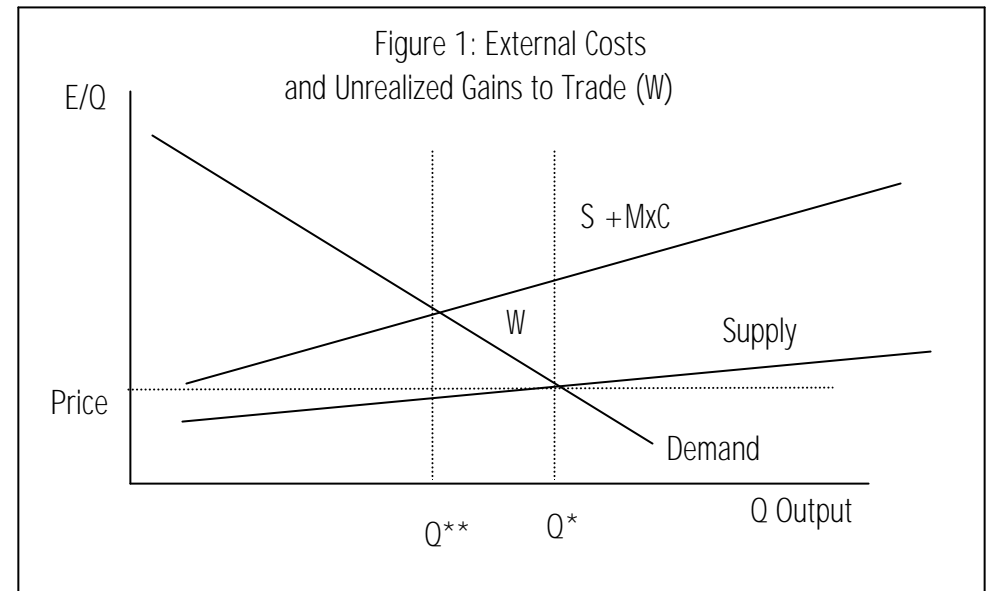


## I. Externalities and Coasian Contracts

- A. Ronald Coase (1960) points out that externality problems can be solved by marketlike transactions involving contracts among the affected parties. Such contracts have come to be called "Coasian Contracts."
- B. Coase points out that individuals affected by the "spillovers" from production could band together and pay firm owners to use different methods of waste disposal.
- C. However, Coase neglects that a host of organizational problems would have to be solved by such groups: a method of collective decision making would have to be chosen, a method of collecting contributions would be required, etc..
  1. Forming such organizations are problematic, because, as Olson (1965) pointed out, such collective activities have associated public goods and political problems that few persons will have incentives to solve.
  2. Perhaps more important, the rewards of public service entrepreneurship tend to be smaller than those generated by entrepreneurship in markets, thus, fewer public goods problems tend to be solved in this way than private goods problems.
- D. Rather than organizing to negotiate with producers and consumers of product X, those affected by the externality can in most cases "ask" government to regulate or tax the production of X.
  1. That is to say, rather than form a regional organization with complete negotiation powers for the interests represented, those affected can form a less complex organization that attempts to persuade government to solve the problem for them.
  2. Not only does lobbying reduce the affected group's organization costs, it tends to require smaller ongoing sacrifices by individual members of the downwind group,

because producers and consumers of X no longer need be fully compensated by those demanding smaller emissions.



1. These cost advantages provide a rational choice explanation for the fact that domestic environmental policies tend to be matters decided by governments, rather than negotiated between large environmental clubs and polluters.<sup>1</sup>
- E. There is a sense in which it is "politics" rather than "economics" that is ultimately responsible for ongoing externality problems, because it is government policies that frame the decisions of firms and consumers that generate the pollution.
- i. Once an externality problem is brought to the attention of government, its continuation or amelioration becomes the result of government policy.

<sup>1</sup> Coasian solutions are also affected by a variety of government policies and may require changing those policies. The initial assignment of rights determine what course of action is necessary. Within governments characterized by an aggressive tort law, those living downstream or downwind could launch a class action suit against the producers for damages imposed by the use of the air or water systems to dispose of waste products. In the absence of such legal remedies, a new organization would have to be created to collect money in order to compensate producers and consumers of X. Such organizations would require some process of collective choice to determine negotiation strategies, assign cost shares to members, and design methods for punishing those who fail to contribute.

In the end, the Coasian result reflects a variety of government policies that affect organizational costs, contract enforcement, and liability under tort law. Government policies may affect such internal arrangements of such groups or special service districts insofar as its policies discourages interest group formation (as within dictatorships), is neutral toward them, or actively encourages them.

- ii. That is to say, the resulting pollution level reflects political incentives.
- iii. If no new specific or general policy is put in place, the pattern of externalities (such as pollution) reflects incentives already present in civil and environmental law.
- iv. If new regulations are adopted, the new pollution level is substantially determined by the regulatory targets and the enforcement of environmental regulations.

## II. International Treaties as Coasian Contracts

A. International externality problems are of interest for a number of reasons.

1. International policies address **regulatory failures** rather than conventional economic externality problems.
2. The existence of regulatory externalities often implies that unrealized gains to trade in national regulations exist, and these can only be realized through Coasian contracts between governments--that is to say, international treaties.
3. Regulatory failures arise because individual governments have only very weak incentives to take account of the effects that their policies have on neighboring countries.

B. For example, consider the case of two neighboring democracies separated by a common river into which effluents may be discharged by both countries.

1. Each government has an incentive to regulate discharges into the boundary water insofar as its own citizens (median voter) demand improved water quality--whether for recreation or health reasons.
  - i. However, neither government has an electoral reason for taking account of the benefits that its policies confer upon the other country's citizens.
  - ii. Under the usual public choice assumptions, self-interested voters behave in the same manner as ordinary consumers and neglect the effects of their electoral demands on other citizens, both within their own countries and in neighboring countries.
  - iii. The citizens of other countries do not vote in the relevant elections.

2. None the less, the two countries' environmental regulations jointly determine the water quality of the boundary river by jointly determining the effluents discharged into it.

- i. Insofar as each country's electorate (median voter) values the water quality of the boundary river, each benefits from the other country's environmental regulations.
- ii. Unless the two countries' environmental regulations are coordinated in some way, each tends to underregulate its discharges into the boundary waters.
- iii. In such cases, there are **mutual gains that can be realized** via environmental **treaties** if both countries increase the stringency of their water quality regulations somewhat, and, moreover there are electoral reasons for attempting to do so (Hoyle, 1991, Congleton, 1992, Fredricksson, 2000b).

C. Treaties, however, may also internalize externalities that mainly affect government officials. Such treaties may make government officials or the ruling coalition better off, but make their citizens worse off on average.

1. For example tax competition reduces the ability of governments to raise taxes and use the proceeds to advance goals of the ruling coalition.
  - a. If a government did so, there would be migration of the over taxed or under served minority to other governments where they were treated better.
2. Here governments may attempt to reduce competition, in a manner analogous to firms in a **cartel**, so that they become freer to use taxes, services, or regulations to advance narrow political or personal goals. (OPEC is a treaty organization.)
  - a. In such cases, international treaties may make "governments" better off by increasing their ability to narrowly target taxes or services, but make the citizens of the signatory nations worse off as they become subject to higher taxes without receiving improved services.
  - b. Treaty organizations such as the European Union are clubs whose memberships are governments rather than individuals, and so the interests are **directly** advanced by treaties tend to be those represented in government.

D. Whether case "B" or case "C" is the externality problem addressed by international treaties is partly a matter of the degree of political competition within the individual signatory nation states and partly a matter of constitutional constraints under which those governments operate.

1. In either case, the **treaties are Coasian contracts** attempt to solve international externality problems.
2. And in either case, the contracts have to be **self enforcing** to succeed.
  - i. There are no supra-national courts with the power to enforce international contracts over the dissent of a sovereign nation state.
  - ii. This is not a small problem, because most international treaties address prisoner's dilemma problems and do not themselves change the nature of the PD game being played by national governments.

<b>Table 1</b>			
Environmental Treaties: The Implementation Dilemma (Two Countries, Each with Moderate Domestic Political Support)			
	B Stringent	B Moderate	B Weak
A Stringent	5,5	2,6	1,5
A Moderate	6,2	3,3	2,2
A Weak	5,1	2,2	1,1

- E. The voluntary nature of international agreements together with the wide range of government types and social settings implies that incentives to sign and implement treaties vary widely.
- F. For example, both the domestic environmental setting and type of government affect the ratification of environmental treaties.
  1. Murdock and Sandler (1997b) find that countries affected by upstream emissions are more likely to sign international treaties than those that are less affected by transboundary emissions.
  2. Congleton (1992) and Fredriksson (2000b) demonstrate that democracies are more inclined to sign and ratify treaties than nondemocracies.
  3. However, Murdock and Sandler (1997a) also find that treaties do not always affect national environmental policies.

### III. Treaty Organizations as Clubs/Cartels

- A. Treaty organizations, like other clubs, attempt to solve problems that can more effectively be addressed collectively than independently.
- B. In cases where a new externality problem is addressed, treaties often create new organizations with the duty of monitoring compliance with treaty obligations and with making suggestions for future refinements of existing treaties.
  1. Indeed, the **institution building part of a treaty** is usually longer than the part that deals with substantive matters.
  2. In fact, some treaties with "substantive titles" only address organizational problems (procedural treaties) and do not deal directly with substantive matters at all! (In some treaties specific externality problems are not even mentioned.)
- C. The voluntary nature of treaty organizations has a predictable effect on the policy making powers and collective decision rules used by those treaty organizations.
  1. These features of treaty organizations are predictable outcomes of "political risks" associated with delegating authority to a central agency.
- D. Treaty organizations could be granted substantial coercive power as a means of solving the externality problems addressed, however they rarely are.
  1. In ordinary clubs and treaties, coercive power includes the **right to exclude** those who fail to pay their dues from club services.
  2. In other more coercive clubs, leaders might also be given the power to penalize individual members for shirking as a means of solving free rider and coordination problems of various kinds. (WTO)
  3. However, there are risks associated with grants of coercive power to a club's leadership that are taken account of by prospective members.
- E. The greater are the political risks, the less power that a government is willing to delegate to a treaty organization's management.
  - i. Governmental "clubs" tend to have higher risks associated with them than ordinary private clubs, which limits the willingness of members to grant treaty organizations significant coercive power.

ii. For the most part, treaty organizations tend to have constitutions (charters) that attempt to **minimize the political risks for the member governments.**

F. Generally, the powers delegated to international treaty organizations are very modest.

1. Most treaty organizations use unanimous rule to make their policy recommendations.
2. Most treaty organizations lack authority to make new substantive policies, and have only the power to make recommendations to the member (signatory) states, who then accept or reject the treaty organization's recommendation.
3. Most treaty organizations lack explicit authority to punish members for violating the terms specified in the substantive parts of the relevant treaties.

#### IV. The Four Stages of Treaty Negotiations

A. The process of negotiating an international treaty is complex, but generally goes through four stages.

B. First there is series of meetings to see whether "potential gains to regulatory exchange" exist. If so, often a "Symbolic Treaty" is signed and ratified.

C. Second, there is a series of meetings that attempts to establish procedures whereby these potential gains may in fact be realized. If a mutually agreeable organizational structure can be found, a "Procedural Treaty" is signed and ratified. Procedural treaties normally establish new treaty organizations of extend the functions of existing ones.

D. Third, there are a series of meetings of the treaty organization which attempt to find mutually agreeable substantive policies that might address the problem that initially attracted the attention of the "member states." If such policies can be found, a "Substantive Treaty" may be signed that specifies the terms of regulatory exchange.

E. Fourth, after a substantive treaty is signed and ratified, each member state has to adopt domestic policies to implement its treaty obligations.

F. Not all international treaties make it through all four steps, because mutually agreeable solutions may not be found by the negotiating policies.

#### V. Is the EU still a Treaty Organization?

A. The present European Union emerged out of a long series of treaties which have gradually extended the policy domain of the EU and also gradually delegated more and more policy making authority to the various EU policy making agencies, chiefly the Commission, Council and Parliament.

B. As the agency charged with developing and recommending policies to member states, the organizational design of the EU government is very much like that of an ordinary treaty organization.

1. Formally, most policies are implemented by national legislatures rather than by the EU.
2. Formally, the member states approve all major policies by unanimous consent.
  - i. (Indeed, insofar as national legislatures review EU policies as they are implemented, it could be argued that all policies are still adopted unanimously.)
  - ii. (Relatively few new policies make it through the formal unanimity process, so a good deal of what the EU has accomplished has occurred via "the back door" of coordinated regulatory decisions--which again are agreed to by the responsible ministries.)
3. The council is essentially an institution designed to represent the political interest of member state GOVERNMENTS (e.g. by member state ministers in the relevant fields of policy making).
4. Membership remains voluntary on the part of all members.
  - i. As sovereign nations each member can withdraw from the various treaty obligations at will, and there are no formal sanctions against doing so.
  - ii. (The new "constitution" makes the "right" of succession explicit, but it is clear that a nation can drop out of individual treaties (as with the monetary union) with little more cost than reduced international good will.
  - iii. It is, of course, possible that sanctions would be imposed on a member state that left the EU, but there are no clear statements to this effect, and the new constitution seems to imply that exit will be fairly painless, although perhaps delayed a bit.

C. In all these respects, the EU remains a treaty organization, although an unusually ambitious one.

D. (In order for the EU to become a true nation state, the government would have to have the power to impose regulations over the objections of member states which would require powers of taxation and police authority.)

## VI. Major EU Treaties

1. Treaty establishing the *European Coal and Steel Community* (signed in Paris on 18 April 1951)
2. Treaty establishing the *European Community* (signed in *Rome* on 25 March 1957)
3. Treaty establishing a *Single Council and a Single Commission* of the European Communities (1967)
4. *Single Europe Act* (1987)
5. Treaty on European Union (signed in *Maastricht* on 7 February 1992)
6. Treaty on European Union as amended by the *Amsterdam Treaty*, signed on 2 October 1997, entered into force on 1 May 1999,
7. *Treaty of Nice* (OJ C 80 10.03.01 pp. 01-) signed on 26 February 2001, entered into force on 1 February 2003.