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PART I

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# 1 *Introduction*

## Institutional choice and global commerce

In the nineteenth century, Egypt experienced the most remarkable explosion of commercial activity anywhere in the Mediterranean. The underlying causes of this development were multiple: a new political elite with a strong modernizing and liberalizing agenda; the advent of revolutionary communications and transportation technologies; and the opening of the Suez Canal, which enormously facilitated commerce between East and West. The transformations brought about by these factors were profound. Alexandria, for example, a quiet trading town in the early nineteenth century with a population of some 40,000 and a foreign merchant community of a few hundred, by 1873 became a bustling cosmopolitan city of 280,000 inhabitants and one of the world's leading commercial hubs.

As early as the middle of the century, merchants had begun to call for a system of global trade dispute resolution. In 1876, after a period of highly protracted international negotiations among leading trading nations, the “Mixed Courts” of Egypt – the world's first international tribunals for commercial dispute resolution – opened their doors in Alexandria and Cairo. Astonishingly, the Mixed Courts went from strength to strength despite an exceptionally challenging geo-political context: British occupation of Egypt in 1882, the Fashoda incident of 1898, and the First World War. By the fiftieth anniversary of the Mixed Courts, the number of foreign and Egyptian judges had grown from the original twenty-five to seventy, supported by a staff of about 14,000 hailing from more than a dozen countries. Nearly 24,000 cases were decided annually by the mid 1920s. The Courts persisted through the Great Depression, eventually closing their doors in 1949. Memory of these extraordinary institutions quickly faded. Today, the Mixed Courts are largely forgotten.

The Mixed Courts of Egypt are only one of several remarkable institutions established by states in support of global commerce that we examine and explain in this book. It is in the nature of sovereignty and,

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paradoxically, anarchy, that states confront choices regarding the institutions that govern their interactions. They can conjure new arrangements, deploy, adapt, or destroy existing ones, or operate outside formal institutional arrangements. What drives these choices? Under what conditions will a state (or, more generally, any actor) USE available institutions, SELECT among alternative institutional forums, CHANGE existing institutional rules, or CREATE brand-new institutions?<sup>1</sup> We address these questions by elaborating a novel framework (USCC) which brings together elements of existing international institutional scholarship through an assumption of bounded rationality. We demonstrate how the twin pulls of challenging cooperation problems and inherited institutional status quos shape institutional choice in global commerce and beyond.

We develop our analysis by building bridges across seemingly competing traditions. In recent years, institutional theorizing in international relations and comparative politics has become much less sectarian and more inclusive methodologically. Once sharply drawn boundaries among historical institutionalists, Realists, Liberal Institutionalists, and others have begun to soften and blur. Scholars now accept that compelling and fruitful theorizing often necessitates combining insights from various theoretical traditions. However, these combinations must be systematic, not *ad hoc*. In this spirit, we embrace the emerging view that the structural variables favored by historical institutionalists need to be supplemented by a stronger sense of agency that emphasizes how institutions operate not only as constraints but also as strategic resources for actors responding to changes in their political and economic contexts.<sup>2</sup> In addition, greater attention to agency opens up a greater role for political conflict and a recognition that “institutions are the object of on-going political contestation, and changes in the political coalitions on which institutions rest are what drive changes in the forms institutions take and the function they perform in politics and society.”<sup>3</sup> It is also essential that an institutional theory account not only for institutional stability and large-scale and discontinuous transformations, but also for incremental

<sup>1</sup> In the text we will use these words capitalized and in “SMALL CAPS” when referring to the theoretical categories.

<sup>2</sup> Thelen, *How Institutions Evolve*, 213; Hall, “Historical Institutionalism in Rationalist and Sociological Perspective.”

<sup>3</sup> Thelen, *How Institutions Evolve*, 31; Knight, *Institutions and Social Conflict*.

changes.<sup>4</sup> We heed and address the call by Peter Hall, Kathleen Thelen, and others for theories that complement analyses of path dependence and punctuated equilibrium models with conceptual tools that capture the dynamic and distinctly temporal logic of institutional change.

Our methodologically inclusive account breaks new ground in international relations (IR) theory but also travels beyond the subfield. As IR scholars, we speak first and foremost to the IR community and our substantive focus – the development of global commercial governance – is of longstanding interest to IR students. But our general theoretical approach will be of broad interest to political scientists, as well as to sociologists and economists interested in international and institutional questions.

A central theme that emerges from our theory and evidence is the striking stability and staying power of the institutional status quo – the arrangements existing at the time a new cooperation challenge arises. As explained below, many of the factors that standard institutional IR theory suggests will drive moves away from the status quo (towards institutional CHANGE OR CREATION) confront powerful countervailing forces. In this respect, our approach shares much with recent historical institutionalist research. Yet we also recognize that there is often pressure for change from actors seeking to improve their situations. In this respect, our approach shares much with recent rationalist research. Our analytics bridge this unnecessary divide by incorporating bounded rationality to provide a distinct way of thinking about institutional choice. We thus offer a long overdue corrective to prevailing views about change in IR.

We advance the institutional research agenda in IR most notably by integrating into a single theoretical framework otherwise disparate accounts of institutional choice: institutional USE; institutional SELECTION (forum shopping); institutional CHANGE (a common focus in institutional research throughout the social sciences); and institutional CREATION. Our USCC framework emphasizes these as key strategic alternatives confronting sovereign states as well as non-state actors. Analytically, we supplement pioneering work on rational institutional design developed in IR a decade ago with a more realistic behavioral model of the capacity of decision-makers.<sup>5</sup> We also join recent efforts

<sup>4</sup> Peters, Pierre, and King, “The Politics of Path Dependence.”

<sup>5</sup> Koremenos, Lipson, and Snidal (eds.), *Rational Design*.

to take power and distributional issues seriously as determinants of institutional strategies.<sup>6</sup> In addition, our analysis encompasses state-centric approaches but could potentially include international organizations (IOs) themselves – and international governance arrangements more generally – as meaningful actors that shape the menu from which states, firms, IGOs, NGOs, and other actors make their choices.<sup>7</sup>

Perhaps most importantly, we relax the assumption of synoptic rationality common to standard institutional IR theory in favor of the more realistic and fruitful assumption of bounded rationality, thereby opening important connections to sociological, constructivist, and institutional economic approaches.<sup>8</sup> In their famous article on New Institutionalism three decades ago, March and Olsen criticized “modern” theories of politics *inter alia* for their use of synoptic rationality.<sup>9</sup> They invited political scientists to ground their work in more realistic bounded rationality and develop theories that allow for the possibility of “inefficiency in history” and the “relative autonomy of institutions.” Broadly speaking, this is what our theory does. Few political scientists have come up with new theories of politics squarely built on bounded rationality.<sup>10</sup> Our theory reveals the considerable added-value from combining traditional rational choice elements with bounded rationality and insights from other “new institutionalist” theories, including sociological institutionalism.

Bounded rationality leads to a fresh view of institutional choice and generates novel implications that we examine in the empirical chapters of the book. We highlight here a few key differences with conventional institutional IR theory and summarize some of the main implications of our approach that we test in later chapters.

<sup>6</sup> Gruber, *Ruling the World*; Drezner, *All Politics is Global*; Barnett and Duvall (eds.), *Power in Global Governance*; Büthe and Mattli, *The New Global Rulers*; Stone, *Controlling Institutions*.

<sup>7</sup> Barnett and Finnemore, *Rules for the World*.

<sup>8</sup> March, “Bounded Rationality, Ambiguity, and the Engineering of Choice”; Oliver, “Strategic Responses to Institutional Processes”; Katzenstein, Keohane, and Krasner, “*International Organization and the Study of World Politics*”; Fearon and Wendt, “Rationalism *v.* Constructivism”; Jupille, Caporaso, and Checkel, “Integrating Institutions”; Wendt, “Driving with the Rearview Mirror”; Zürn and Checkel, “Getting Socialized to Build Bridges”; Williamson, *The Economic Institutions of Capitalism*.

<sup>9</sup> March and Olsen, “The New Institutionalism.”

<sup>10</sup> For exceptions see Jones, *Politics and the Architecture of Choice*; Baumgartner and Jones, *The Politics of Attention*; Baumgartner and Jones, *Agendas and Instability*; Poulsen and Aisbett, “Bilateral Investment Treaties and Bounded Rationality Learning”; Weyland, *Bounded Rationality and Policy Diffusion*.

In standard decision theoretic analysis (and optimal design theory), actors are synoptic searchers (optimizers) able to canvass the whole range of possible choices and sequences of choices in light of their knowledge of the entire payoff structure.<sup>11</sup> In a process known as “backwards induction” they anticipate the distant consequences of their choices and thus fold the “decision tree” they face back from its terminal outcomes to determine their best strategies given the available alternatives. By contrast, boundedly rational choosers are “satisficers” who accept solutions that are good enough, rather than optimal.<sup>12</sup> They have a limited view of the available strategies and do not look all the way down the decision tree. Instead, they fold the tree forward, departing from the status quo to consider alternatives further down the tree only when earlier options fail to satisfy a minimum threshold requirement for acceptability.

Our analysis thus emphasizes that most prevailing institutional choices are “good enough,” or satisfactory, rather than perfect or optimal. The search further down the institutional choice tree – departing from USE of a focal institution to SELECTION of a forum from a menu of existing alternatives, to institutional CHANGE and finally to CREATION of a new arrangement – will occur only when the current situation is clearly inadequate. Deep-reaching searches will be relatively rare and, when they occur, are likely to be difficult and protracted.

Our approach emphasizes that states stick with the institutional “devil they know” as long as the status quo produces results above some minimum threshold. Risk, uncertainty, and other factors reinforce the status quo bias laid bare by the bounded-rationality assumption. We thus expect continued USE of existing arrangements to be the modal institutional choice, since it allows actors to gain sufficient benefits of cooperation without engaging in riskier or costlier institutional engagements. Moreover, even when they decide that the status quo is unsatisfactory, their instinct is to take smaller steps rather than venture far down the path of institutional choice. This contrasts sharply with the implicit prediction in standard institutional IR theory of swift and

<sup>11</sup> The institutional design literature implicitly uses a synoptic approach in evaluating the existing equilibrium as representing a roughly optimal outcome in terms of design features (Koremenos, Lipson, and Snidal [eds.], *Rational Design*). We discuss the limits of rationality here largely in terms of individual decision-making; the problem becomes only more severe and bounded rationality more appropriate in more complicated strategic game-theoretic settings.

<sup>12</sup> Lindblom, “The Science of ‘Muddling Through.’”

direct moves to new efficient arrangements to tackle fresh cooperation difficulties and challenges.

A second set of implications regards the interplay of efficiency and distributional considerations and offers another telling illustration of the distinctiveness of our approach. Under high levels of rationality (assumed in the standard model), cooperation is relatively easy when distributional differences are outweighed by joint efficiency gains, but when distributional differences loom large then cooperation is impeded by difficult bargaining problems.<sup>13</sup> By contrast, bounded rationality may mitigate or aggravate the impact of distributional considerations. When efficiency gains are large relative to distributional issues, bounded rationality may impede actors from achieving what would be relatively easy cooperative gains under full rationality. Conversely, bounded rationality may facilitate cooperation when actors bargain less hard because they cannot anticipate the distributional consequences, or else more readily agree upon distributively fair institutions.

Our theory generates distinct observable implications and, as we show in the empirical chapters, sheds light on a wide range of institutional choices in global commerce from the nineteenth century to the present. These include long-forgotten cases, such as the CREATION of the Mixed Courts of Egypt, and familiar ones such as the CREATION of the GATT/WTO. We also examine a range of other significant instances of USE, SELECTION, CHANGE, and CREATION in postwar to twenty-first century global commercial governance. The theory generalizes beyond commerce and beyond the international but we use this domain to show it at work.

The book contains seven chapters in three parts. Our introductory Part I is organized in three chapters and begins with this introduction. Chapter 2 then develops the theoretical framework explaining the choice of institutional strategies to address cooperation problems. Our analysis starts from the presumption that states have incentives to cooperate so that we can focus on their choice among alternative institutional strategies that can help them do so. As noted above, our key modification to the standard IR cooperation literature is to assume that states are boundedly rational. This locates the argument between

<sup>13</sup> Krasner, “Global Communications and National Power”; Morrow, “Modeling the Forms of International Cooperation”; Fearon, “Bargaining, Enforcement, and International Cooperation.”

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the extreme assumption of rational design (RD) that states craft “optimal” institutions to address their problems and the opposite extreme “path dependency” assumption of historical institutionalism (HI) that institutional choice is driven by circumstances and proceeds without significant attention to overall design and its likely consequences. Both of those extreme assumptions are caricatures, of course, and one of the virtues of our argument is that it allows us to better develop the common ground between the RD and HI approaches by identifying the conditions under which the different logics operate and by providing a mechanism that links them within a unified framework.

Our logic is simple. Many, perhaps most, cooperation problems arise in the context of an already institutionalized status quo with a focal institution that is the default institutional alternative. For example, a new health scare caused by the emergence of a hitherto unknown virus such as SARS will be quickly referred to the World Health Organization (WHO), whereas a global security threat will usually go first to the UN Security Council. In such cases, we expect the focal institution to be USED unproblematically to address the issue. Sometimes, however, multiple institutions may be likely prospects to handle an emergent issue. For example, a North American trade dispute might be referred either to the North American Free Trade Agreement (NAFTA) or to the World Trade Organization (WTO);<sup>14</sup> here we might see forum shopping as states vie to SELECT one or the other institutional arrangement to handle the problem. In yet other cases, no institution provides a sufficiently good match for addressing the problem and states will need to CHANGE an existing institution to handle it. Minor institutional adjustment or rule adaptation resulting from experiences of what works or does not work during regular USE of an institution does not qualify as CHANGE, in our usage. However, alteration of higher-order rules, e.g., the revision of a major treaty or constitution establishing an institution, is CHANGE. Successive treaty modifications in the European Union EU, for example, represent CHANGES in the institution in response to changing cooperation problems over time whereas agreement on lower-order EU regulations represent USE. Finally, and in rare cases, no available institution is suitable (or can be CHANGED) to handle the problem and states find it necessary to CREATE a new institution.

<sup>14</sup> Busch, “Overlapping Institutions.”

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Institutional CREATION is the replacement of one set of governance rules by a novel institutional order, which is likeliest after systemic breakdown or in the face of a major crisis.<sup>15</sup> An example is the CREATION of many new institutions after the Second World War (GATT, NATO, World Bank, IMF, etc.). Again, what is distinctive about our theory is that while states make rational decisions regarding their institutional USCC strategies, they do not necessarily make optimal choices; rather, they settle on the first satisfactory choice along the USCC sequence.

Our theory presents the main institutional strategies of USCC – our dependent variable – as stark alternatives. However, as we illustrate in the empirical analysis, there are no bright lines between USCC categories, and they bleed into one another and interact in practice. USE of an institution will entail CHANGES – minimal ones such as having altered the historical record of whether or not the institution is reasonably effective, or more consequential ones of changing beliefs regarding the focalness of the institution for future interactions. Similarly, CHANGE and CREATION cannot be strictly distinct under our assumption that there is no “blank institutional slate”: CREATION of an institution necessarily can be viewed as institutional CHANGE from a broader perspective. The point is not to get caught up in such conceptual conundrums but to understand the relationship between the categories and how best to apply them as guides to understanding institutional choice.

Our framework implicates a number of relevant theoretical variables, including issue characteristics, efficiency and distributional considerations, power and capabilities, uncertainty and transactions costs. These are too many and complex to consider all at once; we therefore use “partial analysis” by considering the impact of individual factors both theoretically and then empirically. We bring these different elements in selectively to understand the particular circumstances of USCC decisions and provide a summary of their expected consequences in different circumstances. We are attentive to possible interactions among these multiple factors but begin with “main effects” as a manageable way to inaugurate our investigation.

Part I concludes with Chapter 3, which considers why the International Trade Organization (ITO) failed, the General Agreement on

<sup>15</sup> Ikenberry, *After Victory*.