A Defense of the Transactions Costs Approach to Understanding International Institutions

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“Why should it be worthwhile to construct regimes (themselves requiring agreement) in order to make specific agreements within the regime frameworks? Why is it not more efficient simply to avoid the regime stage and make agreements on an ad hoc basis? In short why is there any demand for international regimes apart from a demand for international agreements on particular questions?” Robert O. Keohane (1982, p. 334)

Introduction

1984 marked the publication of Robert Keohane’s monumentally important book *After Hegemony*, which was preceded two years earlier by an article version of the argument in a well-known edited volume of *International Organization*. The main points of Keohane’s book—that countries demand regimes because they help solve cooperation problems and that these regimes make cooperation possible even after the decline of the hegemon—were a much-needed antidote to the resurgence of realism following the publication of Waltz’s *Theory of International Politics* five years earlier, and they were a worthwhile caveat to hegemonic stability theory, which in its various manifestations (Gilpin 1981, Kindleberger 1986, Kennedy 1988) was very much *en vogue* at the time.

But there was another important aspect of this work that made it equally innovative compared to previous work on international cooperation and continues to generate interesting insights today. This was Keohane’s use of the work of Coase (1960), Williamson (1983) and others. His analysis points to the importance of *transactions costs* as an independent variable in understanding certain international cooperative phenomena. What was different about Keohane’s approach, however, was the explicit focus on the *institutional* features of international cooperation, which distinguishes this approach from

*I would like to thank Duncan Snidal for his very insightful comments on an earlier draft of this piece.*
the more abstract game theoretic treatments of the subject of international cooperation. He conceived of these institutions as legitimate attempts by sovereign states to solve a problem. That problem is that the policies that states set unilaterally often generate externalities for other states, which presents an opportunity for a mutually beneficial exchange between them in which each state changes its own policy in return for changes in another country’s (or countries’) policy.

In this paper I argue that standard game-theoretic account of international cooperation—what Snidal (1996) and Abbot and Snidal (1998) fittingly called “decentralized cooperation theory”—while it has extended our understanding of international cooperation enormously cannot answer the questions in the prologue because in that theory institutions are not necessary to facilitate international cooperation. I will make my argument by drawing an analogy to the contributions that transaction cost economics has made to the more standard study of economic transactions. The transactions costs approach to economics arose out of a desire to explain the emergence of the firm and other economic institutions—something which more standard treatments of economics did not address. By analogy decentralized cooperation theory can explain why countries choose to cooperate, how they arrive at their cooperative agreements and how they enforce them in the anarchical international system, but they do not address why countries create international institutions in the process. The transactions cost approach to international cooperation does explicitly answer this question.

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1 Space limitations prevent me from going into constructivist explanations of international cooperation, however I would argue that the point I making a propos decentralized cooperation theory is equally applicable, mutatis mutandis, to the normative constructivist account of international cooperation. Specifically I would raise the point that constructivists have failed to ask why formal institutions are necessary to create international norms. Indeed the constructivist literature leaves the distinct impression that formal institutions are less important at fostering norms than are nongovernmental organizations. Some
After making my analogical case for the continued importance of the transactions cost approach to understanding international cooperation I will turn to a compelling empirical critique of the approach from Moravcsik (1999). In the process of defending the transactions cost approach against that critique I will raise some methodological considerations that scholars may want to keep in mind when conducting future empirical work on the transactions cost approach to international cooperation. Specifically when looking for examples of transactions costs scholars must be careful about sample selection. First scholars should not examine cases negotiations over institutional creation since even the transactions costs approach stipulates that state can, indeed must, conduct such negotiations on their own without the aid of institutions, which by the very fact that negotiations are being conducted obviously have yet to be created. Second being able to find cases where states have been able to conduct successful negotiations without the aid of international institutions is not evidence against the transactions costs approach since the transactions costs approach argues that when transactions costs are low that is precisely what states will do.

The Transactions Cost Approach to Economics

My argument about the transactions costs approach to the study of international institutions hinges on an analogy to the contributions of transactions costs economists to the traditional study of markets, exemplified by the Arrow-Debreu approach. Thus it may be worthwhile spending some time to distinguish between these two approaches to economic transactions. The unit of analysis, naturally, is the transaction, which within

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this literature is typically referred to as a *contract*. Examples of economic transactions are fairly obvious. They can be a simple as a person paying their newsagent for the morning paper or their barber for a haircut and as complicated as major manufacturer of breakfast cereal buying sweeteners by the ton when their market price is fluctuating wildly.

In the Arrow-Debreau approach these transactions are completed via “contingent contracts” in a market where the price at which suppliers are willing to supply the good or service in a given state of the world equals the price at which consumers are willing to buy it in that state of the world. Uncertainty over which states of the world will actually occur in the future is factored into the price. Arrow-Debreau and others have shown that allocations resulting from these transactions are efficient including when it comes to bearing the risks that arise because of uncertainty about the realization of the state of the world when the contract is executed.²

If the price mechanism that is the crux of this approach is so efficient why are not all transactions conducted by it? Many transactions are conducted not within markets via the price mechanism but are undertaken within organizations (typically *firms*) at the direction of a manager. Indeed many corporate entities frankly bear more of a resemblance to a Soviet-style planned economy than to the free market modeled so elegantly by Arrow Debreu and others. As Coase (1937) put it:

Those who object to economic planning on the grounds that the problem is solved by price movements can be answered by pointing out that there is planning within our economic system … which is akin to what is normally called economic planning.

² The classic work on the Arrow-Debreu approach can be found in Arrow (1964) and Debreu (1959), but it is perhaps best to turn to a textbook treatment such as Mas-Colell et. al. (1995 ) for a more thorough review of the topic.
The free market of neo-classical economics does not exist in an unadulterated form—within “free markets” exist pockets of central planning.

Why are some transactions, whether for labor or goods, conducted within markets while others are organized within firms? The Arrow-Debreu approach is extraordinarily powerful and fruitful but, because it does not admit a role for organizations, it is incapable of answering this question, as well as questions like “How do transactions within organizations differ from behavior within markets?” “Are there ways to design organizations to make them more efficient and/or effective?” Coase’s (1937) answer to the question “Why do firms exist?” or “Why are some transactions conducted impersonally via the price mechanism while others are conducted within organizations (firms)” was of course “transactions costs.” Coase posited that there are costs to concluding transactions via the price mechanism—negotiation costs, contracting costs, costs of monitoring and enforcing the contract and so on. Coase and his successors argued that, by concluding these transactions within firms, economic agents are able to avoid these costs, or at least lessen them. The notion of transactions costs is, by design, as comprehensive as possible, a feature which can imbue the concept with a frustrating vagueness. North (1990, 27) defined transactions costs as “the costs of measuring the valuable attributes of what is being exchanged and the costs of protecting rights and policing and enforcing agreements.” Williamson (1989, 142) defined them as “comparative costs of planning adapting and monitoring task completion under alternative governance structures.”

Coase’s answer to the question of why firms exist only begs the next question: “why then are not all transactions conducted in one big firm?” Coase’s response to this
latter question was that inefficiencies arise when resources are allocated by managerial fiat within an organization rather than in response to relative prices.³ In such a case resources are no longer necessarily allocated so that their marginal costs are equal to their marginal benefit. Coase was able to use his transactions costs approach along with simple notions of marginality to speculate about the size of firms. Firms would increase in size until the marginal cost of the inefficiencies of conducting a transaction within an organization were just equal to the marginal cost of conducting that transaction with an outside agent.

To illustrate with a concrete example suppose a firm makes some machine that requires a specialized part. The manager of the firm has one of two options in acquiring these parts. She can either 1) contract with an outside manufacturer to produce them or 2) purchase the necessary machinery, hire workers to run them and have her own firm make them, or, what amounts to the same thing, she can purchase the outside manufacturing firm, that is vertically integrate. It is the major contribution of this literature that option (1) itself has a vast variety of forms of contracting, ranging from simple arms-length spot market transactions to much more complicated contracts that may include renegotiation provisions, dispute resolution mechanisms and so on. Coase is simply claiming that the manager should, in equilibrium, choose the lowest cost option.

The literature has posited that costs of using the price mechanism should be higher, and therefore we should observe more institutionalized transactions when two factors are present. First Arrow-Debreu type contingent contracts must impossible, either because agents are boundedly rational and therefore cannot specify all possible contingencies ex ante or because it is impossible to independently verify when a specific

³ Milgrom and Roberts 1990 referred to them as “influence costs.”
contingency has occurred. Second, the transaction must require investment in some specific asset, meaning an asset that has substantially lower value outside the transaction in question. If these two factors are not present either contracts will be able to be written to cover all contingencies or the threat of liquidating the specific asset via an outside option will keep both sides of the transaction honest. However if these factors are present the owner of the specific asset may fear being held up by the other party to the transaction when some unforeseen contingency that changes the value of their exchange arises (Williamson 1983, 1985, and 1989).

The Transactions Costs Approach to International Cooperation

Turning to international cooperation, the unit of analysis is also the transaction, but in this case that transaction is the international agreement or treaty. Understanding international agreements or treaties as transactions in this way is straightforward: two (or more) countries agree to change their policies in exchange for policies in the other country (or countries). Examples might include:

1) “Our country will reduce our of CO₂ emissions by \( x \) percent if you will reduce your CO₂ emissions by \( y \) percent.”
2) “Our country will eliminate barriers on trade in your goods and services if you do the same for ours.”
3) “Our country pledges to come to your aid with \( x \) troops if you are attacked as long as you pledge to come to our aid with \( y \) troops if we are attacked.”
4) “Our country will loan you \( x \) dollars if you agree to reduce inflation by \( y \) percent.”
Obviously there are countless other possible examples of such arrangements. The point is that international agreements can be thought of as straightforward barter arrangements—a service for a service.\(^4\)

To continue the analogy, we may fruitfully compare decentralized cooperation theory cooperation theory with the Arrow-Debreu approach to markets. It would be fair to say that decentralized cooperation theory, along with perhaps constructivism, dominates the study of international cooperation today. It relies heavily on game theory, typically characterizing an international cooperation problem as a prisoners’ dilemma where Pareto inefficient mutual noncooperation is the single-shot equilibrium.\(^5\) Choosing to cooperate offers a Pareto improvement. Cooperative agreements are created by states via bargaining which is typically modeled with an alternating-offers bargaining model or a war of attrition game.\(^6\) Compliance with the cooperative agreement is a potential problem due the absence of a state to enforce contracts (agreements/treaties). Decentralized cooperation theory posits that this enforcement/compliance problem is solvable because the games are repeated—as long as actors do not discount the future too heavily they will comply with their international agreements. Indeed according to the “folk theorem” there are many enforceable cooperative solutions to the problem.\(^7\) Like

\(^{4}\) Trachtman (1996) says that states are transacting \emph{power}. This terminology confuses the issue in my opinion. States are merely agreeing to alter their policies by a specified degree for some specified period of time as long as the other state also alters its policy by some specified degree for some specific period of time. They can continue the transaction as long as they benefit from it and they can withdraw from the transaction as soon as they see fit. No \emph{power} actually exchanges hands in these transactions. States retain sovereign power after the transaction as before. These international transactions, as I understand them, are nothing more arcane than a simple exchange of services—“you scratch my back and I’ll scratch yours.” The legal instruments that facilitate the transaction are, of course, quite arcane, but the transaction itself requires no new or special terminology.

\(^{5}\) There are other types of cooperation problems, of course—coordination games for instance. I focus on the prisoners’ dilemma for illustrative purposes only.

\(^{6}\) For an example of the former in a multilateral setting see Gilligan (2004). For an example of the latter in a bilateral setting see Fearon (1998).

\(^{7}\) Simmons (1998) offers a helpful review of the compliance literature.
the Arrow-Debreu approach decentralized cooperation theory was extraordinarily fruitful at answering a certain set of questions (when will countries cooperate, how will they enforce their agreements) and it continues to offer new an important insights today.\footnote{Early examples of this approach include the articles in the Oye (1986) edited volume, Stein (1982) and Snidal (1985b). A by-no-means-exhaustive list of a few of the more recent extensions might include: Downs Rocke and Barsoon (1996) who discuss selection bias in the compliance record of international agreements, Fearon (1998) who elucidates the dual roles of states’ discount rates in both bargaining and enforcement, McGillivray and Smith (2001) who augment the basic repeated prisoners dilemma with an agent-specific framework, and my own work (2004) which extends the typical bilateral bargaining model to a multilateral setting.}

However, it is incapable of answering a different set of questions about the effects of institutions because institutions play no role in that theory.

In decentralized cooperation theory, international cooperation can occur in an institutionless void. Cooperative policies are decided upon by states via international bargaining and enforced via trigger strategies. The details of the institutional structure are unimportant. Indeed, in this approach, it is a little difficult to see why countries would even bother to write down their cooperative agreements.\footnote{Morrow (2000) raised this question in his study of alliance agreements. Using a signaling model Morrow (2000) makes the case that by publicly committing to defend another country via a treaty of alliance states are subjecting themselves to costs of reneging (“audience costs”) thereby making alliance commitments more credible. While not explicitly a transaction’s costs argument, it could easily be reinterpreted into the terminology of transactions costs economics where allies write down their commitments to help prevent future opportunistic behavior, namely reneging on promises to defend ones ally once war actually breaks out.} But countries do write them down, of course, and, beyond that, they take great pains to write them down in very precise ways. By invoking Coase, Williamson, and the others, Keohane pointed the way to an explicit focus on institutions—not just cooperation (whether countries do it or not and whether countries comply with their agreements or not) but on the institutional features that make cooperation possible by removing some of the impediments to it.

The way in which Keohane employs the Coase theorem is well-known so I may be brief. Coase’s (1960) main point was that “the problem of social costs” (what we
typically refer to as externalities) are easily solved by private agents acting in their own self interest as long as there exists: 1) a legal system for enforcing contracts 2) perfect information and 3) no transactions costs. Keohane pointed out that these three criteria are typically not present in international politics, and so we cannot rely on countries to solve their externalities problems as easily as the Coase theorem might suggest. Keohane goes on to argue that it is in correcting these three “inversions” of the Coase theorem that the value of international institutions lies.

Keohane was most interested in addressing the questions “Is cooperation possible among rational egoists?” and “Can cooperation last beyond the fall of the hegemon?” Keohane uses his approach to answer both questions in the affirmative. Notice however that neither question required Keohane to resort to the notion of transactions costs. The first answer is a straightforward application of the “folk theorem” and Snidal (1985) was able to show that hegemons were in no way necessary for international cooperation. What does Keohane get out of employing the Coase framework?

The answer, of course, is that invoking transactions costs allows Keohane to answer his questions quoted at the start of this paper. His institutional approach allows us to begin to understand the great variety of institutional forms that we observe in international politics. It allows us to ask and begin to answer a host of questions that decentralized cooperation theory does not even ask: When will countries rely on relatively informal norms and when will they rely on more formal agreements? When will their formal agreements include an explicit dispute resolution procedure and when will they leave such procedures unspecified? How long will the treaties remain in force?
Will renegotiation provisions be included? These are just a few of the questions that are worth answering but that are not even asked by decentralized cooperation theory.

In a purely economic setting Coase’s argument implies that we would expect transactions with relatively low costs to take place via arms-length transactions. Transactions with relatively high costs should be undertaken within the confines of an organization—the firm—or should not be undertaken at all. By analogy international cooperative transactions with relatively low transactions costs should be undertaken via negotiated agreements. International cooperative transactions with high relative transactions costs, if they are undertaken at all, should take place within international institutions. These institutions themselves must be negotiated, of course, and so we will only observe such institutions if the relative transactions costs of creating them, amortized over the expected lifetime of the regime, are also sufficiently small. It is important to recognize that in all cases the concern is with transactions costs relative to the total value of the transaction. States may be willing to pay enormous transactions costs if the value of the treaty they are negotiating is even more enormous, and negligible transactions costs may be sufficient to induce states to forgo negotiations altogether if the expected value of the treaty is sufficiently small.

The virtue of the transactions costs approach is that it not only tells us that states may, under the right circumstances, cooperate, but it gives us insight into the great varieties of forms that that cooperation may take (what Lake has evocatively called “the varieties of international relations”). Consider two countries each of which has a policy that produces some external cost in the other country (think of it as a level of pollution). Roughly speaking we might say that the two countries have four classes of options: 1) do
nothing 2) negotiate a single treaty that reduces their level of pollution by some specified amount, perhaps for some specified period of time 3) negotiate a treaty to reduce the pollution and in addition create a more formal international organization and conduct future negotiations under the auspices of that organization or 4) integrate, that is create a supranational institution that sets a level of the policy for them.

Item (1) is particularly important because it reminds us that if the costs of a cooperative transaction are too high relative to the value of that transaction the two countries will simply forego cooperation. This has important methodological implications because it indicates that we cannot really infer much about the presence of transactions costs from observing international negotiations— if transaction costs are too high countries will not even bother to negotiate, as I will discuss in greater detail later. Both items (2) and (3) represent fairly large categories; indeed casual empiricism would suggest that almost all of the international cooperation that we observe falls into these categories. Breaking them up in two categories is thus somewhat artificial—even within these intermediary categories international cooperation can take any form along a continuum of one-time agreements where two countries merely agree to alter a particular policy all the way to more complicated agreements where new organizations may be created with explicit dispute resolution procedures, renegotiation provisions, contingency (i.e. “escape”) clauses and so on. Instances of (4) are, of course, not unheard of in international politics as the creation of the Common External Tariff and the recent events in the creation of the European Monetary Union attest. Lake (1996) makes a compelling case that empires are essentially an example of (4) whereby a powerful state integrates the security policies of weaker states into its own.
The transactions costs approach to international institutions has been extended fruitfully by a variety of scholars all of which I unfortunately cannot review here. Interestingly some of the greatest insights have come in the field of international security particularly in the way alliances are organized. Lake (1996) offers a fascinating study in which he uses the transactions costs approach to explain why some security relations are organized as alliances while other are organized as empires. Weber (1997) also applies these concepts to international security relations to explain the level of what she calls “bindingness” of alliances and she discusses NATO and plans for a European Defense Community using these concepts. Abbot and Snidal (1998) focus on formal international organizations rather than on the broader category of institutions referred to by Keohane and they provide a long list of possible functions for such organization. International trade policy has been a particularly common area where the approach has been applied. In addition to Trachtman (1996), which I already mentioned, Dixit (1996) provides a case study of some GATT rules within the context of the transactions cost approach, as do Yarborough and Yarborough (1992), who also extend their analysis to regional trade agreements. Although not exclusively a transactions cost approach enterprise, the papers in the edited volume by Koremenos Lipson and Snidal (2001) do employ some transactions costs ideas to their case studies of the rational design of international institutions.

Critiques

The transactions costs approach to understanding international institutions has come under something of an attack lately. I am not speaking of the neo-realist onslaught that
was unleashed shortly after the publication of *After Hegemony* (Grieco 1988, Mearsheimer 1990 are exemplary). That critique was based on misconceptions of the role of models in the social sciences and of the role of assumptions within models, a point which was made convincingly by Powell (1994). Instead I am speaking of a much more serious critique offered by Moravcsik (1999). Employing case studies of the negotiation of five major European integration treaties, Moravcsik concludes that EC/EU staff did little to further integration and in some cases even lagged behind the efforts of state leaders in bargaining the agreements. This research has important negative implications for claims that supranational actors do in fact foster cooperation, but Moravcsik extended his critique more broadly to question the importance of transactions costs generally. In his account, states seemed to have little trouble making agreements on their own, and so he concludes that ex ante transactions costs are generally unimportant impediments to international cooperation. Moravcsik’s analysis is potentially devastating to the transaction costs approach because, after conducting numerous case studies of important international negotiations in search of transactions costs, Moravcsik comes away asking if there are any.

This latter point is one that really must be addressed before the transaction cost research program can move forward. As mentioned above definitions of transactions costs are often frustratingly vague. Empirical examples of them are often offered on an ad hoc basis. Without more precision about what transactions costs are and how they can be measured critics of the approach will remain unconvinced. Simon’s critique of transactions costs economics (calling it by its other name “the new economics of
institutions) is if anything more appropriate to the transactions costs approach to international institutions:

> [the new economics of institutions] suggests a whole agenda of ... empirical work that must be performed ... Until that work has been carried out the new economics of institutions and related approaches are acts of faith, or perhaps piety (1991, 27).

Moravcsik is completely correct in demanding that we subject the transactions costs approach to international institutions to this same kind of empirical testing. Indeed he has done so and he reports that the evidence is lacking.

However, while I agree with Moravcsik’s motives and with much of his account of the negotiations I part company with him in his conclusions. I take issue with his analysis at two levels. First, Moravcsik’s cases are all examples of major institutional innovations in the process of European integration: the Treaty of Rome, the creation of the Common External Tariff and the Common Agricultural Policy, the European Monetary System, the Single European Act and the Maastricht Treaty. If transactions costs are generally negligible one must wonder why the members of the EC/EU deemed it necessary to create these institutions in the first place—to paraphrase Keohane’s questions from the prologue why not simply skip the institution creation and innovation stage and make agreements on an ad hoc basis? Even if Moravcsik is correct that transactions costs were not insurmountable to states without the help of supranational entrepreneurs in these particular negotiations, the question remains why the countries felt the need to create these institutions in the first place. According to the transactions costs approach the very institutional innovations that Moravcsik describes were undertaken to reduce costs on future transactions conducted within the framework of those institutions.
In other words Moravcsik could be accused of changing levels of analysis. He looks for transactions costs in the formation of institutions but the claim of the transactions costs school is that these institutions reduce transactions costs of other cooperative ventures in the future such as engaging in trade negotiations with outside states and setting common agricultural and monetary policy.

My second issue with Moravcsik’s analysis is more methodological but flows from an important theoretical consideration. Moravcsik seems to be assuming that the data that the world has given him was randomly generated. Drawing on the argument I made above there is no reason why we should assume this is the case. We should expect to observe governments negotiating in cases where transactions costs are low and/or organization costs are high relative to the surplus to be divided by the treaty. If that were not the case, states would simply forgo negotiating altogether because the value of the transaction would not cover the transaction costs. The fact that we even observe governments negotiating on these matters suggests that they are cases where transactions costs were low relative to the surplus to be divided.

This is quite plausibly the case in the negotiations that Moravcsik examines, which were major events in the formation of the European Community/Union. Transactions costs even if they were high in some absolute sense, were quite low compared to the surplus to be divided by the treaties which was probably huge. The types of major institutional innovations that Moravcsik examines are precisely the sorts of situations where stakes are high and as such states are probably willing to pay the transactions costs of negotiating these treaties, particularly when one considers that once
the new institutions are created the transactions costs of creating them will be amortized over a long period of time.

Perhaps the following table can help summarize my point. Moravcsik’s argument is about the inefficacy of supranational entrepreneurs and its implications for the presence of transaction costs. In the Table 1, I dichotomize each of these two variables and summarize the possible outcomes. Supranational entrepreneurs can be either “effective” or “ineffective” at promoting cooperation and transactions costs can be either high or low. Moravcsik’s cases cluster in the lower right corner, which does not mean the other cells are empty simply that Moravcsik did not find cases of them. Indeed by focusing on major negotiations that lead to the deepening of European integration Moravcsik excluded cases in the lower left cell.

[TABLE 1 ABOUT HERE]

Indeed Keohane (1989) himself recognized this methodological problem and its implications for regime creation:

If transactions costs are negligible it will not be necessary to create new institutions to facilitate mutually beneficial exchange; if transactions costs are extremely high it will not be feasible to build institutions—which may even be unimaginable … Therefore according to this theory one should expect international institutions to appear whenever the costs of communication monitoring and enforcement are relatively low compared to the benefits to be derived from political exchange. (p. 166-67)

My point in dwelling on these issues is not to be critical of Moravcsik’s analysis, which, with regard to the role of supranational entrepreneurs, is a valuable corrective to
some of the more extreme claims, and which, justifiably, demands more empirical
evidence for the transactions costs approach. Instead my point is to defend the
transactions costs approach against one of its most cogent critics and to try to convince
the discipline that the transactions costs approach continues to be valid and deserves
more empirical study.

The lack of close study of the characteristics of these institutions been raised by
Incidentally both Abbot and Snidal (1998) and Trachtman (1996) in part blame regime
theory developed by Keohane for the unwillingness to delve into such detailed studies.
My argument suggests that that criticism is unfair and that the transactions costs research
program calls for precisely such studies.

In order to effectively test the transactions costs approach to international
cooperation political scientists may want to take a page from economists who conduct
empirical work in the transactions cost vein.\textsuperscript{10} Qualitative research might include
conducting interviews with policy makers to discern why they felt the need to create
international institutions in some cases of international cooperation and not others.
Quantitative empirical work would include looking for correlations between the presence
of international institutions and the variables that the transactions cost approach considers
important—asset specificity, and the complexity and repetition of transactions. Another
tack might be testing if there was a statistically significant increase in the amount of
international cooperation in an issue area following the creation of an international
institution in that issue and whether these effects should be interactive with measures of

\textsuperscript{10}Simon’s critique quoted above notwithstanding, transactions costs economics has made considerable
headway in evaluating its empirical claims. For a thorough, if somewhat dated, review of empirical work in
transactions cost economics see Shelanski and Klein (1995).
the three variables mentioned above, such that increases in international cooperation were larger in percentage terms where those variables are more prevalent.

Conclusion

In the standard game-theoretic treatments international agreements are arrived at via decentralized bargaining and enforced with some form of trigger strategy in a repeated game. These studies have extended our understanding of international cooperation greatly, however, as I have tried to argue in this paper, they are incapable of answering why states bother to create international institutions—why don’t they just cooperate in the decentralized fashion modeled by the game theoretic treatments? This was the question Keohane asked almost a quarter century ago. His answer, which drew upon ideas from transactions cost economics, was that states create institutions when the costs of bargaining and enforcing agreements in the decentralized fashion are too high compared to the benefits of cooperation.

Recently the transaction cost explanation for the presence of international institutions has been criticized empirically by Moravcsik who argued that there was no evidence of serious transactions costs in his five case studies major European negotiations. In this paper I have counter argued that one must be cognizant of selection effects when choosing case studies, since the transactions cost approach expects transactions costs to be low in cases where states are bargaining unaided by institutions—precisely the types of cases covered by Moravcsik’s empirical analysis. Moravcsik however is justified in calling for more empirical work on the transactions cost approach, and I offered a few ideas about how to proceed on that front, for instance testing if variables that the
transactions costs approach claims should prompt states to create institutions, such as asset specificity, are in fact correlated with more institutionalization empirically.

The field of international relations has barely scratched the surface in testing the implications of the transactions cost approach to international cooperation or employing them proscriptively. There are literally tens of thousands of agreements, the institutional characteristics of which have gone unstudied by this approach, and which could render numerous insights as to how best to craft agreements so as to bring about more effective international cooperation. My hope in writing this paper is that international relations scholars will return to the insights of the transactions cost approach and advance the important research program that Keohane began.
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Table 1: Possible Combinations of Supranational Entrepreneurs and Transactions Cost

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**Supranational Entrepreneurs are Effective**

**Supranational Entrepreneurs are Ineffective**