *The Causes and Policy Significance of Pareto Resource Misallocation: A Checklist for Micro-Economic Policy Analysis*, 28 STAN. L. REV. 1 (1975); Frank Michelman, *Pollution as a Tort: A Non-Accidental Perspective on Calabresi's Costs*, 80 YALE L.J. 647 (1971); Frank Michelman, *Property, Utility and Fairness: Comments on the Ethical Foundations of "Just Compensation" Law*, 80 HARV. L. REV. 1165 (1967); A. Mitchell Polinsky, *Controlling Externalities and Protecting Entitlements: Property Right, Liability Rule and Tax-Subsidy Approaches*, 8 J. LEGAL STUD. 1 (1979); A. Mitchell Polinsky, *Resolving Nuisance Disputes: The Simple Economics of Injunctive and Damage Remedies*, 32 STAN. L. REV. 1075 (1980); Posner, *supra* note 4, at 10-15 (describing a strand of law and economics analysis using "wealth maximization" as the measure of efficiency, sometimes referred to as "Kaldor-Hicks efficiency"); Richard Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487 (1980); Shavell, *supra* note 8.

<sup>114</sup> See Danielsen, *Local Rules*, *supra* note 14, at 58-59. Cf. Guzman, *Choice of Law*, *supra* note 21, at 896 (arguing for a system of international choice of law rules based on permitting those economic transactions that increased global welfare and prohibiting those that do not).

<sup>115</sup> Cf. Danielsen, *Local Rules*, *supra* note 14, at 59-68 (arguing that an analysis of the global welfare effects of rules would require getting beyond the traditional focus of international law on territorial sovereignty and jurisdictional authority).

<sup>116</sup> See, e.g., THE CANON OF AMERICAN LEGAL THOUGHT 23-28 (David Kennedy & William W. Fisher, III, eds., 2006) [hereinafter THE CANON OF AMERICAN LEGAL THOUGHT] (for a critical introduction to *The Problem of Social Cost* and a useful bibliography of some of the most important works of law and economics scholarship critical of Coase); Kennedy, *Law-and-Economics from the Perspective of Critical Legal Studies*, *supra* note 8, at 473-474 (containing a bibliography of "greatest hits" law and economics scholarship both mainstream and critical).

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ing among themselves?<sup>117</sup> Whether these are precisely the right questions, whether they can be answered with clarity, and whether the efficient result of cost-free bargaining ought itself to be the polestar for measuring welfare, are all questions on which we might disagree.

In Part 4 of this article, I take up the challenges and complications of answering these questions in the global economy. Some of the difficulties are simply the result of scaling up the frame of analysis to a global level where things are more complex, where jurisdictional differences do matter, and where cultural meanings and bargaining power all play a role in determining the ways in which economic interests will be affected by rules. Along the way, I argue for expanding our analytic methods to bring as many of these factors into our analysis as possible.

At the same time, the effort to understand the welfare effects of domestic rules in a global economy exposes some analytic difficulties that are hard to overcome even in far less complex situations. To a certain extent, for example, the interests that are affected by a rule are themselves determined by rules, just as the preferences and identities of economic actors are themselves, in part, a function of background legal arrangements. It will be difficult, as a consequence, to use the impact on economic actors as a stable point against which to assess the efficiency or welfare effects of rules.

Similarly, the meaning and impact of rules on economic actors will often be a function of the relationship of those rules with other rules and with a variety of background informal arrangements and cultural patterns that differ from place to place. In a global economy, economic activities cross territorial, jurisdictional, political and cultural borders and addressing these differences will require analytic choices among the possible meanings and cultural understandings of a rule that could provide the baseline for an analysis of the rule's effects on global welfare. Addressing this challenge will require the development of analytic methods that enable (or at least acknowledge) the normative and ethical choices implicit in our economic models.

Most importantly, perhaps, the welfare effects of rules in a transnational economy will be a consequence not only of the impact of public rules on private economic actors. In fact, the rules themselves are frequently the result of negotiations or bargains between public and private actors.<sup>118</sup> Moreover, private actors routinely perform public regulatory functions

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<sup>117</sup> Coase's model of analyzing legal rules in light of economic effects and transaction costs spawned a huge literature. See, e.g., George J. Benston & Clifford W. Smith, Jr., *A Transaction Cost Approach to Financial Intermediation*, 31 J. FIN. 215 (1976); Guido Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499 (1961); Guido Calabresi, *The Decision for Accidents: An Approach to Nonfault Allocation of Costs*, 78 HARV. L. REV. 713 (1965); Guido Calabresi, *Transaction Costs, Resource Allocation and Liability Rules—A Comment*, 11 J. L. & ECON. 67 (1968); Steven N.S. Chung, *Transaction Costs, Risk Aversion and the Choice of Contractual Arrangements*, 12 J. L. & ECON. 23 (1969); Harold Demsetz, *The Cost of Transacting*, 82 Q. J. ECON. 33 (1968); Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Process*, 21 J. L. & ECON. 297 (1978); Steven Shavell, *Suit Settlement, and Trial: A Theoretical Analysis Under Alternative Methods for the Allocation of Legal Costs*, XI J. LEGAL STUD. 55 (1982); Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J. L. & ECON. 233 (1979); Edward Zabel, *Consumer Choice, Portfolio Decisions and Transaction Costs*, 41 ECONOMETRICA 321 (1973).

<sup>118</sup> See, e.g., JOHN BRAITHWAITE, *REGULATORY CAPITALISM: HOW IT WORKS, IDEAS FOR MAKING IT WORK BETTER*, 25 (2008) [hereinafter BRAITHWAITE, *REGULATORY CAPITALISM*] ("For 90% of the world's states there are large numbers of corporations with annual sales that exceed the state's GDP. The chief executives of the largest corporations typically are better networked into other fonts of power than the presidents of medium-sized states. Consequently, large corporations do a lot of regulating of states."); JOHN BRAITHWAITE & PETER

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either alone or in concert with other economic actors.<sup>119</sup> As a result, an economic analytic method capable of assessing the dynamic welfare effects of rules in the modern global economy would need to incorporate not only the welfare effects of market adjustments by private actors responding to price in the shadow of law. It would also need to address the welfare effects of rule adjustments by public actors pursuing their interests (public or otherwise) in the shadow of private market behavior, of rule adjustments resulting from public/private bargains, and of rule adjustments by private actors.

In short, many important aspects of the institutional dynamics of legal rules and welfare effects in the global economy are not captured in the current analytic focus of international law and economics scholarship on the proper level of rule-making and the allocation of sovereign jurisdiction. My hope is to suggest ways in which the assessment of the transnational effects of domestic rules can help us to see some of the limits of current international law and economics approaches to the global legal and economic order and why an expansion of the scope of analytic inquiry and methods might be more generally warranted.

### 4. CHALLENGES AND COMPLICATIONS FOR A GLOBAL WELFARE ASSESSMENT OF RULES

In this Part, I explore three sets of challenges to enhancing our analytic capacity to evaluate national legal rules from the perspective of their impact on global welfare using Coase's analytic framework for an economic policy analysis of legal rules as a point of departure. First, I examine the difficulty of determining the scope of effects of a domestic rule in the global economy and of identifying the interests that might be implicated by these effects once we relax our expectation that the economic impact of a domestic rule is generally "domestic" unless the rule is formally applied abroad. Second, I examine the challenge of identifying rules and understanding their effects once we recognize that the meaning and effect of rules on the allocation of resources in the global economy will be shaped by the diverse political, institutional and cultural contexts in which the interests affected by the rules are situated and with which the rules interact. Finally, I explore the challenges of looking beyond Coase's analytic insight regarding the significance of "private" market adjustments to the allocation of resources under "public" legal rules to consider other types of dynamic adjustments that seem ubiquitous in the global economy—adjustments such as public/private bargaining over the content and application of rules, private rule-making through private ordering

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DRAHOS, *GLOBAL BUSINESS REGULATION*, 27 (2000) [hereinafter BRAITHWAITE & DRAHOS, *GLOBAL BUSINESS REGULATION*] ("The most recurrently effective actors in enrolling the power of states and the power of the most potent international organizations (e.g. the WTO and the IMF) are large U.S. corporations.")

<sup>119</sup> See, e.g., Dan Danielsen, *How Corporations Govern: Taking Corporate Power Seriously in Transnational Regulation and Governance*, 46 *HARV. INT'L L.J.* 411 (2005) [hereinafter Danielsen, *How Corporations Govern*]; Dan Danielsen, *Corporate Power and Global Order*, in *INTERNATIONAL LAW AND ITS OTHERS* 85 (Anne Orford, ed., 2006); BRAITHWAITE, *REGULATORY CAPITALISM*, *supra* note 118, at 1-31; BRAITHWAITE & DRAHOS, *GLOBAL BUSINESS REGULATION*, *supra* note 118, at 3-36; Gunther Teubner, "Global Bukowina": *Legal Pluralism in World Society*, in *GLOBAL LAW WITHOUT A STATE* 4 (Gunther Teubner, ed., 1997) [hereinafter TEUBNER, *GLOBAL LAW WITHOUT A STATE*]; Jean-Philippe Robé, *Multinational Enterprises: The Constitution of a Pluralistic Legal Order*, in TEUBNER, *GLOBAL LAW WITHOUT A STATE*, *supra*, at 45-77; Peter T. Muchlinski, "Global Bukowina" Examined: *Viewing the Multinational Enterprise as a Transnational Law-making Community*, in TEUBNER, *GLOBAL LAW WITHOUT A STATE*, *supra*, at 79-108.

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mechanisms and public legal and administrative adjustments to the adverse effects of public and private adjustments elsewhere in the global system.

Focusing on these challenges helps bring to light the normative choices in what seem to be simply analytic ones. What interests *should* count in a global economy? How *should* we resolve conflicts among divergent cultural expectations or business practices embedded in diverse legal cultures when they clash not through jurisdictional conflict, but simply through the routine operations of a global economy? How *should* we measure the impact on “welfare” of bargaining between public and private actors over the content and application of rules if the notions of “interests” and “welfare” the bargainers are “maximizing” turn out to be quite different ones? Although the analytic methods and research foci that have been central to international law and economic scholars to this point have much to contribute to our understanding of these issues, we may need to engage more directly and explicitly with these difficult normative questions if we are to develop a more comprehensive understanding of the relationship between rules and general welfare in the global legal and economic order.

**Identifying the Interests Affected by a Rule by Reference to the Scale and Scope of its Economic Effects**

One well-recognized challenge to analyzing the relative costs, benefits and welfare effects of legal rules is the necessity for the analyst to define the boundaries of both the scale and scope of the effects of the rule being analyzed and the interests that, by virtue of those effects, might be willing to bargain to adjust those effects, before the analysis can be conducted.<sup>120</sup> Warren Samuels described this challenge as follows:

The point is clear with regard to the boundaries of analysis. The very definition of community governs whose interests are to be considered, and how much they are to count. The optimal solution likewise is a function of the decision locus (the power to regulate), as well as the regulatory behavior, of the jurisdictional decision makers. Different specifications of community and jurisdiction lead to diverse solutions. Moreover, the allocation of political power is economically indeterminate without an antecedent premise specifying whose interests are to count: the identification of community *and* jurisdiction governs the “neutral” efficient solution.<sup>121</sup>

This issue becomes all the more pronounced in the context of domestic rules and transnational effects because the interests affected are likely to be more widely disbursed and the effects of the rules more causally attenuated and therefore harder to identify empirically or to anticipate analytically.

These issues have been less salient for international law and economics scholars to date for a number of reasons. Perhaps most significantly, as I have said, assessing the global

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<sup>120</sup> See, e.g., Warren J. Samuels, *Normative Premises in Regulatory Theory*, 1 J. POST-KEYNESIAN ECON. 100 (1978), reprinted in LAW AND ECONOMICS: AN INSTITUTIONAL PERSPECTIVE 128 (Warren J. Samuels & A. Allan Schmid, eds., 1978) [hereinafter Samuels, *Normative Premises in Regulatory Theory*]; Thomas C. Heller, *The Importance of Normative Decisionmaking: The Limitations of Legal Economics as a Basis for Liberal Jurisprudence—as Illustrated by the Regulation of Vacation Home Development*, 1976 WISC. L. REV. 385 (1976).

<sup>121</sup> Samuels, *Normative Premises in Regulatory Theory*, *supra* note 120, at 129 (citation omitted).

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welfare impact of substantive rules has not, by and large, been their project. As discussed in Part 1, the international law and economics scholars have focused more on analyzing or predicting state behavior or assessing the impact of private transactions on state behavior. When analyzing global regulation, international law and economics scholars often assume the scope of a rule's effects to be coextensive with the geographic territory of the rule-maker unless the rule is formally applied by the rule-maker or a foreign sovereign outside the territory of the rule-maker.<sup>122</sup> Moreover, with respect to identifying constituent interests, these scholars often assume that states aggregate the interests of their constituents and therefore sovereign rule-making or bargaining can be treated, for analytic purposes, as reflective of those interests.<sup>123</sup> In this sense, the territorial nation-state becomes a proxy both for the expected scope of rules and their effects (absent the express intent of the rule-maker to the contrary) and for the expression of the net balance of interests among diverse constituencies in relation to legal rules. While Part 1 explored several ways in which these assumptions proved helpful in illuminating important aspects of the global legal and economic order, they are not well suited to analyzing the global economic impact of the domestic application of domestic rules.

In "The Problem of Social Cost," Coase was able to defer these complex issues with respect to the scale and scope of legal rules and the identification of the diverse constituencies impacted by those effects through the simplicity and structure of his examples. His focus on simple "two-interest" economies made up of farmers and ranchers in adjacent properties or homeowners living near a polluting factory enabled him to show how ordinary private law rules such as common law tort rules could affect the allocation of resources between two parties (or groups) under circumstances in which the economic impact of the legal rule on the behavior of the two parties could be presumed.<sup>124</sup> Close geographic proximity, a shared (if greatly simplified) legal regime and a clear articulation of the affected interests in each example made bargaining among the parties in the shadow of the rule seem more than a mere theoretical possibility. Whether the parties actually would bargain to adjust the allocation of resources as between them was, for Coase, a question of the magnitude of the transaction costs of the bargain versus the benefits to be achieved by the parties in the particular circumstances.<sup>125</sup> Through such simplified scenarios Coase was able to suggest that the impact of legal rules on the allocation of resources among economic actors in an economy was not an exceptional occurrence, but rather a frequent if not inevitable one under real world conditions of positive transaction costs.<sup>126</sup>

Of course, even in a domestic economy it seems likely that the economic effects of a legal rule that shaped the allocation of resources and the levels of production among economic actors such as farmers and ranchers would extend well beyond the farmer and ranchers themselves, and therefore add to the complexity of a Coasean analysis of the rule. But once we imagine expanding the frame of analysis to assessing the transnational effects of a domestic

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<sup>122</sup> See *supra* notes 80 and 81 (discussing approaches to analyzing the extraterritorial application of rules).

<sup>123</sup> See, e.g., TRACHTMAN, *THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW*, *supra* note 6 at 34-37 (asserting that states effectively aggregate the preferences of their constituents and assuming, for analytic purposes, that national laws perfectly reflect constituent preferences); Guzman, *Choice of Law*, *supra* note 21, at 895 (explaining the reasons for his analytic assumption "that the government of each country maximizes the domestic welfare of local residents."). *But see supra* note 86 (providing examples of public choice scholars taking a contrary view).

<sup>124</sup> See Coase, *The Problem of Social Cost*, *supra* note 99, at 95-104.

<sup>125</sup> See *id.* at 114-115.

<sup>126</sup> See COASE, *THE FIRM, THE MARKET, AND THE LAW*, *supra* note 112, at 13.

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rule in the global economy, the significance of defining the scale and scope of a rule's actual economic effects and identifying the constituencies that might, by virtue of those effects, be induced to bargain to adjust those effects becomes more acutely apparent. Since Coase's model seeks to analyze the relative efficiency of legal rules based on their effects on "the system as a whole,"<sup>127</sup> it would seem quite important to establish a correlation between the magnitude and scope of the rules' effects and the economic activity being analyzed wherever such effects might be felt or such economic activities affected. Moreover, it would seem that one's ability to identify the constituencies likely to be economically affected by a legal rule would be, in large part, a function of one's ability to determine (or predict with some accuracy) the scale and scope of the economic effects of the rule. It would seem, then, that using Coase's model for assessing the transnational economic effects of a national rule would be, in large part, contingent on one's ability to predict the scope of the economic effects of the legal rule under analysis in order to identify and incorporate the interests of all of the constituencies sufficiently affected by the rule to bargain their interests in the absence of transaction costs.

In order to explore the significance of these issues for a Coasean analysis of the transnational economic effects of a domestic rule, imagine that the State of Delaware is considering a possible change in its "business judgment rule." The "business judgment rule" is a rebuttable presumption that all business decisions by Delaware managers are made in good faith and in the best interest corporation.<sup>128</sup> The effect of the rule is to exempt managers from personal liability for even grossly negligent business decisions that cause injury to the corporation absent a showing of actual bad faith, self-dealing or a personal benefit to the detriment of the corporation.<sup>129</sup> Imagine Delaware is considering a change that would permit personal liability for managers of Delaware corporations for grossly negligent business decisions that result in reasonably foreseeable and significant harm to human life, health or the environment and direct or indirect harm to the corporation. Thus, much like Coase's examples of tort liability rules in "The Problem of Social Cost," the proposed Delaware rule change would involve assessing the economic effects of a move from a rule of no liability for managers to one of liability under some limited circumstances.

In theory, the issue of the scale and scope of the economic effects of the rule should be resolved by the zero-cost bargaining assumption because all economic actors affected by the original and the alternative rules would assert their interests through cost-free bargaining. However, as a practical matter, a policy analyst seeking to apply the Coase model in this situation would need to hypothesize the scope and magnitude of economic effects of the rules in order to imagine and identify the constituencies likely to be affected by and therefore to bargain for adjustments to the economic effects of the rules in the absence of transaction costs

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<sup>127</sup> See *id.* at 27 ("The aim of economic policy is to ensure that people, when deciding what course of action to take, choose that which bring about the best outcome for the system as a whole.").

<sup>128</sup> See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (The business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts.").

<sup>129</sup> See, e.g., *In re The Walt Disney Company Derivative Litigation (Disney III)*, 907 A.2d 693, 747 (Del. Ch. 2005) ("[The Business Judgment Rule] presumption applies when there is no evidence of 'fraud, bad faith or self-dealing in the usual sense of personal profit or betterment' on the part of the directors. In the absence of this evidence, the board's decision will be upheld unless it cannot be 'attributed to any rational business purpose.' When a plaintiff fails to rebut the presumption of the business judgment rule, she is not entitled to any remedy, be it legal or equitable, unless the transaction constitutes waste.") (citations omitted).

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or who might be affected by the rule but precluded from bargaining for market adjustments in the presence of transaction costs. One way to resolve this issue for analytic purposes would be to assume that the scope of the economic effects of the respective rules would be coextensive with the jurisdictional authority of rule-maker—in this case, the State of Delaware. Yet the magnitude of the economic resources under the control of Delaware corporations, the global scale of their economic activities and the potential of corporate governance rules to shape the content and quality of corporate decision-making all suggest that any assumption that treated the scale and scope of economic effects of a change in Delaware corporate law were limited to the State of Delaware would not be a very realistic or helpful one.<sup>130</sup>

An alternative to assuming an alignment between territorial jurisdiction and economic effects might be to assume, as Coase did, that the constituencies likely to bargain with regard to the effects of a rule would be those most directly affected by it. Coase confined his analysis to those constituencies with a direct property interest impacted by the rule, such as farmers and ranchers, farmers and passing trains, and homeowners and factory owners.<sup>131</sup> In the context of a change in Delaware corporate law, a parallel assumption might lead us to focus on the economic effects of the alternative Delaware liability rules on shareholders and managers of Delaware corporations. Independent of the analytic benefits of such a simplifying assumption, it might also seem sensible in light of the common conventions of corporate law which generally treat corporate fiduciary duty rules as primarily about risk allocation and monitoring costs between shareholders as the corporations “owners” and managers as their “agents.”<sup>132</sup> Thus, shareholders and managers might seem to be those most directly affected by the scope and content of Delaware fiduciary duty rules.

The danger here is that what seem like “common sense” assumptions about the legal interests and legitimate regulatory authorities to be considered in a particular legal context may result in analytic biases or distortions of one sort or another. In fact, these assumptions could arise from the very legal rules whose impact on global welfare we are trying to assess. Delaware corporate law, for example, focuses us on the relationship between managers and shareholders. Ultimately, measuring a rule’s economic effects by reference to those interests the rule was intended to affect does not tell us anything about the interests that actually have an economic stake in the rule or those that should count from a normative perspective. In this sense, such an assumption is no more (or less) satisfactory than assuming that the economic effects of rules are confined to jurisdictional boundaries. Each of these default positions for understanding the relevant interests that count in relation to a legal rule are themselves defined by our interpretation of the scope of the rule at issue. As a result, they could lead us quite far

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<sup>130</sup> According to the Division of Corporations of the State of Delaware, more than 850,000 businesses are incorporated in Delaware, including more than 50% of all publicly traded companies in the United States and 63% of all Fortune 500 companies. <http://www.corp.delaware.gov/aboutagency.shtml> (last visited May 15, 2010).

<sup>131</sup> See Coase, *The Problem of Social Cost*, *supra* note 99 at 95-114.

<sup>132</sup> For a classic statement of this idea, see *Bayer v. Beran*, 49 N.Y.S.2d 2, 5 (Sup. Ct. 1944) (“Directors of a business corporation are not trustees and are not held to strict accountability as such. Nevertheless, their obligations are analogous to those of trustees. Directors are agents; they are fiduciaries. The fiduciary has two paramount obligations: responsibility and loyalty. Those obligations apply with equal force to the humblest agent or broker and to the director of a great and powerful corporation. They lie at the very foundation of our whole system of free enterprise and are as fresh and significant today as when they were formulated decades ago.”).

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from a realistic assessment of those interests actually economically affected by the rule and, as a consequence, the impact of the rule on global welfare.

For example, even if a change in the Delaware business judgment rule were imagined to have a significant impact on the kinds of decisions that Delaware managers would make regarding the activities of their foreign subsidiaries, it seems quite unlikely that analytic attention would focus on the effects of such a rule change on worker safety or environmental welfare in the countries in which Delaware multinational corporations have operations. As a consequence, the economic interests of workers and farmers in those countries in the content of the Delaware rule might well be overlooked. A likely explanation for this failure is the notion that Delaware corporate governance rules are primarily, if not exclusively, of interest to state or national constituencies. Unlike the direct geographic and causal proximity of the affected constituencies posited in Coase's paradigmatic examples, the causal link between a change in the corporate decision-making rules of Delaware and an impact on the economic and physical well-being of workers or farmers abroad might not appear to be an obvious one even if the actual effects of the rule choice on the welfare of those constituencies could be shown to be considerable.

If we assume, for sake of argument, that a change in the business judgment rule that permitted personal liability for grossly negligent business decisions that result in reasonably foreseeable and significant harm to human life, health or the environment would have some impact on the kind of decisions managers of Delaware multinational corporations would make in respect to worker or environmental safety in operations abroad, it would seem that foreign workers and farmers might well have significant interests in the contents of the Delaware business judgment rule and the scope of its transnational economic effects. Moreover, in the absence of transaction costs, we might expect that workers and farmers would bargain their interests along with Delaware shareholders and managers (as well as other affected constituencies) to adjust the economic effects resulting from the rule in a way that maximized the value of total production for the global economy. This might be particularly true if the costs of obtaining equally beneficial domestic worker safety, environmental and tort rules in each of their home countries would exceed the costs of bargaining in relation to the Delaware business judgment rule or its alternative.

In fact, if we took into account all of the constituencies that might be affected by a change in the Delaware business judgment rule transnationalized through the business decisions of Delaware corporations across the globe, we might reasonably expect that the universe of affected constituencies (and hence potential bargainers) would be significantly larger than the shareholders and managers of Delaware corporations and the workers and farmers affected by the business decisions of Delaware multinational corporations abroad. The problem analytically is that the way we interpret the scope of the rule we are considering is itself one of the elements defining the interests we need to consider to analyze the rule's effects. Hence, even if we assumed that the interests most affected by the business judgment rule were managers and shareholders of Delaware corporations, there would be no basis to conclude that the rule reflects a net increase in welfare for the global economy as a whole without consideration of the economic effects of the rule on other interests. This would be true even if the rule could be shown to optimize the allocation of resources as between shareholders and managers.

My point is not that local or national rules with transnational effects should be analyzed exclusively or even primarily on a global economic scale. Rather, I mean to suggest that regardless of whether transaction costs are excluded or included in the analysis, a hypoth-

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esis regarding the scale and scope of the economic effects of the legal rule(s) being considered and the interests likely to be affected by the rule(s) must be resolved, at least provisionally, before an analysis using the model can proceed. Moreover, the answers to these apparently *analytic* issues require choices that are unavoidably *normative* in character and distributional in effect. Samuels describes the normative character of these analytic judgments as follows:

The point which I want to make is that judgment involves the inevitable exercise of normative choice, ultimately with regard to which interests are going to count. . . . Measurement difficulties lead to practices implying preferences as to whose interests are to be given most weight. . . . The point arises in two connections. First, the identification of costs and benefits is a function of perspective: what is a cost and what a benefit is a function of selective perception. Cost-benefit identifications are made from one decision-maker's point of view, they would not necessarily be the same when made from another decision maker's perspective. Second, since there is no over-arching, independent calculus, the problem arises as to whose valuation to use. The use of any valuation is equivalent to making inter-personal utility comparisons that favor certain interests and govern both the analysis and the policy conclusions, and carry inevitable allocative and distributional consequences.<sup>133</sup>

It would seem, then, that the analytic value of conclusions drawn from a Coasean economic policy analysis of the transnational economic effects of a domestic rule would depend, in part, on the assumptions made regarding the scale and scope of the legal rule and its economic effects in the global economy and whether those assumptions could be better correlated to observable economic behavior under real world conditions when compared with analyses based on alternative assumptions. Yet even if Coase's analytic model cannot deliver reliable empirical conclusions regarding the global welfare effects of particular domestic rules, the model may still provide a methodology for developing more informed hypotheses about the transnational economic effects of different types of domestic rules using assumptions of varying scope and complexity, and may yield important new insights into the significance and role of domestic rules in the global legal and economic order.<sup>134</sup> In particular, the Coasean analytic framework seems to be a useful supplement or perhaps corrective to the state-centered approaches of First and Second Strand international law and economics scholars.

For example, the analytic focus of Coase's framework on tracing the economic *effects* of domestic rules irrespective of territorial or jurisdictional borders and irrespective of where a rule is formally applied seems particularly well-suited to exploring circumstances, such as the one suggested by the Delaware corporate law example, where there is a significant disjunction between the scope of a rule's actual (or anticipated) economic effects and the political, territorial and jurisdictional limits of the rule-maker. As we have seen, the transnational economic effects of Delaware corporate rules are not dependent upon their extra-territo-

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<sup>133</sup> Samuels, *Normative Premises in Regulatory Theory*, *supra* note 120, at 129.

<sup>134</sup> *Cf. id.* at 139-40 (suggesting that the economic analysis of regulation is not a "value-free" method of analysis and urging economists to make their normative choices more explicit and to test their assumptions by multiple studies using different normative and factual assumptions).

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rial application by the State of Delaware or their formal application by foreign jurisdictions. Rather, the rules and their effects are transnationalized primarily through the economic activity and decision-making of Delaware corporations and the impact of that activity and decision-making on others in the global economy. If domestic rules with transnational economic affects are both ubiquitous and unavoidable in an interdependent global economy, it would seem quite important to develop economic analytic methods that could look beyond the formal limits of sovereign jurisdictional power and the formal extra-territorial application of domestic rules to enable a more realistic account of those situations where territory, jurisdiction and rule effects do not overlap.

Another possible benefit to exploring a Coasean effects-based approach to the issue of domestic rules in the global economy is that it may provide an alternative to the unsatisfying and in many if not most cases counterfactual analytic assumption that states are efficient aggregators of the individual preferences of their constituents.<sup>135</sup> As discussed previously, the costs and benefits of this assumption have been debated among international law and economics scholars.<sup>136</sup> By tracing the economic effects of rules and analyzing the possibilities for and obstacles to market adjustments by affected constituencies, a Coasean approach may help scholars and policymakers to better identify transnational constituencies with shared and/or divergent economic interests in particular rules, regulatory regimes or institutional formations. An effects-based approach may also help us to imagine analytic methods better able to address important differences among constituencies *within* sovereign jurisdictions regarding the content of rules, regimes and institutional formations—differences that the efficient sovereign aggregator assumption makes hard to cognize, but public choice theory makes hard to discount.

Developing new analytic methods that facilitate the identification of diverse constituencies linked by the economic effects of national and transnational rules could help lay the foundation for new transnational political formations. In some circumstances, these new political formations might more accurately reflect the aggregation of constituent interests at the global level than regulatory acts by one or more nation-states or international institutions, and thus, potentially provide more reliable mechanisms for the enhancement of global welfare. After all, if the diverse global interests adversely affected by a particular rule, regime or institution are not insignificant, the lack of an extant analytic or political mechanism to take those interests into account might reasonably be understood as a weakness both in our capacity for economic policy analysis and in the global governance regime. Of course, whether to remove or respond to obstacles to participation with respect to the choice of a domestic legal arrangement with transnational effects (whether through participation in the formulation or scope of the legal arrangement or through market adjustments) would be a good idea as a matter of global economic policy would itself depend on an assessment of whether eliminating or reducing the obstacles to participation or bargaining would likely increase global welfare more than the status quo arrangements.

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<sup>135</sup> As public choice theorists have so often suggested, it is quite difficult to conclude that law-making by even an economically developed democratic state bears any relationship to an efficient aggregation of the preferences of its constituents. Once we expand our frame of reference beyond developed, democratic states to the broad range of political processes and administrative capacities among states across the globe, such an assumption seems to veer dangerously close to the absurd.

<sup>136</sup> See *supra* note 123.

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If we are to develop a comprehensive economic analysis of rules in the global economy, we will need to be able to offer an account of the not infrequent circumstances where the incongruity between the economic effects of the rule and the territorial or jurisdictional boundaries of the rule-maker (whether a state, a collectivity of states or an international organization) seems likely to be significant or where the interests economically interested in a rule cannot be easily aggregated within particular geographic jurisdictions or at particular levels of the global institutional order. Doing so will require us to bring into our economic approaches normative judgments about which interests matter and why. If those interests are jurisdictional or territorial, or defined by corporate law as restricted to shareholders and managers, at least we will know where we are starting. Treating these choices as matters of fact or merely analytic (rather than normative) seems particularly problematic in an interdependent global economy structured by fragmented and plural legal orders. It is to the challenge of pluralism—of legal orders, of values, of cultures—that I now turn.

### **B. The Institutional and Cultural Embeddedness of Rules and the Challenge of Comparison**

If we return for a moment to Coase's quite simple heuristic example—a rancher, a farmer and a rule—we can see that the analytic challenge goes beyond identifying the interests affected the rule. To use Coase's method, one must also be able to identify the operative rule itself. In a global economy, identifying the rule turns out to be as difficult as identifying affected interests because the meaning and impact of a rule is highly context dependent. The rules which surround it, the procedural and institutional system within which it is situated, the general qualities of the legal order of which it is a part, as well as the informal business practices, expectations and cultural values in relationship to which it is understood and applied *de jure* or *de facto*, will all affect the impact of a rule on the behavior of diverse economic actors and hence the effects of the rule being analyzed on welfare as a whole. Thus, a second challenge to developing a comprehensive analytic framework for assessing the global welfare effects of rules is how to discern analytically and normatively where a rule ends and its context begins and how to take account of political, legal, institutional and cultural differences in measuring a rule's effects.

Institutional economists have long sought to devise a method for determining whether institutions emerge and change as a result of rational choices made by economic actors in response to external conditions or whether the choices and preferences of economic actors (including those regarding institutions and institutional change) are themselves shaped by the political and institutional context in which the actors find themselves.<sup>137</sup> Similarly, institutional economists have long struggled to understand the role and significance of cultural expectations and practices on the formation of economic preferences, behaviors and institutions.<sup>138</sup>

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<sup>137</sup> For an historical analysis of this debate, see RUTHERFORD, INSTITUTIONS IN ECONOMICS, *supra* note 11, at 27-50.

<sup>138</sup> See *id.*; see also DOUGLASS C. NORTH, UNDERSTANDING THE PROCESS OF ECONOMIC CHANGE 6 (2005) ("Institutional constraints cumulate through time, and the culture of a society is the cumulative structure of rules and norms (and beliefs) that we inherit from the past that shape our present and influence our future. Institutions change, usually incrementally, as political and economic entrepreneurs perceive new opportunities or react to new threats affecting their well-being. Institutional change can result from change in the formal

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In the past, “old” and “new” institutional economists could be distinguished to some extent by the significance given to these questions in their analytic methods with “old” institutional economists paying more attention to the history, diversity and specificity of institutional and cultural context and “new” institutional economists tending to make more generalized assumptions across institutional and cultural contexts based on some conception of *homo oeconomicus*.<sup>139</sup> More recently, scholarly voices from within “new” institutional economics have been calling for greater sensitivity to the significance of political, institutional and cultural contexts in the economic analysis of institutions.<sup>140</sup> One scholar of institutional economics, Thrainn Eggertsson, has suggested that new institutional economics may be divided into two sub-schools with the “neo-institutional school” staying closer to the classical rationality assumptions of *homo oeconomicus* and the “new institutional school” advocating more heterogenous influences on economic decision-making including political, cultural and psychological influences that challenge more orthodox economic assumptions regarding the rational basis of choice.<sup>141</sup> International law and economics scholars would seem to fall closer to the “neo-institutional” end of this typological range—paying little or no attention to political or cultural differences in their analyses of the economic behavior of either states or private actors.<sup>142</sup>

In “The Problem of Social Cost,” Coase similarly avoids the analytic challenges that arise when rules are embedded in broader rule systems and given meaning and effect by their sociological contexts. In articulating his analytic framework in relation to tort liability rules (e.g. liability or no liability for damage to property), Coase does not give any analytic attention to related legal regimes such as property law, contract law, environmental law or zoning law. Nor does he consider the cultural or business practices of economic actors in respect of the rules or the interpretive or enforcement practices of the institutions charged with administering the rules.<sup>143</sup> For purposes of his analysis, Coase treats the meaning, cultural expecta-

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rules, the informal norms, or the enforcement of either of these. The political-economic structure of the society and the way it evolves is the key to whose choices matter and how they conspire to shape policies.”) [hereinafter NORTH, PROCESS OF ECONOMIC CHANGE].

<sup>139</sup> See RUTHERFORD, INSTITUTIONS IN ECONOMICS, *supra* note 11, at 175 (“The [Old Institutional Economics] has been directly associated with ‘holistic’ approaches in the sense of concentrating on the issue of how established institutions condition and mould individual behavior, not merely by providing constraints but by affecting the goals and values adopted by individuals. This contrasts with the perspective of those in the [New Institutional Economics] who argue that institutions are given constraints (and do not affect individuals’ goals and preferences), or arise purely out of the self-interested action of individuals.”).

<sup>140</sup> See PEARSON, ORIGINS OF LAW AND ECONOMICS, *supra* note 4, at 165-67 (describing a tendency within new institutional economics to stray from the *homo oeconomicus* model to pay increasing attention to psychology, sociology, evolutionary theory, ideology, and culture in their theories of institutions and institutional change).

<sup>141</sup> THRAINN EGGERTSSON, ECONOMIC BEHAVIOR AND INSTITUTIONS 7-10 (1990).

<sup>142</sup> The possible exception might be the public choice scholars, though their work seems more oriented to articulating general potentialities and tendencies within states than to analyzing the particular political structure or orientation of any particular state. See, e.g., Stephan, *Barbarians*, *supra* note 6, at 746 (“Public choice theory seeks to apply certain insights derived from the study of private economic behavior to collective action problems, including the form of concerted activity that constitutes government.”). See also Guzman, *Public Choice and International Regulatory Competition*, *supra* note 19; O’Hara, *Opting Out of Regulation*, *supra* note 86; Stephan, *Accountability and International Lawmaking*, *supra* note 6.

<sup>143</sup> See Coase, *The Problem of Social Cost*, *supra* note 99, at 95-104. Coase does suggest that it would be fruitful for the economist to study “how, in practice the market, firms and governments handle the problem of harmful effects” including “the work of the broker in bringing parties together, the effectiveness of restrictive covenants, the problems of large-scale real-estate development company, the operation of government zoning,

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tions and institutional practices in respect of the liability, property and contract rules as stable, clear and transparent—creating predictable incentives and price effects for affected parties.<sup>144</sup> The purpose of this simplifying set of assumptions is to enable Coase to isolate the liability rule as the only variable affecting bargaining behavior in order to explore his hypothesis regarding the dynamics of market adjustments to the economic effects of rules in the absence and the presence of transaction costs.<sup>145</sup> In sum, as with the issue of the scale and scope of rule effects, Coase leaves the issue of rule embeddedness outside the scope of his analysis.

The embedded nature of rules complicates the Coasean tradition of welfare analysis in several ways. Most directly, whether an analysis of the welfare effects of a particular liability rule for farmers and ranchers is generalizable will depend on whether the rule can be expected to have the same meaning and produce the same effects for all similarly situated farmers and ranchers. If for some farmers and ranchers, the impact of the rule is eased or heightened by an adjacent rule (e.g. a mandatory punitive damages rule or a proximate cause rule which limits claims against animal owners for damage done by their animals), the impact of those adjacent rules would need to be taken into account—in some sense, netting out the intra-legal effects of the different rules upon one another to assess the actual effects of the original liability rule on the system as a whole.

A similar type of analysis is required if different ranchers and farmers understood the meaning of a liability rule in different ways, perhaps as a result of varying local business cultures or practices (e.g. if some local farmers simply shot cattle on their land or powerful ranchers precluded enforcement of the liability rule through intimidation). Again, it would be necessary to net out what the rule actually “means” for the behavior and choices of different farmer and rancher constituencies in order to make an assessment of how the rule (or a different rule) would affect general welfare. To a certain extent, this problem can be dealt with analytically by assimilating these differences among economic participants to having different “preferences.” The difficulty with this analytic move, however, is that it obscures the interactive relationship between the rule system being analyzed and the construction of those preferences.<sup>146</sup> This is particularly significant when focusing on the ways in which these interactive effects are dispersed across divergent cultures, national and local rule systems, and informal normative orders.

Of course, in fairly homogeneous jurisdictions or contexts, it might seem perfectly reasonable to ignore outlier idiosyncrasies in either rule interactions or cultural practices in estimating the impact of a particular rule on general welfare. Setting these issues aside seems like a more risky proposition in the global economy because the range of rules with which a particular domestic rule might interact and the possible variations of what a “rule” might be understood to “mean” across diverse constellations of legal systems and cultural contexts are

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and other regulating activities,” though he makes no suggestion that these studies would require the economist to analyze the inter-relationship *between* these diverse regulatory rules or regimes. *See id.* at 118-19.

<sup>144</sup> *See id.* at 104 (“It is necessary to know whether the damaging business is liable or not for damage caused, since without the establishment of this initial delimitation of rights there can be no market transactions to transfer or recombine them.”).

<sup>145</sup> *See* COASE, *THE FIRM, THE MARKET, AND THE LAW*, *supra* note 112, at 13.

<sup>146</sup> *Cf.* NORTH, *PROCESS OF ECONOMIC CHANGE*, *supra* note 138, at 5 (stating, with respect to the rationality assumption in economics: “[T]he uncritical acceptance of the rationality assumption is devastating for most of the major issues confronting social scientists and is a major stumbling block in the path of future progress. The rationality assumption is not wrong, but such an acceptance forecloses a deeper understanding of the decision-making process in confronting the uncertainties of the complex world we have created.”).

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likely to be large, and therefore, quite significant for assessing the impact of the rule on global welfare. It would seem, then, that adapting the Coasean economic policy framework for use as an analytic tool for assessing the transnational effects of national rules would require some mechanism for taking account of the likely possibility that the same domestic rule could produce quite different effects and responses in different legal and cultural contexts across the global economy.

To explore a concrete example of the economic significance of embedding legal rules in their broader legal and political contexts, I turn to a comparative study of corporate governance rules by Professor Mark Roe.<sup>147</sup> In his book “Political Determinates of Corporate Governance,” Professor Roe challenges a prominent theory among scholars of corporate law that differences in the structure of share ownership and equity markets in continental Europe and the United States can be attributed to their differing corporate law regimes. Roe states:

Today’s most popular academic explanation for why continental Europe lacks deep and rich securities markets is the purportedly weak role of corporate and securities law in protecting minority stockholders, a weakness that is said to contrast with America’s strong protection of minority shareholders.<sup>148</sup>

Roe continues with a short description of the basic argument underlying the “quality-of-corporate-law” theory as follows:

The basic law-driven story is straightforward: imagine a nation whose law badly protects minority stockholders against a blockholder extracting value from small minority stockholders. A potential buyer fears that the majority stockholder would later shift value to itself, away from the buyer. So fearing, the prospective minority stockholder does not pay pro rata value for the stock. If the discount is deep enough, the majority stockholder decides not to sell, concentrated ownership persists, and stock markets do not develop.<sup>149</sup>

Roe suggests that while the quality-of-corporate-law argument is appealing in theory, it is insufficient to explain the not infrequent circumstances in rich, developed countries where “ownership does not separate from control *even where core corporate law is good enough*.”<sup>150</sup> More specifically, he argues, “Where managerial agency costs due to potential dissipation of value are substantial, concentrated ownership persists *even if conventional corporate law quality that prevents diversion of value is high*.”<sup>151</sup>

Given the high number of rich countries with concentrated share ownership *and* high quality corporate law protection for minority shareholders, Roe suggests we must look beyond the corporate law itself to explain the differences in ownership structure and equity markets in

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<sup>147</sup> See e.g., MARK J. ROE, *THE POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT* (2003) [hereinafter ROE, *POLITICAL DETERMINANTS*].

<sup>148</sup> *Id.* at 164-65.

<sup>149</sup> *Id.* at 165.

<sup>150</sup> See *id.* at 167.

<sup>151</sup> *Id.* .

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the U.S. and Europe.<sup>152</sup> Roe finds his answer by situating the corporate law of each jurisdiction in its broader political and legal context.

Roe suggests, for example, that corporate law in the U.S. has the effect of reducing monitoring costs of corporate managers by shareholders because of the broader legal and political context in which the corporate law is situated, including a limited political commitment to labor protections, few regulatory obstacles to the creation of economic incentives designed to align management and shareholder interests such as large executive compensation packages, stock options and stock grants, bonuses, and other perquisites, and securities regulation mandating significant corporate disclosure that exposes managers to market pressure and oversight regarding job performance.<sup>153</sup> Roe goes on to conclude that such reduced monitoring costs facilitate more widely dispersed stock ownership, more risk spreading through diversification and more efficient capital markets in the U.S. than Europe.<sup>154</sup>

By contrast, corporate law in Europe produces quite different economic effects when situated in its legal and political contexts. Specifically, Roe argues that a range of pro-labor Social Democratic policies in Europe have limited the ability of shareholders to create financial or equity-based incentives for managers to act in the profit-maximizing interest of shareholders.<sup>155</sup> As a consequence, Roe suggests that European managers are generally more likely than their U.S. counterparts to make corporate decisions that focus on stability and firm size rather than earnings growth, and on job security rather than shareholder value.<sup>156</sup> According to Roe, these differences have led to higher monitoring costs for shareholders, resulting in more concentrated share ownership (with management oversight by large controlling shareholders or groups) and less efficient capital markets in Europe than in the U.S.<sup>157</sup> He concludes:

Today's policy-makers have reasons to come to grips with these political reflections inside the large firm. International agencies seek to change corporate governance systems in developing and transition countries. But corporate governance is not just mechanical rules and basic institutional capacities (such as good corporate law, good courts, and so on). The corporation ties, sometimes tightly, to national politics, and plunking down modern (usually read as American) rules and business institutions would be unlikely to produce the reformers' desired results if the institutions badly match the politics. The mechanical rules and institutions could be the same, but if the politics sharply differs, so might the corporate results.<sup>158</sup>

While this short summary simplifies Roe's analysis, it suggests the complexity of obtaining an accurate picture of the economic effects of corporate law rules in the U.S. and in Europe when the issue of rule embeddedness is taken into account. Assuming *arguendo* that Roe's comparative analysis of the content and economic effects of the corporate law regimes

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<sup>152</sup> *See id.*

<sup>153</sup> *See id.* at 1-8, 38-46.

<sup>154</sup> *See id.*

<sup>155</sup> *See id.* at 2.

<sup>156</sup> *See id.* at 2-3.

<sup>157</sup> *See id.* at 3, 38-46.

<sup>158</sup> *Id.* at 7.

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in the U.S. and Europe is correct, one might reasonably conclude that similar rules do not necessarily lead to similar outcomes, economic incentives or effects for interested parties, even in quite developed market economies, in part, because of the issue of rule embeddedness. In fact, Roe's analysis suggests that by considering the corporate governance regimes of Europe and the U.S. as part of the much larger social, political, legal and economic systems in which they operate, one can begin to understand the real economic meaning and effects of those regimes both domestically and transnationally. Moreover, his analysis suggests that in the global economy, it is not only the complex domestic system of rules, norms and practices within the jurisdiction making the rule that shapes its economic effects, but also the diverse systems of foreign rules, norms and practices which might serve as the alternative(s) to it.<sup>159</sup>

As a matter of economic theory, one might posit that if transaction costs were zero, economic actors would be able to bargain around whatever plural constellations of rules and politics actually governed their respective transnational activities and thereby maximize global welfare regardless of the geographic dispersion of bargainers or the complexity of the bargaining process. However, as we try to imagine the range of possible outcomes of such a complex negotiation process, the difficulty of predicting the outcomes of zero-cost bargaining makes any assertion of a particular causal chain of rules, market adjustments and effects speculative at best. Thus, the issue of embedding legal rules in their legal and political context adds significantly to the complexity of analyzing domestic rules with transnational effects. While this complexity could be expected to expand exponentially as the economic effects of the rule being analyzed moved through multiple legal and political contexts in the global economy, the analytic significance of the issue of rule embeddedness in respect to any particular rule would vary from case to case. Nevertheless, since it seems likely that embeddedness issues will arise in many cases in the transnational context, it would be prudent to remain cognizant of the potential significance of legal and political context in every case involving an analysis of the transnational effects of rules.

Related to and perhaps no less significant than the role of legal and political context in shaping the meaning, application and interpretation of legal rules, is the role of cultural expectations and local practices. Because differences in cultural expectations and local practices can have a significant impact on the way economic actors understand and respond to legal rules in particular contexts, it seems reasonable that such differences would shape not only the economic effects of legal rules but also market adjustments to those effects. Though it seems obvious, the potential for differences in cultural expectations, local practices and policy approaches to the legal rules affecting any economic activity will grow exponentially as the effects of the rules and activities expand across legal jurisdictions, cultural communities and geographic boundaries. While it would be impossible to catalog all of the myriad ways different cultural expectations and local practices might shape the transnational economic effects of rules, I will focus on three that seem particularly significant.

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<sup>159</sup> Cf. Choi & Guzman, *National Laws, International Money*, *supra* note 10, at 1857-58 (arguing that issuers and investors choose among competing national regimes for securities regulation and that regulatory competition regimes coupled with the internationalization of the securities market will result in a positive impact on the efficiency of securities markets and global welfare); Trachtman, *Unilateralism, Bilateralism, Regionalism*, *supra* note 10, at 70-75 (arguing, in the context of securities regulation, that nations look to their national policy goals and the laws of other jurisdictions to make a determination as to whether their policy goals could best be achieved through unilateral enforcement of national rules, or some form of regional or multilateral inter-state cooperation).

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The first has to do with the way in which different expectations or understandings about the baseline normative context or background rules in particular contexts can shape the transnational effects of a rule. Taking account of baseline norms and background rules involves being cognizant of the differences between societies, legal systems and cultural communities regarding what behaviors seem to be part of the basic social understanding and hence, in a sense, “go without saying” and what behaviors seem special or deviational, for which some action or declaration might be needed to signal the intention of a divergence from the expected. Sometimes these expectations might be embodied in formal legal rules and sometimes they might be perpetuated through social practices, but without investigating the particular circumstances and context, it would be a mistake to conclude that the formal rules on the books were actually the most significant norms governing economic behavior. Another way of understanding this point would be to suggest that people’s values and preferences with respect to economic decision-making may be shaped by their cultural expectations and experiences in ways that might not be apparent from a review of the applicable legal rules on the books. Because differences in cultural expectations and local practices may alter the “on-the-ground” meaning or effects of a legal rule in different geographic or cultural contexts, they may also affect the kinds of market adjustments that might be made with respect to, and ultimately the welfare effects of, the legal rule itself.<sup>160</sup>

In theory we might speculate that, in the absence of transaction costs, parties could bargain around differing cultural expectations regarding background norms by making more elaborate agreements with contingencies for different interpretations of the bargain.<sup>161</sup> As a practical matter, it is difficult to imagine the elimination of the impact of these different cultural expectations for the bargainers themselves because many of these differences and potential misunderstandings might not be visible at the time of bargaining even if they would surface later in the context of a dispute. The problem is even more complex for the policy analyst trying to assess the welfare effects of a legal rule because it would be necessary to endeavor to anticipate all the different background norms and cultural expectations relevant to bargaining among the affected constituencies as well as all of the ways in which the affected constituents would resolve those differences, both in absence and the presence of transaction costs, without the benefit of either actual bargaining or dispute proceedings that could make visible the cultural expectations or local practices that might not otherwise be apparent from a review of the formal legal rules on the books. Of course, the actual impact of cultural expectations and local practices regarding background norms on the transnational economic effects of a particular local rule, or on market adjustments to those effects, would depend on the particular circumstances of each case. But given the breadth of cultural and legal diversity in the transnational context, it seems reasonable to expect that the impact would be significant enough to merit analytic consideration in many if not most cases. At a minimum, it would

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<sup>160</sup> For a discussion of the considerations and complexities of devising a single online customer contract for use with customers in 27 countries, see Danielsen, *How Corporations Govern*, *supra* note 119, at 417-20. There is a long tradition in American legal thought of looking beyond the “law on the books” to consider the “law in action” by tracing the sociological effects of a rule. For a superb collection of essays from what came to be known as the “Law and Society” movement, see LAW AND SOCIETY: READINGS ON THE SOCIAL STUDY OF LAW (Stewart Macaulay et al., eds., 1995). For an annotated bibliography of sociological approaches to law in the United States, see THE CANON OF AMERICAN LEGAL THOUGHT, *supra* note 116, at 458-64.

<sup>161</sup> *Cf.* Coase’s suggestion that in the absence of transaction costs parties will engage in more complex contracting in order to take account of possible changes in the relative legal positions of the parties due to changes in the legal rules, COASE, THE FIRM, THE MARKET AND THE LAW, *supra* note 112, at 172-73.

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seem that the possible impact of cultural expectations regarding background norms would need to be considered if only to demonstrate a lack of significance to the particular case under study.

A second way in which differences in cultural expectations or local practices might shape the behavior of economic actors and the transnational economic effects of local rules is the way in which such differences might make it difficult for policy-makers, analysts or bargainers to see causal connections between certain rules and certain economic effects. As with different understandings of background norms, cultural differences or “blind spots” can make it difficult for constituencies to recognize the extent to which particular legal rule is affecting their economic welfare. Such a failure of recognition would in turn affect whether that constituency would react to the legal rule even if the actual economic effects of the rule on it are substantial.

This type of difficulty might commonly arise in circumstances where a certain type of social or economic activity has been traditionally governed by different normative or legal regimes in different societies, legal jurisdictions or cultural communities. For example, in some jurisdictions the legal regime most closely associated with the regulation of work by women outside the home might be anti-discrimination, labor, constitutional or human rights law; while in other jurisdictions, it might be religious, family, property or caste law. A labor economist might be able to show that relative differences in the levels of labor market participation by women in South East Asia, Western Europe, the Middle East or the United States are affecting global wage rates, productivity levels and the total value of global production. Nevertheless, affected workers, economic policy analysts and regulators might (rightly or wrongly) attribute these economic effects to different local rules or rule schemes based on the jurisdiction from which they hailed. In other words, people are likely to see both the “problem” and possible “solutions” in terms of the legal and cultural framework with which they are most familiar based upon their cultural experience.

In these circumstances, Coase’s insight regarding the reciprocal causation of economic effects by actors on one another might be helpful.<sup>162</sup> In other words, using a Coasean perspective might help us to consider the possibility that the distribution of labor market participation of women around the globe, the resulting economic effects, and the impact of those effects on global welfare, are all the product of some combination of the transnational effects of diverse national religious, anti-discrimination, family, and labor law rules, as well as adjustments by economic actors to the effects of such rules locally and globally. Nevertheless, it might be difficult for affected workers or policy-makers to recognize, for example, that religious rules in the Middle East could be shaping labor conditions for women in the West or that anti-discrimination rules in the West could be shaping labor conditions for women in the Middle East. Moreover, even if these effects could be recognized, it might be difficult to predict analytically how various affected constituencies would adjust these effects through bargaining given these cultural differences in normative expectations and approach.

Even assuming that all affected constituents and policy-makers could agree that the goal of global economic policy should be to choose the set of rules, norms and market adjust-

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<sup>162</sup> See Coase, *The Problem of Social Cost*, *supra* note 99, at 96 (asserting the reciprocal nature of circumstances where the activities of economic actors are affecting one another, “The real question that has to be decided is, Should A be allowed to harm B or should B be allowed to harm A? The problem is to avoid the more serious harm.”).

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ments that would be most likely to increase the value of total global production (probably a dubious assumption in the context in the gender equality), it would be very difficult to imagine that there would be agreement among constituents or policy-makers as to which rule(s) to adjust or which normative approach(s) (e.g. anti-discrimination, family, religion, property) should be used to achieve the shared efficiency goal given the diverse legal approaches to gender and work issues around the globe.

In these circumstances, the Coasean analytic method might be less helpful. In fact, given that a range of possible rule combinations and normative approaches might result in similar levels of increased global welfare (even if the different approaches might lead to different effects in terms of the allocation of resources and the distribution of labor market participation for women around the globe), we would have to make choices about which among the possible range of normative approaches and rule options to make the focus of economic policy review and analysis in order to use the Coasean analytic framework as a comparative policy tool.<sup>163</sup> Whether we base these choices (consciously or unconsciously) on cultural values, empirical “best guesses,” ideological preferences, or more likely some combination, neither the analytic framework itself nor the general policy goal of increasing total global welfare would enable us to escape the irreducibly normative character of the choices and the distributional consequences those choices would entail. Moreover, the possibility of cultural blind spots remains both for the economic actors that are the subject of study and for the analysts trying to study them.

The example of cultural blind spots resulting from different regulatory/cultural approaches to women and work hints at a third way in which cultural expectations and local practices might shape both the economic effects of legal rules and our methods for analyzing those effects—market actors, policy-makers (and even potentially policy analysts) might over- or under-value legal rules or regulatory approaches based on cultural familiarity or bias.<sup>164</sup> For example, familiar local rules might be valued over unfamiliar foreign ones, even if the unfamiliar rule would actually lead to an increase in total welfare. Or status quo local rules might be valued over more efficient foreign alternatives because of inertia or unjustified expectations regarding the challenges and costs of adjustment to a new rule scheme. Or in circumstances of distrust in the status quo system, local rules schemes may be significantly undervalued relative to foreign alternatives, even if the foreign rules might be mal-suited to the local legal and cultural context and lead to an overall reduction in welfare.

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<sup>163</sup> The possibility that different legal rules might be “efficient” in a particular situation while producing radically different distributional consequences for affected constituencies was articulated in the early and canonical piece of law and economics scholarship. Guido Calabresi & Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1970). Calabresi & Melamed went on to argue that if multiple, efficient rules were possible, then choosing among them was inherently normative and could not be made on the basis of efficiency criteria alone. *See id.* at 418-21. The remainder of the article is devoted to articulating a framework for guiding that choice. *See id.* at 426-42. For an important critique of Calabresi & Melamed’s choice-guiding framework and the law and economics literature their article spawned, *see* Duncan Kennedy, *Cost-Benefit Analysis of Entitlement Problems: A Critique*, 33 STAN. L. REV. 387 (1981).

<sup>164</sup> In recent years a large body of “behavioral” law and economics scholarship has emerged premised on the notion that human choice is not only determined by economic constraints, but also by endogenous preferences, background, knowledge, skills and numerous other psychological factors and constraints. For an excellent introduction to this important work, *see, generally* THE LAW AND ECONOMICS OF IRRATIONAL BEHAVIOR (Francesco Parisi & Vernon L. Smith, eds., 2005).

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The basic notion here is that culture and experience shape one's preferences, judgment and sense of value; which in turn affects one's interpretation of the meaning and impact of rules and how one responds to regulatory options and change. At the same time, a society's rules and norms, including common or informal ones, will shape the culture, experience and preferences of its members. In other words, legal rules and norms create a kind of regulatory "path dependence" in which the past shapes and limits one's understanding of the present and vision for the future in ways that may not be fully rational from an economic policy perspective.<sup>165</sup>

One possible transnational consequence of this type of cultural bias or path dependence is that economic actors, regulators and we, as economic policy analysts, may tend to over-generalize from the fact that a particular rule or regulatory regime works well in one context, to a conclusion that it will work equally well in other contexts or that regimes that seem to increase general welfare in one context will lead to increased social welfare in others. This kind of thinking can sometimes be seen in the notion that one dominant or familiar regulatory practice is, in fact, "best practice" and therefore should be adopted by others around the globe.

Two examples seem suggestive here. The first involves debates around whether a strict uniform intellectual property regime based on U.S. and European models and embodied in WTO/TRIPS Agreement is the best regime for the globe as a whole, or whether some differentiated regime of intellectual property protections attuned to different cultural conditions and levels of economic development is more likely lead to increased global welfare.<sup>166</sup> A second example involves debates surrounding whether the Anglo-American and the Eurasian approach to corporate governance should form the basis for global corporate governance reform or whether some combination of different regimes in different economic contexts is more likely to lead to increased global welfare.<sup>167</sup>

Without seeking to resolve either of these debates, the human tendency to see what is familiar as what is best seems too common to ignore for those trying to predict or measure how legal rules shape economic behavior and total production under theoretical and real world

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<sup>165</sup> Douglass North articulates the point as follows: "The interaction of beliefs, institutions, and organizations in the total artifactual structure makes path dependence a fundamental factor in the continuity of society. . . Path dependence is not 'inertia,' rather it is the constraints on the choices set in the present that are derived from historical experiences of the past. Understanding the process of change entails confronting directly the nature of path dependence in order to determine the nature of the limits to change that it imposes in various settings." NORTH, *PROCESS OF ECONOMIC CHANGE*, *supra* note 138, at 52.

<sup>166</sup> For scholars taking up this debate, *see, e.g.*, Ha-Joon Chang, *Intellectual Property Rights and Economic Development—Historical Lessons and Emerging Issues*, 2 J. HUM. DEV. 287 (2001); Amir H. Khoury, *A Neo-Conventional Trademark Regime for "Newcomer States"*, 12 U. PA. J. BUS. L. 351 (2010); Kenneth Shadlen, *Policy Space for Development in the WTO and Beyond: The Case of Intellectual Property Rights* (Global Dev't and Env't Inst. Working Paper No. 05-06 2005), available at <http://www.ase.tufts.edu/gdae/Pubs/wp/05-06PolicySpace.pdf>; Stephan, *Institutions and Élités*, *supra* note 21; Peter K. Yu, *TRIPS and its Discontents*, 10 MARQ. INTELL. PROP. L. REV. 369 (2006).

<sup>167</sup> For scholars taking up this debate, *see, e.g.*, Peter Gourevitch, *Corporate Governance: Global Markets, National Politics*, in *GOVERNANCE IN A GLOBAL ECONOMY: POLITICAL AUTHORITY IN TRANSITION* 305 (Miles Kahler & David A. Lake, eds., 2003); Rafael La Porta et al., *Investor Protection and Corporate Governance*, 58 J. FIN. 3 (2000); Rafael La Porta et al., *Corporate Ownership Around the World*, 54 J. FIN. 471 (1999); ROE, *POLITICAL DETERMINATES*, *supra* note 147, at 159-96; Ajit Singh, *The New International Financial Architecture, Corporate Governance and Competition in Emerging Markets: Empirical Anomalies and Policy Issues*, in *RETHINKING DEVELOPMENT ECONOMICS* 377 (Ha-Joon Chang, ed., 2003).

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conditions. While sensitivity to the potential difficulties and downsides of a “best practice” or “one-size-fits-all” approach to economic regulation in diverse cultural contexts with diverse traditions and market conditions has increased in recent years, it seems possible that the Coasean approach to economic policy analysis might actually exacerbate the “best practices” impulse to find a single optimal global rule scheme. This is because the Coasean approach, in its traditional form, works by comparing rules and economic effects with the aim of ranking one rule as “better” relative to another from a welfare perspective. As such, it does not seem well-suited to analyzing the global economic effects of hybrid regulatory regimes involving a combination of different rules in different contexts such as, for example, a regime that combined strict intellectual property protections in developed countries and weaker or more diverse levels of intellectual property protection in developing countries.<sup>168</sup>

In sum, in the transnational context, cultural expectations and practices regarding background rules and normative approaches along with various forms of cultural blind spots and regulatory biases may make it much more difficult to see clearly or assess accurately how particular rules might be affecting particular economic interests, or how the adverse effects of such rules might be ameliorated through market adjustments or alternative rules.

For example, cultural issues might make it more difficult for the economic policy analyst to predict accurately whether the rules will produce effects on particular constituencies of economic actors or the behavior of affected constituencies in relation to such rules. Or, they might influence the analyst’s choices regarding which rules are likely to be most significant in terms of transnational effects or which normative approach would most likely lead to an increase in total global welfare. Or, they might lead the analyst to focus too heavily on finding the best “global rule” while missing possible hybrid regulatory solutions involving combinations of rules that might lead to greater increases in global welfare than the “global rule” solution. There can be no doubt that attempting to take these cultural issues and biases into account would add immeasurably to the complexity of the Coasean economic policy analytic. Yet, the likelihood of their significance in shaping numerous local effects around the

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<sup>168</sup> By comparison, the international law and economics literature dealing with regulatory competition seems more adept at incorporating the possibility of hybrid regimes. See, e.g., Choi & Guzman, *National Laws, International Money*, *supra* note 10, at 1883-1906 (recognizing a range of possible regulatory strategies for international securities regulation including private mechanisms, national rules, cooperative agreements, a supra-national organization, but asserting that regulatory competition among national regimes and issuer choice is the best regime for global welfare); Guzman, *International Antitrust*, *supra* note 48, (arguing that while national incentives make inter-state cooperation on antitrust difficult, a cooperative global regime would be best from a global welfare perspective); Guzman, *Public Choice and International Regulatory Competition*, *supra* note 19, at 980-84 (responding to public choice critiques of the welfare-enhancing potential of international cooperation, he argues that different levels of cooperation may be appropriate for different regulatory purposes); Stephan, *Institutions and Elites*, *supra* note 21 (arguing that harmonizing the international rules governing the allocation of jurisdiction for local lawmaking would be more welfare enhancing than international intellectual property rules (like the TRIPS Agreement) or harmonized substantive rules at the national level); Stephan, *Futility*, *supra* note 48 (arguing that contractual choice of law provisions and national regulatory competition would be superior from a global welfare perspective to unified or harmonized international rules for commercial transactions). Nevertheless, while hybrid regimes are often considered, most of this scholarship points to a single, global optimal solution for each situation. For an exception, see Trachtman, *Unilateralism, Bilateralism, Regionalism*, *supra* note 10, at 117 (arguing that “multiple coexisting degrees of institutionalization” are needed to accommodate the diverse interests, needs and policy concerns of states and other constituencies in the area of securities regulation).

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global as well as the overall global economic impact of domestic rules seems too great to be ignored.

Perhaps the enormous complexity involved in actually employing the Coasean analytic method to assess the relative economic effects of legal rules in the global economy led international law and economics scholars to turn to other analytic methods, such as firm theory and comparative institutional analysis, public choice analysis and game theory. Yet, given the significant impact of different legal and political contexts and different cultural and institutional practices on the meaning and effects of national and international rules for different constituencies in the global economy, it seems likely that any economic analytic approach seeking to shed light on the actual functioning of the global legal and economic order would need to grapple with the implications of these issues and complexities. Moreover, if our economic analysis (whatever our analytic method) requires us to make choices such as: which rules system(s) or cultural practice(s) to treat as “normal” and globally generalizable and which to treat as “deviational” and hence analytically irrelevant? or whether and to what extent state regulatory or bargaining positions reflect an effective aggregation of the diverse political and cultural constituencies within states? or whether to attribute particular economic effects to a particular rule or to the background legal, political, institutional or cultural context in which the rule is situated or with which the rule interacts globally?, we must also address the normative implications and consequences of our “analytic” choices in making and justifying those choices.

In fact, the added complexity notwithstanding, one possible benefit of taking to heart the Coasean analytic aspiration to assess the actual economic effects of rules is that such an effort might make us more attentive to the possible analytic risks and policy implications of assuming similar behavioral effects and economic responses to legal rules or regimes among economic actors situated in diverse legal, political and cultural contexts. At a minimum, attempting to take Coase’s analytic aspiration seriously has helped to clarify the need to improve our analytic capacity for assessing the economic significance of institutional and cultural embeddedness, if only for the purpose of better understanding the analytic “costs” and normative implications of the various simplifying assumptions we deploy to exclude those issues for our broader account of the global legal and economic order.

### **C. The Dynamics of Regulatory Change: Bargaining Over the Rules and Adjustments**

Thus far, I have explored the analytic importance of two complex challenges to the project of devising an analytic method for assessing the transnational effects of national rules on global welfare—first, defining the scale and scope of the a rule’s effects and identifying and incorporating the interests of constituents economically affected by a rule, and second, taking account of the significance of the diverse legal and political contexts and cultural expectations and practices on the meaning and effects of a rule. Through this exploration we have also seen that while taking up these challenges would add significantly to the complexity of our analytic framework, avoiding this complexity when we know it to be a ubiquitous part of the workings of the global order could leave us deploying analytic assumptions that require justification in political, ethical or normative terms to produce what might be limited and largely unconvincing accounts of the welfare effects of rules in the global economy.

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In this section, I examine a third challenge to developing a compelling economic account of the issue of national rules with transnational effects—that of developing some analytic method for addressing the fluid dynamics of regulatory change across the global legal and economic order. Coase’s analytic method helps in this regard by drawing our attention to the dynamic potential of economic actors bargaining “in the shadow of a rule” to transform the general welfare effects of the rule itself. In this way Coase suggests that the economic effects of a rule are determined not only by the public rule-maker in creating the rule, but also by the reactions to the rule by private constituencies economically affected by it.<sup>169</sup> His analysis further suggests that the extent and content of bargaining by affected constituents in relation to a rule is always a function of the particular economic circumstances of those constituents (including the costs of bargaining itself) and therefore, an analysis of the economic effects of a rule can only be done relative to alternative legal and economic arrangements in a particular context.<sup>170</sup>

Coase’s analysis is quite helpful in illuminating the possible welfare impact of market responses by “private” economic actors to rules made by “public” actors. Nevertheless, there are several additional ubiquitous observable phenomena in the global economy that Coase’s focus on “public” rule-makers and “private” bargains does not capture. Among these is the fact that economic actors not only bargain with each other “in the shadow of the rules.” They also bargain with states (and other institutional rule-makers) over the content and the scope of enforcement of rules and create their own rules through private ordering. In addition, private actors are not the only actors that respond to the economic effects of rules. States (and other institutional rule-makers) also respond to real and anticipated adverse economic effects of foreign rules, and private reactions to those effects, through legal and institutional adjustments within their domestic regimes, as well as through bargaining with other rule-makers over the rules.

In this section, I will explore some of the reasons why incorporating these phenomena into Coase’s analytic framework is fraught with difficulties. Nevertheless, if our economic analytic framework is to capture the “real world” welfare effects of rules and rule-making in the global economy, we will need to incorporate these phenomena into our analyses or, at the very least, explore the analytic costs of failing to do so.

It is beyond dispute that economic actors frequently engage in bargaining with states and other regulatory institutions over the content and the enforcement of rules both domestically and trans-nationally. They do so through diverse mechanisms including meeting directly with heads of state, regulators and legislators, lobbying through third parties, making campaign contributions, charitable donations and bribes, making or withholding investments (or promising or threatening to do so), organizing themselves into trade associations, private standards organizations or self-regulatory institutions, funding or providing legislative or market research, interpreting rules and regulations in ways that challenge, resist or refuse compliance, requiring “stand-still” provisions in agreements with states that limit the state’s regulatory or enforcement discretion, and numerous others.<sup>171</sup>

Though Coase never addresses the possibility of bargaining over the content or enforcement of rules in his theory, one might have expected him to do so. After all, the logic of

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<sup>169</sup> See Coase, *The Problem of Social Cost*, *supra* note 99, at 97-104.

<sup>170</sup> See *id.* at 114-19.

<sup>171</sup> See *supra* note 118; see *supra* note 119.

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his analysis suggests that economic actors will seek to adjust the economic effects of rules whenever the benefits of such adjustments are greater than the transaction costs of bringing them about. Thus, as a matter of theory, we might expect economic actors to seek to affect the content, application or enforcement of a rule by bargaining with the rule-maker directly whenever the benefits of doing so would exceed the costs and the costs of doing so would be less than the costs of making market adjustments to the effects of the rule with other economic actors. Without entertaining such a possibility, it would seem difficult to explain in economic terms the literally billions of dollars spent by economic actors on rule influencing activity, from lobbying to litigation costs to campaign contributions to bribes.

Similarly, it is easy to imagine circumstances in which it would be economically rational for the “state” to bargain directly with economic actors if the costs of non-action or regulatory alternatives exceeded the costs of bargaining. Without entertaining this possibility, it would be difficult to explain economically the use of diverse state arrangements with private actors such as no-action or comfort letters, advisory and interpretive rulings, settlement agreements, tax credits or holidays, public infrastructure investments and below-market loans as a condition to private investments, regulatory stand-still provisions in investment or concession agreements and many others.

It might be possible to estimate the costs for lobbying, litigation, time, and the whole range of other costs that are incurred by economic actors in connection with trying to influence “the state” to adopt, alter or limit the effects of a legal rule, or the correlative costs of state bargains with economic actors to achieve some regulatory or economic benefit. However, entertaining the analytic possibility that states and private actors might engage in bargaining similar to the bargaining among economic actors themselves, that the “costs” of such bargaining could be analyzed as “transaction costs” which might influence public/private bargaining behavior, and that the results of such bargaining could be analyzed in transactional terms similar to “market transactions” among private economic actors, pose a host of complex issues for the Coasean analytic framework.

For example, Coase defines “transaction costs” as “the costs of carrying out market transactions.”<sup>172</sup> Thus, treating the costs associated with obtaining a change in a legal rule as “transaction costs” would seem to require that the state or local government be included as a participating “bargainer” along with non-state economic actors or firms if an actual change to a legal rule is one of the options that could be accomplished through a “market transaction” as opposed to an adjustment to the *economic effects* of a legal rule on the allocation of resources through transactions between non-state economic actors.

Further, “market transactions” as used by Coase seem to entail the exchange of factors (understood by him as “rights to perform certain actions”)<sup>173</sup> between non-state actors or “firms” in pursuit of their respective economic interests.<sup>174</sup> While the fact that firms and “the state” (or other public rule-makers) frequently bargain with each other over legal rules is a reality of modern economic life, treating such bargains as “market transactions” would seem to challenge basic micro-economic assumptions by blurring disciplinary distinctions between “public” state actors and “private” economic actors and between “market transactions” and

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<sup>172</sup> See Coase, *The Problem of Social Cost*, *supra* note 99, at 115; *see id.* at 114-19.

<sup>173</sup> *See id.* at 155 (“We may speak of a person owning land and using it as a factor of production, but the landowner in fact possesses is a right to perform certain actions.”).

<sup>174</sup> *See id.* at 114-17.

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legal rules, with the consequence of undermining any theoretical economic preference for the optimality of market-based versus rule-based allocations of resources from the standpoint of economizing efficiency.<sup>175</sup>

Moreover, if Coase had imagined that bargaining between private economic actors and “the state” over the content or effects of the legal rule being analyzed were an option, he would have needed to include that option in his analysis of every legal rule he considered in formulating his model. This is because, in the absence of transaction costs, it seems likely that affected constituencies, like homeowners and factory owners, would also bargain with the applicable regulatory authority to change the rule if doing so would be less costly than negotiating a “market transaction” with each other or that the state might bargain with the applicable constituents if doing so would be less costly than seeking a political or rule-based solution. In either case, if a public/private bargain over a rule change is less costly than a private “market adjustment,” such a bargain would increase the value of total production and hence welfare. Yet, Coase never describes this possibility in any of his examples in “The Firm, The Market, and The Law” whether he is excluding transaction costs from his analysis or taking them into account.

Perhaps one reason for this omission (aside from maintaining the clear disciplinary separation in micro-economics between the public and private realms) might be that treating “the state” as a potential bargainer in the Coasean framework would also introduce the possibility that state bargaining might be motivated by interests other than economizing the allocation of resources. Setting aside for the moment public choice concerns about whether the state is an effective aggregator of constituent interests, it seems possible, if not likely, that states would often seek to advance policy interests through bargaining that are broader than or might conflict with efficiency in the private market.<sup>176</sup> When public choice concerns are factored into the equation, we would need to consider an even broader range of possible bargaining incentives for public actors, such as maximizing their regulatory authority, or maintaining political power, or satisfying powerful constituents at the expense of total welfare and many others.<sup>177</sup>

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<sup>175</sup> Coase believed that market transactions would be more efficient than legal rules in allocating resources in a society in all circumstances except those in which high transaction costs limit economic actors from engaging in market transactions to adjust any inefficiency in the initial allocation of resources under a legal rule. He states: “In these conditions, the initial delimitation of legal rights does have an effect on the efficiency with which the economic system operates. One arrangement of rights may bring about a greater value of production than any other. But unless this is the arrangement of rights established by the legal system, the costs of reaching the same result by altering and combining rights through the market may be so great that the optimal arrangement of rights, and the greater value of production it would bring, may never be achieved.” *See id.* at 115.

<sup>176</sup> *See, e.g.,* TRACHTMAN, *THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW*, *supra* note 6, at 10, 22 (referring to bargaining between states, Trachtman states: “The assets traded in this international ‘market’ are not goods or services per se, but assets peculiar to states: components of power, or jurisdiction.” He continues, “[A]s we consider the ‘market’ among states for regulatory authority, or jurisdiction, which this work proposes as the central study of international law, we recognize that in this market, efficiency means the optimal effectiveness of regulation, where regulation is the expression of state preferences. There may be conflicts between efficiency in the private market for goods and services, and efficiency in the public market for regulatory authority.”).

<sup>177</sup> *See, e.g.,* Stephan, *Barbarians*, *supra* note 6, at 747-50 (describing public choice theory and its account of how lawmakers, in order to maintain their political power, can be induced by well-organized, insular interest groups to enact laws that benefit those groups to the detriment of society as a whole).

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It would seem, then, that taking into account the possibility of bargaining with “the state” over the rules in a Coasean policy analysis would require a substantial revision of the basic assumptions of the model, including the basic micro-economic distinction between public regulatory activity and private economic activity. Further, such revisions might pose a significant challenge to the model’s purpose as a framework for measuring the relative economic effects of legal rules and transaction costs on the workings and efficiency of the economic system as a whole by blurring the distinction between legal rules and transaction costs and between market allocations and rule allocations of resources in the economy.<sup>178</sup>

Including public choice insights in our analysis could help to flesh out some of the motivations (in addition to economizing efficiency) that might be at work in state and sub-state regulatory and bargaining activity. Nevertheless, even public choice analysis seems to rest on maintaining a relatively clear distinction between private economic activity and public regulatory activity, even when seeking to theorize the capture of public regulatory capacity by powerful private constituencies. Yet, if public/private bargaining over the rules is an ubiquitous aspect of global economic life, then basing our analytic methods on the maintenance of a clear analytic distinction between “public” regulatory activity and “private” bargaining may come at the expense of an ability to capture the actual economic significance of public/private bargaining for the global legal and economic order.

A second challenge for taking account of the dynamic nature of regulatory change in the global economy is the possibility of legal and institutional adjustments. As already suggested, the Coasean economic policy framework encourages us to be attentive to market adjustments by private parties to the economic effects of legal rules. As we have seen from our discussion of public/private bargaining over the rules themselves, market adjustments are only one type of adjustment that might take place in relation to the economic effects of a legal rule. In addition, it seems probable that public authorities would seek to adjust or ameliorate the “harmful effects” of a foreign legal rule by making adjustments in their own rules or institutional practices.

Like rule embeddedness, the challenge of adjustments arises from the fact that legal rules are situated with and operate in relation to other rules and institutions, but the focus here is on the ways that an initial allocation of resources resulting from a legal rule can be enhanced, ameliorated, reduced or nullified by changes or shifts in other rules or institutional practices in the system. An example of this kind of adjustment comes from the commonly observed phenomenon in the trade context that as tariff rates have declined under the WTO/GATT regime, states have sought to protect their domestic industries from foreign competition through the proliferation of non-tariff barriers to trade.<sup>179</sup> The simple point here is that states often respond to the adverse effects of rules in one part of the regulatory system by changing their rules and practices in others. In this sense, rules affect rules, and are adjusted

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<sup>178</sup> See, e.g., *id.*

<sup>179</sup> See, e.g., JOHN H. JACKSON, *THE WORLD TRADING SYSTEM: LAW AND POLICY OF INTERNATIONAL ECONOMIC RELATIONS* 154 (2d ed. 1997) (noting, with respect to non-tariff barriers to trade, the “ingenuity of man to devise various and subtle as well as explicit ways to inhibit the importation of competing goods is so great that any inventory of such measure quickly becomes quite large.”); Brian Alexander Langille, *General Reflections on the Relationship Between Trade and Labor (Or: Fair Trade is Free Trade’s Destiny)*, in *FAIR TRADE AND HARMONIZATION PREREQUISITES FOR FREE TRADE? VOLUME 2: LEGAL ANALYSIS* 235-36 (Jagdish Bhagwati & Robert E. Hudec, eds., 1996) (describing the shift in the focus of international trade regulation from tariffs to non-tariff barriers as the trade regime effectively eliminated tariffs as barriers to trade).

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dynamically not only as a result of negotiations among public interests in ways we might model through public choice theory, but also in an iterative relationship to private interests, whose bargaining we model in market terms.

To make this issue more concrete in the context of domestic rules with transnational effects, let us return to the example of the hypothetical change in the Delaware business judgment rule. In the first section of this Part, we explored ways in which economic actors could adjust to the effects of the initial Delaware business judgment rule or the proposed alternative rule through bargaining. In order to fully assess the impact of the proposed rule change on total welfare, we would need to anticipate the likelihood and costs of regulatory and institutional adjustments in addition to assessing the effects of these possible “market adjustments” to the rules. Examples of possible regulatory or institutional adjustments might include some or all of the following. Because of the disproportionate adverse impact a change in the Delaware business judgment rule might have on the State of Delaware (even if the change significantly enhanced welfare globally), Delaware might respond by combining the change in the business judgment rule with an increase in indemnification rights for board members of Delaware companies or a total cap on damages for grossly negligent business judgments. Either of these additional rule changes would or could have the effect of blunting or altering the effects of the change in the Delaware business judgment rule and thus, the economic effects of that change both locally and globally.

For example, by reducing the likelihood of personal liability judgments under the new business judgment rule, these related rule changes might also limit the impact of the new business judgment rule on the decisions of Delaware boards, including decisions to respond to the rule by reincorporating in another jurisdiction to avoid the rule or to put pressure on the Delaware legislature by threatening to do so. Such decisions might reduce the economic impact of the rule on Delaware and change the bargaining behavior of affected Delaware constituencies in respect to the original rule and the proposed alternative. The reduced likelihood of personal liability under the new rules might also limit the impact of the rule change on risky decisions with respect to worker safety or environmental issues made by Delaware corporate managers in respect to foreign operations. This, in turn, might limit the beneficial effects of the rule change for workers and farmers in developing countries where Delaware multinationals do business and hence, their willingness to bargain for adjustments to the original rule or the proposed alternative business judgment rule. In either case, it would seem that the regulatory adjustments by Delaware to ameliorate the disproportionate adverse effects of the proposed change in the business judgment rule would alter the economic effects of the rule change both locally and globally.<sup>180</sup>

Alternatively, Delaware might ameliorate or reduce the overall economic impact of a change in the business judgment rule through changes in institutional practices rather than the adoption of new rule(s). For example, the Delaware courts might interpret the change in the business judgment rule very narrowly to reduce the number and range of cases likely to pro-

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<sup>180</sup> It seems possible to imagine that affected constituencies might now bargain to adjust through market transactions the Delaware regulatory adjustments and/or that the Coasean policy analyst might imagine, in theory, that in the absence of transaction costs, parties would expand bargaining to adjust all the rules to maximize the total value of production, but to do so would seem to require both affected constituencies and the Coasean analyst to anticipate and account for the likelihood and impact of new regulatory and institutional adjustments to adjust for the prior adjustments, and so we are back where we started, with the challenge of adjustments asserting itself at a new level in the bargaining or analytic process.

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duce liability under the new rule. Or they might imply a threshold “economic impact” requirement for shareholder standing to bring a fiduciary duty suit under the new rule and thereby reduce the number of cases that might be brought with respect to business decisions that adversely impact the health or environmental welfare on a far away constituency but have little economic impact on the bottom line of the corporation. Or they might refuse to enforce foreign court judgments finding management liability under the new rule, thereby increasing the costs and reducing the number of cases by effectively forcing foreign litigants to bring their law suits in Delaware or the U.S.

Each of these changes in institutional practice might be the result of conscious state policy or of uncoordinated activities by actors in the institutional machinery of Delaware. Nevertheless, as with the rule adjustments described earlier, these changes in institutional practice might also have an impact on the scope and meaning of the revised Delaware business judgment rule on the allocation of resources the rule might produce both locally and globally, and on the nature and likelihood of market adjustments to the original business judgment rule or the proposed alternative rule.

Regulatory and institutional adjustments to a change in the Delaware business judgment rule might also take place among affected constituencies other than Delaware. For example, developing states seeking to attract more foreign investment from Delaware multinational corporations might limit or revoke local liability rules so that courts (in Delaware or elsewhere) would be less likely to find the behavior of Delaware managers “grossly negligent” under the new business judgment standards. Delaware corporations operating world-wide might change their internal deliberation or reporting practices to make their decision-making less transparent, or they might seek to bolster board decisions with opinions from non-board experts to create a reliance defense to gross negligence allegations, or they might reincorporate in other jurisdictions to avoid the rule change, or they might threaten to do so in the hope of provoking Delaware to change or adjust the rule or its mode of enforcement.

The point is that the transnational effects of a domestic rule are not static—each effect will elicit counter-effects, shifts and adjustments, not only through bargaining in the market, but also through adjustments to other legal rules and institutional practices across the global system. These dynamic regulatory and institutional adjustments will, in turn, shape the impact of the rule on the behavior of affected economic constituencies across the globe, including the market adjustments that they might make to the effects of the rule, and ultimately the effects of the rule on global welfare. If this is an accurate characterization of global regulatory processes, then a decision to stabilize the system for analytic purposes with an assumption of “fixed” legal entitlements at a particular moment in time will affect not only the character of the adjustments we treat as significant, but also the “initial” allocation of resources and entitlements against which adjustments are measured. Once again we can see that the implications of these analytic choices are also normative and therefore contestable on normative as well as analytic grounds.

If regulatory and institutional adjustments are like market adjustments, a reasonably common if not prevalent mode of reaction by other jurisdictions to the transnational effects of foreign rules, we will need to find a means for anticipating and incorporating the economic impact of these adjustments in our analysis. Coase suggests that in the absence of transaction costs, parties would address the possibility of changes in the legal rules applicable to their

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economic activity through the negotiation of more elaborate bargains.<sup>181</sup> It seems possible to imagine that parties might seek to address dynamic regulatory and institutional adjustments similarly through elaborate provisions regarding various adjustment contingencies. But even if such elaborate bargains were possible in theory, they would seem to require a level of clarity as to initial resource allocations, market adjustments, and the positions and calculations of other parties in response to such adjustments, including regulators and institutional actors adjusting to the results of bargaining, that other parts of this analysis have put into question. Moreover, even if one assumes that such elaborate bargaining takes place in the absence of transaction costs, it would be quite difficult if not impossible as an analytic matter to model and predict the outcomes of such complex and elaborate bargaining or the economic effects of the underlying rule itself on total welfare.

Under such circumstances, it would seem that the most we could hope to achieve through this type of Coasean welfare analysis of a legal rule would be to identify one of the numerous possible alternative allocations of resources that might emerge from such complex market, regulatory and institutional adjustment processes based on a particular set of assumptions regarding those adjustments. Moreover, it would be difficult to assert that a particular allocation of resources would be more welfare-enhancing than another one based on different assumptions, without some normative criteria for preferring one to the other—criteria which the analysis itself cannot provide.

The case for the significance of the legal and institutional adjustments to a Coasean economic policy analysis is even more compelling when transaction costs are included in the analysis. Imagine an economically significant jurisdiction decided to lower its maximum corporate tax rate. Neighboring or even far away jurisdictions competing for corporate investment might respond to this reduction by making a similar adjustment in their own corporate tax rate or by creating alternative tax schemes to equalize or limit the benefits of the foreign rate reduction, or by offering tax abatements, rebates, holidays or other compensating subsidies to lure corporate investment that might otherwise have been attracted to the other jurisdiction by the lower tax rate.

In reaction to the original rule reducing the domestic corporate tax rate and the regulatory and institutional adjustments to that rule, affected economic actors might adjust their local, regional or transnational corporate structures to minimize their total corporate tax liability. Or they might choose to invest in the jurisdiction with the lower corporate rate or threaten to disinvest from jurisdictions with higher or different tax rates in the hope of receiving incentives, abatements or other compensating adjustments. Or they might play jurisdictions off one another to obtain the most favorable deal. Or they might reorganize their corporate functions, transfer pricing or flow of payments to ameliorate the effects of the lower rate for competitors operating in the lower rate jurisdiction.

As we try to flesh out just a few of the numerous possible actions and reactions to the initial rule and regulatory and institutional adjustments to the initial rule, we can quickly see how the costs associated with these adjustments by both public and private actors could have a significant impact on the behavior of economic actors and regulators as well as the transnational effects of the initial rule on global welfare. While the initial tax rate reduction might appear to increase global welfare when attention is focused on its impact on the costs of production for local players, it may, in fact, result in a reduction of total global welfare once

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<sup>181</sup> COASE, *THE FIRM, THE MARKET AND THE LAW*, *supra* note 112, at 172-73.

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the additional costs of regulatory and institutional adjustments (including the reactions of market actors to such adjustments) are factored into the analysis.

Even if it were only infrequently the case that the inclusion of regulatory and institutional adjustment costs could completely alter the global welfare effects of a domestic rule, it seems likely that such adjustments would quite frequently be sufficient to affect the costs and bargaining associated with a domestic rule in ways that would alter the global allocation of resources among constituencies affected by the rule. Therefore, developing an analytic method for better accounting for these institutional and regulatory adjustments would be desirable to the extent it helped us to get a more accurate picture of the transnational welfare effects of rules.

Thus far, we have seen the ubiquity of bargaining between states (or rule-makers) and between rule-makers and economic actors over the rules, and of regulatory and administrative adjustments by rule-makers to the adverse effects of foreign rules and economic activity, in the global legal and economic order. At the same time, we have seen that assimilating these phenomena into a Coasean approach to economic policy analysis is quite difficult for several reasons.

First, treating the “public” rule-maker as a potential “bargainer” over the rules introduces the possibility of bargaining criteria other than economizing into the analysis. For example, it seems likely that rule-makers would be willing to trade off some degree of efficiency in the allocation of resources for the attainment of other policy goals, such as distributional equity or protecting a vulnerable (or powerful) constituency or preserving the rule-maker’s own power. Consequently, predicting bargaining behavior and possible bargains among affected constituencies (now rule-makers and economic actors in various combinations) even in the absence of transaction costs, would be quite difficult and require a great deal of knowledge about the particular political or policy goals of the rule-maker/bargainers and a normative mechanism for weighing these concerns in relation to more traditional economizing ones, such as reducing costs and maximizing returns.

Second, the possibility that bargained-for adjustments might be based on criteria other than economizing problematizes the Coasean conclusion that in the absence of transaction costs, bargained-for adjustments would necessarily enhance welfare by increasing the value of total production. While it is reasonable to expect that some rule-adjusting bargains would increase total welfare; it seems likely that others would reflect more complex calculations of “welfare gains” in which the public and private bargainers would conclude bargains that they all deemed beneficial, even if the total value of production remained unchanged or decreased. In such circumstances, in addition to expanding our analytic inputs to include possible bargaining criteria beyond economizing, we would need to expand the conception of “total welfare” against which we measured the outputs of our analysis to include criteria other than the maximization of the value of total production. Alternatively, we would need to generate normative arguments for why the exclusion of such other welfare criteria would be justifiable or appropriate in circumstances where we could reasonably expect those criteria to shape the bargains made by affected constituencies with regard to the legal rule we were analyzing.

Third, in a world that includes both “public” and “private” bargainers and “public” and “private” rule-makers, it becomes much more difficult to distinguish in any meaningful way between “market adjustments” and “rule adjustments.” While Coase acknowledged that under conditions of high transaction costs, rule adjustments could sometimes approximate the

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maximization of total welfare, he used price theory to argue that market adjustments by private parties were more likely to result in an efficient allocation of resources than state adjustments to the legal rules in most circumstances.<sup>182</sup> Yet, it becomes much more difficult to maintain any general theoretical preference in favor of market adjustments over rule adjustments either on efficiency or welfare grounds, once we incorporate into our analysis the possibilities of public/private bargaining over the content as well as the economic effects of the rules. This is because economizing may not be the only basis for bargaining among public and private actors, and bargains struck may result in adjustments to the rule itself or to the allocation of resources in relation to the rule.

Finally, when we consider the possibility that, in addition to bargaining with economic actors, public rule-makers adjust the adverse economic effects of foreign rules by making changes in their domestic rules or administrative practices or by bargaining with other rule-makers to induce adjustments in the foreign rule, the number of variables that would need to be incorporated into our analysis in order to account for the full range of dynamic adjustments that we might reasonably expect to occur with respect to legal rules in the global economy would increase significantly, whether in the presence or the absence of transaction costs. All this added complexity might lead to the conclusion that even a modified Coasean analytic framework may become either too speculative or too indeterminate to be useful for assessing the transnational economic effects of domestic rules. On the other hand, the usefulness of the Coasean analytic would need to be assessed in relation to available alternatives. Moreover, the benefits of any simplifying assumptions that reduced analytic complexity would need to be measured in relation to the potential adverse consequences of their use.

International law and economics scholars from both the First and the Second Strands have grappled with some of these phenomena. For example, as to the issue of inter-state bargaining, some First Strand scholars have sought to illuminate the motivations and global welfare risks of inter-state cooperation through public and rational choice analyses,<sup>183</sup> while others have explored the high transaction costs of complex inter-state bargains and sought to articulate doctrinal or institutional alternatives that would reduce transaction costs and increase welfare through comparative institutional analysis and firm theory.<sup>184</sup>

Some Second Strand scholars have sought to use transaction cost economics or public choice theory to explain when inter-state cooperation through more or less formal means might be desirable from a global welfare point of view,<sup>185</sup> while others have argued that inter-state bargaining might be usefully explained as transactions for regulatory power in a global market for jurisdictional authority.<sup>186</sup> While all of these approaches are useful to explain and predict state bargaining behavior with respect to the economic effects of legal rules in the global economy, they seem less helpful for illuminating the impact on global welfare of private adjustments to the economic effects of domestic rules, or for analyzing the impact of

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<sup>182</sup> See, *supra* note 175.

<sup>183</sup> See, e.g., Stephan, *Accountability and International Lawmaking*, *supra* note 6 (public choice); GUZMAN, *HOW INTERNATIONAL LAW WORKS*, *supra* note 6 (rational choice).

<sup>184</sup> See, e.g., Aceves, *Transaction Cost Economics and State Practice*, *supra* note 6 (transaction cost theory); Trachtman, *The Firm and International Economic Organization*, *supra* note 6 (firm theory and comparative institutional analysis).

<sup>185</sup> See, e.g., Guzman, *Choice of Law*, *supra* note 21 (transaction costs analysis); Stephan, *Futility*, *supra* note 48 (public choice theory).

<sup>186</sup> See, e.g., TRACHTMAN, *THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW*, *supra* note 6, at 10.

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public/private bargains over national and international rules on the likelihood, scope or nature of inter-state cooperation.

Some First and Second Strand scholars have also sought to theorize the proper role of private economic actors in shaping the global legal order. For example, some First Strand scholars argue that global welfare could be improved if “command-and-control” regulatory strategies gave way to legal rules that reflected actual international business or state practice.<sup>187</sup> Others argue that legal mechanisms that facilitate regulatory competition and party choice would improve global welfare in some circumstances by enabling economic actors to choose the regulatory framework best suited to their needs.<sup>188</sup>

Further, some Second Strand scholars have sought to engage the significance of private ordering in the global economy by arguing that global welfare would be improved by the creation of jurisdictional rules that more clearly defined the boundaries between public regulatory jurisdiction and private freedom of action.<sup>189</sup> These analytic approaches illuminate some of the ways private actors could (or, in the view of some authors, should) shape the global legal order to increase global welfare. They seem less useful, however, for helping us to distinguish analytically “public” rules from “private” transactions when the rules themselves may be the result of public/private or private/private bargains. Moreover, these approaches seem susceptible to the same normative choices and challenges that plague the Coasean framework when attempting to weigh analytically the “economic” bargaining criteria of private actors and the “political or policy” criteria of states, or to determine by what standard of “welfare” we should measure effects of the public/private bargains struck.

First and Second Strand scholars also have tried to address some aspects of the issue of adjustments by states to the changing and unanticipated consequences of rules. For example, some First Strand Scholars have used transaction costs analysis to assess the costs and limits of managing this issue through more complex state bargains.<sup>190</sup> Others have sought to model the dynamics of state behavior by hypothesizing complex, multi-part games.<sup>191</sup>

Second Strand scholars have sought to address this issue by exploring international mechanisms for limiting extra-territorial assertions of jurisdiction and managing jurisdictional conflicts when they arise, perhaps on the theory that state adjustments become less significant internationally if their effects are mostly contained territorially.<sup>192</sup> While these First Strand approaches can be helpful in explicating state behavior in negotiations over a particular rule or issue, they do not attempt to account for the possibility that states may alter the effects or significance of their inter-state bargains outside the negotiating context by altering other domestic rules or institutional practices. Moreover, these First Strand approaches tend not to consider the possibility that states often do not speak with one voice—while one branch may be negotiating a rule, another may be altering the new rule’s effects by adjustments in the broader scheme of rules with which the new rule interacts or in the administrative practices

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<sup>187</sup> See, e.g., Cooter, *New Law Merchant*, *supra* note 6 (business practice); Aceves, *Transaction Cost Economics and State Practice*, *supra* note 6 (state practice).

<sup>188</sup> See, e.g., Choi & Guzman, *National Laws, International Money*, *supra* note 10.

<sup>189</sup> See, e.g., Choi & Guzman, *Portable Reciprocity*, *supra* note 21; Stephan, *Institutions and Élites*, *supra* note 21.

<sup>190</sup> See, e.g., Aceves, *Transaction Cost Economics and State Practice*, *supra* note 6.

<sup>191</sup> See, e.g., Mock, *Game Theory and International Relations*, *supra* note 6.

<sup>192</sup> See, e.g., Choi & Guzman, *Dangerous Extraterritoriality*, *supra* note 21; TRACHTMAN, *THE ECONOMIC STRUCTURE OF INTERNATIONAL LAW*, *supra* note 6, at 26-31.

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through which the rule is interpreted or applied. At the same time, Second Strand approaches based on territorial sovereignty and jurisdictional rules may be helpful for thinking about the welfare consequences of the formal extra-territorial application of rules. Yet, they seem less helpful in analyzing those situations where the transnational effects of domestic rules are the result of private economic activity rather than sovereign intention.

Perhaps our exploration of the issue of dynamic adjustments has left us with more questions than answers. Examining the challenges of using a Coasean economic policy framework to analyze the global welfare effects of domestic rules did focus attention on different aspects of the dynamics of regulatory change in the global economy than the ones that have been the focus of international law and economics scholarship to date—aspects such as public/private bargaining over the rules and the possibility of legal and institutional adjustments by public actors in addition to market adjustments by private actors. Given the significance of these new aspects for the operation of and the allocation of resources in the global legal and economic order, we will need to find ways to take them into account. Doing so may lead us to move away from assumptions common among international law and economics scholars like assuming that public bargaining over regulatory policy can be analogized to private bargaining in a market for goods and services or that public and private actors inhabit alternate worlds. At the same time it may require us to move toward more complex and uncertain analytic postures and more explicit normative commitments. In fact, if our exploration of the challenges of incorporating these aspects into a Coasean analytic framework is any guide, contemplating a more fluid separation between “public” regulatory activity and “private” economic activity may challenge us to rethink many of our disciplinary assumptions and to engage more directly with the political and normative implications of our analytic choices than we have to at this point.

### **5. TOWARD A MORE COMPREHENSIVE APPROACH TO INTERNATIONAL LAW AND ECONOMICS**

In today’s global economy, we need to enhance our ability to evaluate legal rules from the perspective of their impact on global welfare. A better understanding of the impact of legal rules on global welfare could help both to explain the role of law in shaping the distribution of resources in the global economy and to develop the legal tools needed to bring about more just and equitable results. Scholars working in the emerging field of international law and economics have contributed a great deal to our understanding of the workings of the global legal and economic order. Their work has been particularly helpful in exploring the relative merits of different institutional levels and forms of rule-making and of different regimes for allocating jurisdictional authority and managing conflicts among sovereigns in an increasingly interdependent global economy.

This work has provided fewer insights for assessing the transnational welfare effects of domestic rules. A better understanding of the ways in which diverse domestic rules shape the allocation of resources, economic opportunity and welfare in other parts of the globe would significantly enhance our broader understanding of the structure and functioning of the global legal and economic order. Therefore, I have proposed that we should expand the scope of international law and economics research to include this issue as a focus of study. Perhaps more importantly, however, examining the analytic and normative difficulties of attempting such an expansion has helped to illuminate some broader challenges that we face in adapting our international law and economics frameworks and habits of mind to better capture the

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dynamic complexity and diversity of the role of law in global economic life. While the challenges are many, I will focus on two which this essay has brought into focus.

First, we need better and more refined analytic tools for engaging with the real complexity of law in the global economy. We have seen the challenge of complexity in variety of forms—from assessing the scope of a rule’s effects, to identifying the interests that might be affected by a rule, to accounting for the diverse legal, political and cultural contexts that may shape the meaning and economic effects of a rule in different places, among different constituencies and for the globe as a whole, to conceptualizing the range and dynamic nature of market and institutional adjustments among public and private actors that not only respond to but transform the meaning and effects of the rule in the global economy. When we take seriously the fact that sometimes a rule’s global economic effects are not primarily a function of either sovereign intention or sovereign application, we draw into question our notions of sovereign territory as a general limit on the scope of domestic rules, sovereign rule-making as a reflection of constituent preferences and inter-state competition and bargaining as the principle ordering mechanism for the global economy. Similarly, when we take seriously the ubiquity of public/private bargaining over rules and private rule-making in the global order, we blur common economic distinctions between the state and the market, the regulator and the regulated, and market allocations and rule allocations of resources. While the fact that these ideas and distinctions lie some distance from reality is hardly news, relaxing our attachment to them may have significant implications for our analytic models which often rely on them even as we recognize their frequently counter-factual character. As each of these ideas and distinctions play an important role in much of international law and economic scholarship, reconsidering the implications of our use of them both for the research questions we pose and for the analytic models we deploy is a project worth undertaking.

A second and related challenge is the need for better and more refined tools for assessing the normative character and stakes of the choices and assumptions implicit in our analytic frameworks. Using an economic policy framework to assess the welfare effects of rules in a global context requires a number of choices among possible assumptions which must be based on criteria we cannot derive from the framework itself. While it is customary (if not always observed in practice) to acknowledge assumptions and justify them on analytic grounds, it is much less common to acknowledge the normative character of one’s choice of analytic assumptions and to justify them as such. Nor do we investigate with sufficient frequency the possible normative costs of particular assumptions relative to others. These omissions are not the result of a lack of awareness that there *are* choices, costs and consequences. Rather, our frameworks of analysis and habits of mind make it difficult to conceive of ways in which these choices, costs and consequences might be usefully taken into account without limiting the scope of our theoretical claims or undermining the scientific character of our analyses.

One way we might begin to engage the challenges of complexity and normativity in our work would be to subject our choices regarding analytic methods and assumptions to the kind of rigorous inquiry that that we might apply to discerning the determinants of institutional choice in other spheres. When we use terms like “individual,” “investor,” or “state,” what are the characteristics (psychological, political, historical, cultural, institutional) that we invoke with these abstractions? How do those characteristics shape the kinds of choices we expect these actors to make in particular circumstances, and what are the normative implications of generalizing those characteristics as opposed to others in our analyses? Analyzing

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with more precision what we mean when we deploy terms such as these in a diverse global context seems no less important to our understanding of global economic processes than Coase's admonition that we give substantive content to such widely deployed economic concepts as the "consumer," the "firm" and the "market."<sup>193</sup>

Moreover, we might explore the normative (as opposed to the analytic) consequences of assuming states efficiently aggregate their constituents' preferences when for most of the world's population, anything remotely resembling accountable, representative government is a distant dream. Or we might examine how our assumptions about the structure of rational decision-making and the given and fixed nature of individual or state preferences might limit our ability to account for the dynamic role of institutions and institutional change in shaping preferences or of the range and diversity of factors that shape how choices are perceived and made in different cultural, political and economic contexts.<sup>194</sup>

A serious and continuing engagement with these types of questions, many of them reformulations of the types of questions that brought "new institutional economics" into being in the first place, will challenge our established analytic practices and modes of thinking, and introduce new levels of theoretical uncertainty and normative controversy into our work. This may seem like a set-back, perhaps as the turn to institutional economics may have seemed like a set-back for more orthodox economists in the past. Yet such uncertainty and controversy may be a necessary and productive component of engaging more directly and realistically with the global legal and economic order.

In doing so, we might again seek guidance from institutional economics, both in its more historic incarnations and in emerging streams in its current ones. We might, for example, look with fresh eyes on the work of "old institutional economists" such as Thorsten Veblen, Clarence Ayers, Westley Michell and John Commons, as well as work building on these forebears by scholars such as Alan Gruchy, Wendall Gordon, Warren Samuels, A. Allan Schmid and Marc Tool.<sup>195</sup> While the insights and methods of "old institutional economics"

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<sup>193</sup> See COASE, *THE FIRM, THE MARKET, AND THE LAW*, *supra* note 112, at 3 ("The preoccupation of economists with the logic of choice, while it may ultimately rejuvenate the study of law, political science, and sociology, has nonetheless had, in my view, serious adverse effects on economics itself. One result of this divorce of the theory from its subject matter has been that the entities whose decisions economists are engaged in analyzing have not been made the subject of study and in consequence lack any substance. The consumer is not a human being but a consistent set of preferences. The firm to an economist, as Slater has said, 'is effectively defined as a cost curve and a demand curve, and the theory is simply the logic of optimal pricing and input combination.' Exchange takes place without any specification of its institutional setting. We have consumers without humanity, firms without organization, and even exchange without markets.") (internal citations omitted). While "new institutional economics" has enhanced our attention to these issues, Coase's words still resonate and we might consider his challenge anew as we deploy economic concepts at the global level.

<sup>194</sup> See *NORTH*, *supra* note 138 (questioning the continuing utility of rational choice assumptions in social science research). Cf. COASE, *THE FIRM, THE MARKET, AND THE LAW*, *supra* note 112, at 3-4 ("The rational utility maximizer of economic theory bears no resemblance to the man on the Clapham bus or, indeed, to any man (or woman) on any bus. There is no reason to suppose that most human beings are engaged in maximizing anything unless it be unhappiness, and even this with incomplete success.").

<sup>195</sup> Examples of some very useful attempts at such a reassessment of "old institutional economics" include GEOFFREY M HODGSON, *ECONOMICS AND INSTITUTIONS* (1988); PEARSON, *ORIGINS OF LAW AND ECONOMICS*, *supra* note 4; RUTHERFORD, *INSTITUTIONS IN ECONOMICS*, *supra* note 11. For work by Veblen, *see, e.g.*, THORSTEIN VEBLEN, *THE PLACE OF SCIENCE IN MODERN CIVILIZATION* (Cosimo Classics ed. 2007); THORSTEIN VEBLEN, *THE THEORY OF THE BUSINESS ENTERPRISE* (Scribner's Sons ed. 1915). For work by Ayers, *see, e.g.*, CLARENCE AYERS, *THE THEORY OF ECONOMIC PROGRESS* (2d ed. 1962); Clarence Ayers, *The Nature and*

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have often been dismissed by “new institutionalists,” the diverse attempts by “old institutional economists” to deal with complexity, particularity, culture, history, values, ideology, psychology and the role of social systems and institutions in shaping individual preferences may prove a rich source of “new ideas” for engaging more directly with the complexity and diversity of actors and institutions that comprise the modern global economy.<sup>196</sup>

We might also look to those “new institutional economists” who have been calling for a broader and more comprehensive approach. I have in mind here scholars like Thrainn Eggertson, Alexander Field, Avner Greif, Gary Libecap and Douglass North.<sup>197</sup> In his 2005 book “Understanding the Process of Economic Change,” Douglass North provides a provocative image of what such an expanded approach might entail:

What kind of a theoretical framework must we develop to understand the process of economic change? The theory we possess is static; and while a truly dynamic theory may be beyond our reach we can incorporate the dimension of time as an integral part of our analysis. . . . Economics is a theory of choice—so far so good. But the discipline neglects to explore the context within which choice occurs. We choose among alternatives that are themselves constructions of the human mind. Therefore how the mind works and understands the environment is the foundation of this study. But what is the environment? This human environment is a human construct of rules, norms, conventions, and ways of doing things that define the framework of human interaction. . . . Moreover, we must understand what is the underlying force driving the constructs the mind makes. Why do rules, norms, conventions, and ways of doing things exist? What induces the mind to structure human interaction in this way? The

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*Significance of Institutionalism*, 26 ANTIOCH REV. 70 (1966); Clarence Ayers, *Fifty Years Developments in Ideas of Human Nature and Motivation*, 26 AMER. ECON. REV. 224 (1936). For work by Wesley Mitchell, *see, e.g.*, WESLEY C. MITCHELL, BUSINESS CYCLES: THE PROBLEM AND ITS SETTING, STUDIES IN BUSINESS CYCLES No. 1 (1927); WESLEY C. MITCHELL, THE BACKWARD ART OF SPENDING MONEY AND OTHER ESSAYS (1937); 1-2 WESLEY C. MITCHELL, TYPES OF ECONOMIC THEORY (Joseph Dorfman, ed., 1969). For work by Commons, *see, e.g.*, JOHN R. COMMONS, THE LEGAL FOUNDATIONS OF CAPITALISM (1924); JOHN R. COMMONS, INSTITUTIONAL ECONOMICS: ITS PLACE IN POLITICAL ECONOMY (1934); John R. Commons, *Law and Economics*, 34 YALE L.J. 371 (1925). For work by Gruchy, *see, e.g.*, ALLAN G. GRUCHY, CONTEMPORARY ECONOMIC THOUGHT: THE CONTRIBUTION OF NEO-INSTITUTIONAL ECONOMICS (1972); ALLAN G. GRUCHY, THE RECONSTRUCTION OF ECONOMICS (1987); ALLAN G. GRUCHY, MODERN ECONOMIC THOUGHT: THE AMERICAN CONTRIBUTION (1987). For work by Gordon, *see, e.g.*, WENDELL GORDON, INSTITUTIONAL ECONOMICS (1980). For work by Samuels and Schmid, *see, e.g.*, LAW AND ECONOMICS: AN INSTITUTIONAL PERSPECTIVE (Warren J. Samuels & A. Allan Schmid, eds., 1981). For work by Tool, *see, e.g.*, MARK R. TOOL, ESSAYS IN SOCIAL VALUE THEORY: THE NEOINSTITUTIONAL ALTERNATIVE (1986); Mark R. Tool, *A Social Value Theory in Neoinstitutional Economics*, 11 J. ECON. ISSUES 823 (1977).

<sup>196</sup> *See* RUTHERFORD, INSTITUTIONS AND ECONOMICS, *supra* note 11, at 1-4.

<sup>197</sup> For work by Eggertsson, *see, e.g.*, THRAINN EGGERTSSON, ECONOMIC BEHAVIOR AND INSTITUTIONS (1990). For work by Field, *see, e.g.*, Alexander J. Field, *On the Explanation of Rules of Using Rational Choice Models*, 13 J. ECON. ISSUES 49 (1979). For work by Greif, *see, e.g.*, Avner Greif, *Cultural Beliefs and the Organization of Society: A Historical and Theoretical Reflection on Collectivist and Individualist Societies*, 102 J. POL. ECON. 912 (1994). For work by Libecap, *see, e.g.*, GARY D. LIBECAP, CONTRACTING FOR PROPERTY RIGHTS (1989); Gary D. Libecap, *Review of Douglass C. North, Institutions, Institutional Change and Economic Performance*, 30 J. ECON. LIT. 221 (1992). For works by North, *see, e.g.*, DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE (1990); NORTH, THE PROCESS OF ECONOMIC CHANGE, *supra* note 138.

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new institutional economics (NIE) takes us part-way. . . . [T]his book explores what drives humans to undertake these artificial constructs and then develops and expands on the tools of the NIE to provide a framework for explicitly exploring the nature of economic change.<sup>198</sup>

The challenges of undertaking such a broad research agenda on a global scale are truly daunting. Yet, if we are to begin to incorporate the complexity and diversity we see all around us into our analyses of law in the global economy, we must endeavor to try.

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<sup>198</sup> NORTH, UNDERSTANDING THE PROCESS OF ECONOMIC CHANGE, *supra* note 138, at 11.

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