

# The Institutions of NAFTA

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## ABSTRACT

Since NAFTA was concluded in 1994, talk of next steps in North American integration has been a frequent topic of scholarly and public debate. At the heart of that debate reside questions of whether to deepen or expand, reinvigorate or consolidate the agreement. As NAFTA matured, part of this debate focused on the agreement's relative degree of institutionalization. These issues received renewed attention in the aftermath of the September 11, 2001 terrorist attacks on the United States. Drawing upon the insights of the so-called new institutional economics, this paper argues that NAFTA is, in its entirety, a set of institutions governing North American economic relations. As the post-9/11 debate over the next steps in North America moves forward, policy makers would be wise to consider how modifications to these institutional structures are shaping incentives, including the way we think about economic relations in North America.

**Key words:** economic institutions, NAFTA, integration, reasoning

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## INTRODUCTION

On January 1, 1994, Zapatista rebels launched a rebellion in Chiapas, Mexico, intended to coincide with the implementation of the North American Free Trade Agreement (NAFTA). New Year's Day 2008 saw a similar –albeit much less violent– set of protests as Mexican farmers blocked several entry points at U.S. border crossings. Why? January 1 was the date final tariff reductions under NAFTA were to be phased in, mainly on agricultural goods. After nearly 15 years, NAFTA had been fully implemented. While the protests in Mexico were the bookends of the implementation phase, the controversy over NAFTA has by no means been restricted to Mexico, nor has it been limited to the implementation phase. Debate over the impact, meaning, and implications of NAFTA can be found nearly everywhere, and has even featured prominently in U.S. presidential politics.

Moreover, the debate over the economic, social, and political consequences among social scientists and the public at large has tended to deteriorate into starkly contrasting and uneven sets of economic, social, and political evidence over which there has been no shortage of debate (Wise and Studer, 2008; Courchene, Savoie and Schwanen, eds., 2005; Weintraub, ed., 2004; Wise, 1998).

As pointed out by Gary Hufbauer and Jeffrey Schott, much of what was promised from NAFTA was impossible from a free trade agreement and much of what has occurred since NAFTA cannot be directly tied to policy changes NAFTA facilitated (Hufbauer and Schott, 2005: 4). NAFTA's political supporters oversold –and continue to oversell– the benefits while detractors overstated –and continue to overstate– its negative consequences.

While the public policy debate over NAFTA, and the larger benefits of trade liberalization will undoubtedly continue, scholars have largely ignored a key area of investigation that could go some distance toward arbitrating the debate: institutions. The ink on NAFTA had hardly dried when discussions of the next phases of North American integration began (Weintraub, 1994). What would North America beyond NAFTA look like? What were the merits of “broadening” versus “deepening”? Should membership be expanded or consolidated? As NAFTA matured after 1994 and its operation was evaluated, some cited the comparative lack of “institutionalization” in the NAFTA region as a major reason for its perceived failures in areas such as economic dislocation, dispute settlement, or the environment (Anderson, 2006; Pastor, 2001).

Yet, in all of this debate over NAFTA's effects, proposals for “fixing” the agreement, or speculation over what the “next phase” should look like, there is seldom an explicit consideration of institutions beyond the standard economic theory of

integration (see Robson, 2004; Goldfarb, 2003; Dobson, 2002; Eichengreen, 1996). Similarly, proposals for “fixing” NAFTA or moving toward the “next phase” in North American integration do not consider the profound ways in which even subtle alterations to international trade rules can dramatically alter incentives for political, social, and economic activity. Scholars from a variety of disciplines might agree that institutions matter, but conceptual ambiguity over the definition of institutions has thwarted the application of a particular view of institutions to the analysis of international trade. As its point of departure, this article begins with Douglass North who said: “Institutions are the humanly devised constraints that structure political, economic, and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, and property rights)” (North, 1991: 97-98).

Under this definition, a whole range of social, political, and economic phenomena could be the result of institutions. One of the broad claims made by this paper is that NAFTA is, in its entirety, a set of institutions in the tradition of Douglass North. NAFTA has come to represent many things to many people. However, at bottom it is a set of institutions that have not only facilitated growth in trade and investment flows, but has also shaped the way we have come to *think* about economic, social and political, relations in North America.

As North also reminds us, productivity depends upon specialization and with it increased complexity in economic exchange, fraught with growing uncertainty and numerous transactions costs. Were it not for the development of institutions to help guide economic activity, economic actors would be completely lost in a world where the cost and uncertainty of obtaining information upon which to base economic decisions would virtually prohibit economic exchange. Institutions, therefore, necessarily evolve along with economic specialization and help transform the uncertainty associated with imperfect information into risk, thereby reducing transactions costs, and facilitating the capture of the potential gains from trade (North, 1990: 99-100).

In North’s most recent work, he proposes five elements underlying the process of institutional change and associated impact on economic performance: competition, scarcity, incentives, historical context, and *human perception* (North, 2005: vii). As recognition of the importance of institutions has grown, more and more research has been emerging on their impact on economic performance.

The *human perception* component of institutional change has been the least explored of the five components identified by North, but is perhaps the most important for understanding how institutions guide the economics and politics of North American integration. Traditional models of decision-making, including rational choice and Herbert Simon’s “bounded rationality” (1997), assume a utilitarian form of

rationality whereby humans pursue their goals efficiently, and decision-making, then, becomes a simple maximization process with self-interest at its core. However, these models have failed to elucidate how human beings perceive and understand the choices they confront.

This article makes three main claims. *First* is the basic claim that NAFTA is, and has functioned as, a set of institutions. *Second*, this paper will argue that incorporating the insights of psychology into how we perceive the rules of international trade should be a more prominent factor in their design. The *third* claim is that the insights of psychology and institutional economics should be even more prominent within contemporary policy debates over North American integration as policy-makers confront the challenges of post-9/11 security imperatives and their evident linkage with economics.

The balance of this paper will be structured into five parts, beginning with an overview of scholarly thinking about what institutions are and how they function along the lines outlined by North above. Part II will graft this conceptual approach to institutions onto NAFTA itself and begin building the case for an approach to international trade rules that more explicitly incorporates the consideration of institutions. Part III will add to the case for viewing NAFTA as a set of institutions through a review of empirical literature dealing with institutions and their effects, but also to argue for a closer examination of the *human perception* component of institutional change. Part IV will turn explicitly to literatures in psychology and cognitive science dealing with perception and reasoning and argue that while North American institutions need more explicit consideration by scholars and public policy officials, so, too, does the psychology behind our interpretation of them. Finally, Part V will return to the North American framework, but this time in the context of institutional change since the terrorist attacks of September 11, 2001 that have melded security to economics in the NAFTA area.

## **PART I: WHAT ARE INSTITUTIONS?**

The neoclassical economic model is comprised of many elements and makes numerous assumptions, but, at its core, it is all about choice under constraint (McCloskey, 1996). Whether our level of analysis is the consumer, the firm, or heads of state, each is confronted with a range of constraints, including scarcity, that shape the choice sets and structure decision-making. The constraints that shape our economic, social, and political decision-making are nearly everywhere we look and are comprised of a series of rules (formal and informal), practices, customs, and heuristics (or rules

of thumb), and their enforcement mechanisms through which we cognitively interpret the disparate and myriad information we are confronted with each day.

The definition of institutions borrowed from Douglass North is useful in terms of directing our understanding of patterns of economic activity toward the many humanly devised constraints that structure that activity, but is vague in terms of providing us with a clear explanation of what institutions are, what they are not, or where to look for them. Engaging in a systematic analysis of institutions requires that we know what they are. North's definition of institutions as informal constraints (sanctions, taboos, customs, traditions, and codes of conduct) and formal rules (constitutions, laws, and property rights), seems to suggest that institutions might be found everywhere. They are. Institutions are everywhere shaping our economic decision-making. That they are such a ubiquitous –and influential– part of our economy argues strongly for including them more explicitly alongside neoclassical theory as tools for understanding our economic system.

Classical economists such as Adam Smith and David Ricardo were among the first to point to the efficiency implications of specialization and the division of labor for rising standards of living (Irwin, 1996). As economies shift from autarkic modes of production toward more sophisticated and impersonal forms of production, specialization, and exchange, the ties of kinship underwriting the productive process through trust and familiarity lose their effectiveness in facilitating the process of exchange. With specialization and exchange, economic decision-makers are confronted with a series of problems arising from the inter-temporal nature of exchange including asymmetrical information, opportunistic behavior, moral hazard, and adverse selection (Stiglitz, 2002; Carlos and Nicholas, 1990; Weingast, 1984; Macneil, 1978).

Scholars of institutional economics, such as Douglass North, have pointed us toward the many ways in which institutions help structure and simplify our decision-making and dramatically shape economic outcomes. Institutions come in many forms including cultural traditions (Axelrod, 1986), formal constitutional rules, including the enforcement of contracts and property rights (Weingast and Marshall, 1988; Macneil, 1978; De Soto, 2000; Pipes, 1999), informal agreements such as handshakes, or the powerful ties among family members (North, 1990).

Were it not for the development of institutions to help guide economic activity, economic actors would be completely lost in a world where the cost and uncertainty of obtaining information upon which to base economic decisions would virtually prohibit economic exchange. Institutions, therefore, necessarily evolve along with economic specialization and serve to transform the uncertainty associated with imperfect information into risk. This in turn reduces the impact of transactions costs and facilitates the capture of the potential gains from trade (North, 1991: 99-100).

Yet, considerable ambiguity remains over what an institution actually is. One popular means of describing what institutions are makes them analogous to the formal rules of a football game (North, 2005). Two teams take the field bound by the same written rules, but may employ different strategies for winning the game. The rules shape the way the game is played, but are not determinative of the outcome. Douglass North's numerous attempts to simplify our thinking about institutions are intuitive, but somewhat limited in helping us transform institutions into subjects of analysis and investigation (Hodgson, 2006). This confusion is compounded by the widespread use of "institution" by scholars to help describe different phenomena. In some instances, such as in contract law, scholars do not even use the term "institutions," referring to them instead as "contractual structures" or "relational patterns" (Macneil, 1974; 1978). In other disciplines, such as international relations, the term "institution" is used to refer to everything from normative behavior between states, regimes (Keohane, 1982), formal treaties (international contracts) (Guzman, 2005), or bricks-and-mortar organizations such as the bureaucracies of the European Union or the United Nations (Pastor, 2001; Mearsheimer, 1994; Koremenos, Lipson and Snidal, 2001).

These conceptual ambiguities have arguably inhibited the application of institutional frameworks to many streams of social science inquiry, including international trade. Yet, scholars have begun to build upon Douglass North's initial definition to differentiate this particular brand of institutionalism from others. To begin, while institutions both constrain and enable behavior, institutions are also much more than common or coordinated behavior. They are mental representations that "enable ordered thought, expectation, and action by imposing form and consistency on human activities" (Hodgson, 2006). John Searle pushes the conceptual precision behind institutions further through what he terms "institutional facts." According to Searle, institutional facts are observer dependent in that they depend on human consciousness for their existence and meaning. Hence, a US\$20 bill exists as a physical piece of paper with numbers, some color, and the face of a famous person. However, it becomes an institutional fact only because of the functions we collectively assign to it, namely its use as a medium of exchange or as a unit of value. Unlike the physical characteristics of the bill, each of these is dependent on the mental representation humans assign to it.

Other kinds of institutional facts are derived from similar kinds of observer-dependent constructions, such as property (Pipes, 1999; de Soto, 2000), the price system (Hayek, 1945), or even passports. Few would argue that these institutional facts are unimportant in shaping human behavior, but in and of themselves, each of them has no inherent function or status except that which humans assign to

them. A US\$20 bill has no inherent qualities derived from its physical structure. Yet, our ability to assign status and function to it –Searle calls this collective intentionality– transforms the US\$20 bill from being simply a piece of paper into something considerably more useful.

When we contrast these kinds of institutional facts with facts rooted in the physical reality of our world, such as weights, distance, or gravity, we can see the difference. Physical facts are observer independent, and would exist with or without the presence of humans (Searle, 2005). In other words, institutional facts depend entirely upon people and the meaning and function they collectively attach to them, whereas facts as we observe them in the physical world exist independently of us. Searle argues that “the essential role of human institutions and the purpose of having institutions is not to constrain people as such, but, rather, to create new sorts of power relationships. Human relationships are, above all, enabling, because they create power” (Searle, 2005: 10). Institutions support, create, and guide a series of duties, obligations, and requirements that both restrain and create incentives for different behaviors. Consequently, observer-dependent institutions, such as money, require a significant degree of support from people to maintain them as institutional facts. In other words, we need to buy in. Doing so requires broad agreement about the meaning, status, and function of such institutions. For that, we need the uniquely human capacity for language that allows us to assign abstract meaning, status, and function to things that do not have obvious utility because of their physicality (Searle, 2005: 11-12). Paraphrasing Searle, without language, we would be unable to assign status. Without the ability to assign status, there would be no governance of power relationships via institutions, no frameworks into which we could place imperfect information, no simplifying rules to help us mitigate the risk associated with inter-temporal exchange.

Institutions are often said to be analogous to the rules, say, of a football game as above. However, in thinking about institutions as sets of rules, an important distinction can be made between those rules that are constitutive and those that are regulative. Rules governing driving can be considered regulative. People would still drive in the absence of traffic rules, but the ensuing chaos would undoubtedly result in more accidents. By contrast, constitutive rules generate behavior that is a direct manifestation of the rules themselves. Chess, money, property, government, and a range of professional sports, all exist by virtue of the underlying rule sets that initiate behavior (Searle: 2005). As we will see below, the institutions of NAFTA are both.

## NAFTA Has Institutions?

Conceptual ambiguities regarding institutions as used broadly in the social sciences are compounded in trying to apply these insights to international economics. Consider, for example, the pervasive use of the term of “rules” to describe the nature and function of institutions (Wise and Studer, 2007; Hufbauer and Schott, 2005; Rodriguez, Low and Kotschwar, eds., 1999). Depending on the academic discipline, rules, regimes, and norms are often used interchangeably. What is the difference between a rule and a norm? Under what circumstances do rules become regimes? And when, if ever, do we begin calling any of them institutions (Finnemore and Sikkink, 1998; Keohane, 1984: 5-17)? In fact, some disciplines are so confident of the meaning of such terminology that our shared understanding of definitions is often assumed. Adding further to the conceptual difficulties is North’s own distinction between formal and informal institutions seemingly covering virtually every kind of human interaction (North, 1990; 2005). Scholars have argued that these categories are more than semantic differences and have considerable conceptual importance, particularly where enforcement issues are concerned. For example, whereas norms involve a network of mutual beliefs rather than actual agreements, rules are the product of explicit agreements brought about by some authority, also implying a series of enforcement sanctions. Like rules, norms do involve approval or disapproval, but rules imply sanctions enforced by an agreed upon authority (Tuomela, 1995). In other words, norms and rules are similar, but differ importantly in terms of their enforcement. NAFTA is clearly more than a simple set of norms, primarily because of its formalized status and enforcement mechanisms, and might arguably be thought of as a trilateral contract (Koh, 1997; Salacuse, 1990; Macneil, 1974; 1978). Yet, when can an agreement like NAFTA graduate to the ranks of institutions as defined here, when the NAFTA area is so infamously said to be comparatively devoid of institutions (Pastor, 2001)?

North’s own definition of institutions as being composed of both formal and informal varieties only adds to conceptual difficulties by suggesting institutions govern virtually every conceivable kind of human interaction. This may be the case, but as Hodgson (2006) has pointed out, the use of the term “formal” seems to imply rules that are codified in legal systems while “informal” evidently denotes those that are extra-legal, or even illegal. Hodgson points to further distinctions between “rules” and “constraints,” adding further confusion to the applicability of institutional analysis to the understanding of economic performance. From a methodological point of view, focusing on formal rules as enshrined in a legal system is important, but may ultimately undervalue the importance a range of informal, but powerful, institutions that shape human behavior as well (Hodgson, 2006).



However, one of the most important conceptual ambiguities in work on institutions is the confusion over the differences between “institutions” and “organizations.” Hodgson (2006) argues that North has been insufficiently clear about the differences. Yet, much of that ambiguity stems from the level at which, and length of time over which, North applies the analysis of institutions. North is concerned with broad trends in economic and political change, some of which extend over a period of several centuries (2005). Yet, North’s basic distinction between institutions and organizations can be applied to micro- and macro-level analyses, as well as to both long and short periods of time. The most important distinction between institutions and organizations is actually the separation between individuals and the rules governing their behavior. This is an ambiguity that also pervades the debate over the lack of institutionalization in NAFTA (Wise and Studer, 2008; Schwanen, 2004; Pastor, 2001; Weintraub, 1994).

For clarity, we should look, as North (1990) does, to Ronald Coase (1937; 1960), who approached the structure of firms from the vantage point of transaction costs economics. In essence, the size and structure of an organization, or firm, was a product of efforts to internalize transaction costs associated with contracting and production. Firms and organizations will simply try to make exogenous transaction costs endogenous. How firms and organizations do so depends on the “rules” or institutions internal to the firm that are designed to manage endogenous governance. In short, institutions are readily identifiable within organizations such as firms. Firm governance, even among firms in the same sector, can vary significantly and have a significant impact on the relative performance of different firms. And, like institutions anywhere else, institutions internal to the firm have a collective intentionality to them that confer upon them a status and function within the organization, and are often constitutive of the very behavior they structure within the firm. Institutions are critical to, but separate from both organizations and the humans who work within them.

It might seem there is no direct parallel between the micro-level activities of the profit maximizing firm trying to reduce transaction costs and the kind of activity we see taking place as a result of NAFTA. Yet, applied to the macro-economies of North America, the parallel comes into sharp relief. The Coase Theorem suggests to us a rationalization of transaction costs between firms and suppliers in the process of production. Internalizing some of those transaction costs through alterations to a firm’s structure and production processes suggests the growth of efficiencies within the firm. If we think of the NAFTA area as a kind of “firm” in this light, we can see that NAFTA altered the structure of North American production by internalizing a range of transaction costs that were once external to each of the three NAFTA

countries. In other words, as NAFTA's rules facilitated the reduction of tariffs and other trade barriers within North America, border measures faced by each country were effectively internalized within North America.

## PART II: THE INSTITUTIONS OF NAFTA

Robert Pastor's widely cited book on NAFTA is an evaluation of the merits and shortcomings of two different integration models: the European Union and the emerging North American community anchored by NAFTA (Pastor, 2001). Pastor concludes, in part, that, whereas the European Union is paralyzed by too many institutions, the North American community faces a different set of problems because it has too few. Pastor's conception of institutions differs significantly from that posited here and more closely resembles institutions as defined by scholars of international relations (norms, rules, regimes, conventions, and organizations). However, Pastor correctly notes the absence of formal, permanent organizational structures in NAFTA. NAFTA contains no permanent adjudicatory body or office staffed with officials from all three countries. NAFTA is "run" out of each nation's existing trade policy bureaucracies, disputes are handled on an ad-hoc basis, and there are few enforcement mechanisms other than the threat of retaliation (recall Tuomela, 1995).

The point is that while NAFTA lacks some of the formal organizational bodies we most often associate with international institutions, even a cursory reading of the agreement makes clear that *NAFTA is emphatically, and almost purely, a set of institutions as defined by North and amplified by scholars like Searle and Hodgson.*

The literature on recent North American economic development is full of narratives about the politics of integration, as well as economic analysis of integration's effects. There are countless references in the academic and public policy literature, as well as the popular press, about how NAFTA has reshaped the way in which we think about economic activity in North America, how NAFTA has restructured commercial activity, and how the agreement fostered drives toward increased efficiency and productivity. We regularly hear a wide range of pronouncements about the impact of NAFTA on a variety of non-economic issues ranging from social policy to sovereignty. In short, we can find numerous anecdotal examples of how NAFTA has supposedly reshaped the way we conceive of North American relations in both economics and a range of other policy areas. Yet, while many would concede that NAFTA has been profoundly important in shaping the way we think about North American economic issues, there has been virtually nothing scholarly written about the ways in which NAFTA, as a set of institutions, has actually been responsible for it.

## The Rules of the NAFTA Game

We might usefully begin thinking about NAFTA in these terms by considering the oft-overlooked preamble of the agreement which promises NAFTA will “strengthen the special bonds of friendship and cooperation” among all three countries. While the preamble is not a particularly substantive part of NAFTA, we see in it a number of the characteristics pointed to by Hodgson in terms of “enabling ordered thought” about trade in North America, “shaping expectations,” and by imposing “form and consistency” on our thinking about trade among NAFTA partners. The preamble does all of this by also promising to reduce uncertainty about the broader trilateral relationship among NAFTA partners by extending the “shadow of the future” well into the distance. In other words, the agreement promises to alleviate uncertainties regarding the inherently inter-temporal nature of trade by saying that NAFTA will be more than a one-off exchange among the parties. The Preamble also sets out a number of principles that are both evaluative and prescriptive in setting the bounds of normative behavior.

Some of NAFTA’s most important institutions are found in Chapter One and the statement of objectives in Article 102, where the norms of *national treatment*, *most favored nation treatment*, and *transparency* are enshrined in the agreement. All three of these concepts rank among those that regularly litter the pages of scholarly literature and the popular press, but are often taken for granted as underlying norms supporting institutions. *National treatment* has been especially controversial for some, but profoundly important for institutional stability facilitating economic activity in North America. Applied throughout the agreement, *national treatment* ensures that the goods, services, and investments of firms from a NAFTA party will not face discrimination due to national origin. The related principle of *most favored nation treatment* (MFN) required that each NAFTA party extend to each other the most favorable treatment each gives to non-NAFTA countries. Combined with a commitment to *transparency*, these three principles alone contribute to the reduction of uncertainty and transactions cost, and enhance the stability of property rights and the ease of contracting across national borders.

The point is that each of these principles, and the broader agreement as a whole, embody the regulative, evaluative, prescriptive elements identified earlier. National treatment, MFN, and transparency are regulative in that they shape patterns of economic interaction that would exist independent of those principles. Both national treatment and MFN are evaluative in that they set benchmarks against which discrimination can be assessed and prescriptive in setting behavioral expectations among NAFTA parties with respect to non-NAFTA countries. These principles

are also constitutive in that firms which might previously have avoided NAFTA partner markets due to reservations about discrimination or transparency see these principles enshrined throughout NAFTA and elect instead to service partner markets. In other words, NAFTA actually generates the activity it also regulates, evaluates, and prescribes. The most obvious example of this kind of constitutive behavior is trade diversion, wherein NAFTA area preferences stimulate trade between producers that are not necessarily the lowest cost producers.

Moreover, these same principles can also be cast in terms of institutions versus institutional facts. National treatment, MFN, and the concept of transparency are all observer-dependent, and therefore institutions as described by Searle. If each of these principles is going to be regulative, evaluative, prescriptive, and constitutive, they need the collective assignment of status and function. In other words, each of the NAFTA parties needs to see eye-to-eye in terms of what the agreement means as much as with what it says.

### **Do We All Agree? Chapter 11 and Chapter 19**

NAFTA is a physical document full of words that has no inherent value or function. Neither the pages, nor the words written on them, actually do anything. Research on norm development by international relations scholars has also highlighted the evaluative and prescriptive nature of norms, rules, and regimes (Finnemore and Sikkink, 1998). NAFTA satisfies these criteria as well, facilitating determinations of fairness through its dispute settlement mechanisms, and defining the outlines of expected and acceptable behaviors in the conduct of international trade. However, without complete agreement on the status and function NAFTA's provisions carry, many institutional facts would cease, as might NAFTA itself as a set of institutions.

Two areas of emerging disagreement on this question illustrate this element well: Chapter 11 and Chapter 19. Chapter 11 of NAFTA was originally designed to strengthen the legal protections afforded private investors as they operated in host countries. Traditional protections offered under customary international law frequently left foreign investors subject to the discriminatory whims of host country governments, periodically resulting in outright expropriation (Reif, 2004; Graham, 2000; Salacuse, 1990). Given the history of Mexico's bouts with economic nationalism, including expropriation, NAFTA negotiators assumed it would be the main target of Chapter 11 investor-state dispute resolution. However, in addition to the regulative, evaluative, and prescriptive nature of Chapter 11, the provisions have also become highly constitutive of legal proceedings launched against all three countries. In fact,

of the 29 separate Chapter 11 arbitration cases that had been filed through fall 2007, 4 have been against Canada, 12 against Mexico, and 13 against the United States.

Interestingly, virtually none of these cases allege that there was an outright nationalization or expropriation of property as we think of it historically. Instead, suits creatively allege forms of discriminatory treatment in the application of regulatory measures imposed by states that are tantamount to expropriation of private property. It is remarkable that in the nearly 15 years since NAFTA began its implementation, there have only been 29 Chapter 11 suits. The twenty-nine Chapter 11 cases represent legal responses to a changed set of incentives brought about by NAFTA and by the lack of agreement among state parties and private interests over what Chapter 11 means rather than simply what it says.

A similar set of problems over the collective intentionality behind status and function hovers over Chapter 19. The long-running Canada-U.S. softwood lumber agreement has exposed important differences in the meaning and function Canada and the United States assign to Chapter 19. Chapter 19 shifted litigation over trade remedy law (anti-dumping and countervailing duties) away from domestic court proceedings and into *ad hoc* bi-national review panels (Hufbauer and Schott, 2005; Macrory, 2002). Each country would maintain their respective trade remedy laws, but Canada and Mexico hoped the shift to a bi-national panel system would speed dispute mechanisms and make them more impartial (Hart, Dymond and Robertson, 1994: 379-380). However, the bitterness of the softwood dispute has exposed significant differences in how Canada and the United States have come to see the status and function of Chapter 19 (Anderson, 2006).

The United States has tended toward a narrowly constructed interpretation of Chapter 19 provisions flowing from both the limited nature of NAFTA as a shallow form of integration, and the broad U.S. preference for preserving sovereignty latitude in international agreements. In practice, this means *ad hoc* panels may, at Canadian request, review the actions of U.S. agencies in adjudicating domestic law. However, panel rulings will not be allowed to infringe upon U.S. legislative prerogatives. By contrast, Canada has come to see the Chapter 19 provisions more expansively in terms of adjudicatory and enforcement powers. Specifically, Canada hoped that Chapter 19 would function similar to domestic court systems and act as an arbiter of disputes (Anderson, 2006; Gagne, 2000, 2003).

The apparent divergence between Canada and the United States over the status and function they each assign to Chapter 19 might reasonably be applied to NAFTA more broadly. Canadians have widely come to see U.S. willingness to adhere to the "spirit" of the agreement rather than just the "letter" as a litmus test for Canada-U.S. relations writ large.

## Cognitive Dissonance?

North American economic integration has been the subject of extensive analysis by scholars, heavily dominated by both economists and political scientists. Economists, in particular, have been prolific contributors to the debate over economic integration through their analyses of the impact of the North American Free Trade Agreement, as well as projections about the impact of potential successor agreements (this is a vast literature, but see Hufbauer and Schott, 2005; Pastor, 2001; Dobson, 2002). In spite of the considerable economic evidence linking NAFTA to real gains in export growth, GDP, and standards of living in North America, there is emerging evidence of growing discrepancies between what NAFTA actually says on paper, how it operates in practice, and what the agreement has come to “mean” on a variety of non-economic fronts (the softwood dispute being one component of that evidence).

All of this is supportive of the necessity of viewing NAFTA as a set of institutions as policy makers consider the future of North American integration. This will become even more evident as we turn to the important insights from microeconomics and psychology that reinforce the simple idea that “institutions matter.”

## PART III: INSTITUTIONS AND ECONOMIC PERFORMANCE

Transaction costs, uncertainty, contractual relations, and property rights—the domain of institutional economics— all, whether we always appreciate it or not, underlie contemporary discussions of North American integration. There is an important and burgeoning literature on economic development growing out of the analysis of institutions, which simply posits that institutions matter for economic performance (De Soto, 2000; Ferguson, 2004; Rodrik, 2006; Rodrik, Subramanian and Trebbi, 2004; Hall and Jones 1999; Glaeser et al., 2004). The analysis of institutions and their impact on economic performance reaches into literatures including industrial organization and the theory of the firm (Coase, 1937; Bolton and Scharfstein, 1998; Demsetz, 1997; Hart and Moore, 1990; Kronman, 1985), the development of property and contract law (Macneil, 1978; 1974), governance in domestic political bodies (Moe, 1991; Weingast and Marshall, 1988), and a simple neoclassical rationale for the integration of the state itself (North, 1981; Alesina and Spolaore, 1997).

One especially fertile area for the analysis of institutions has been in development economics, and in particular the work of Peruvian economist Hernando de Soto, who has argued that one of the principal failures of capitalism in most regions of the world outside the developed West is the inability to raise the capital so key

to development. For many in the West who have become accustomed to understanding *how* our economic system functions while forgetting *why* it functions, solutions to the challenges of development amount to simplistically trying to replicate Western modes of law and organization in developing countries through prescriptive formulas such as the Washington Consensus (Williamson, 1990; Rodrik, 2006). When such methods fail, explanations often include spurious references to cultural or religious differences rather than challenging the policy prescriptions themselves (De Soto, 2000: 3-4). One of the great mysteries of development is the divergence in economic performance among countries (Rodrik, Subramanian and Trebbi, 2004; Dollar and Kraay, 2002; Glaeser, et al., 2004; Easterly and Levine, 2003; Acemoglu, Johnson and Robinson, 2001) even among those with ostensibly similar legal and political structures. As De Soto (2000) vividly demonstrates, one of the central problems facing developing countries is the failure of their institutional structures to provide the basis for shifting the substantial capital that exists in their extra-legal economies into the legal economy.

Recent empirical evidence on the merits of institutions suggests they are necessary, but not sufficient, elements in economic development (Rodrik, 2006; Rodrik, Subramanian and Trebbi, 2004). In fact, recent work on property rights in Latin America suggests there remain important limitations to institutions such as land titles in freeing some of De Soto's dead capital (Field and Tororro, 2006; Galian and Scharrodsky, 2006).

This growing body of evidence in development scholarship exploring both the *how* and *why* behind the functioning of economic systems stands in sharp contrast to the lack of scholarly attention paid to the development of macroeconomic institutions in developed countries. One exception here has been the work of Beth and Robert Yarbrough, who in the late 1980s tried to apply some of the insights of micro-level work on institutions to international trade (1985; 1986; 1987a; 1987b). Most intriguingly, the Yarbroughs argued that institutional structures such as the General Agreement on Tariffs and Trade (GATT) operate much like a private contract by delineating the terms of the relationships that develop among the membership, as well as how the GATT transforms uncertainty in trade relations into risk by managing the opportunistic behavior associated with the kinds of inter-temporal exchange involved in international trade (1987b), not unlike the ordering of relations between private parties through contracts (Macneil, 1978; 1974), or the same kind of broad management of risk alluded to earlier when we begin viewing NAFTA as a trilateral contract.

Interestingly, while the voluminous literature on NAFTA includes countless analyses on the merits of rules-based trade and the relative merits of institutionalization in North America, particularly since the terrorist attacks of September 11, 2001, no

attention has been given to how the rules of NAFTA shape economic activity beyond standard econometric analyses of growth of trade and investment flows. Even here, the measurement challenges associated with directly tying NAFTA to the growth in trade and investment flows have been the source of some debate (Studer and Wise, 2008: 27-75; Hufbauer and Schott, 2005; Weintraub, 2004: 3-20). It is clear from the numerous public opinion surveys and academic studies focused on the possibility of a nascent North American identity that NAFTA is shaping how Canadians, Americans, and Mexicans think about a range of issues, much of it in favor of closer economic ties (Bennett, 2004). Yet, NAFTA is also having an impact on how North Americans think about economics beyond the typical scholarly considerations of how many widgets cross borders, the convergence of values, or the emergence of a tri-national identity.

#### **PART IV: HUMAN PERCEPTION AND INSTITUTIONS, PSYCHOLOGY AND COGNITION**

Among the most basic of findings of psychologists and cognitive scientists has been the tendency for humans to try to order their complex world through simplifying heuristics, or rules of thumb (Simon, 1979; 1959; Baron, 2000). In economics, this function is partially served by the many institutional structures that help guide economic decision-making in what would otherwise be a world characterized by pervasive uncertainty and opportunism. Institutions such as the price system, systems of property rights, and the rule of law provide us with guidelines through which we process the imperfect information around us. Under the neoclassical model, we frequently talk about the “profit maximizing” firm under conditions of perfect competition. If competition and information were perfect, the precise structure of economic organizations like firms would be irrelevant for economic performance (Coase, 1937). Were we in a world of perfectly competitive conditions, we could confidently talk about a zero-transaction-cost world where markets instantly established market clearing price and quantities for supply and demand and we could instantly contract with each other for virtually all forms of exchange. In other words, in such a world, economic decision-making would devolve into straightforward maximization problems instead of being fraught with uncertainty and risk. Hence, because we live in a world characterized by high transaction costs, imperfect information, and considerable uncertainty, it only makes sense to talk about the “profit maximizing” firm in the context of that maximization being a firm’s goal rather than an outcome.



## Rational Choice Institutionalism

In both the economics and public choice literatures, rational choice modeling, notably game theory, has been a popular method of identifying the key factors motivating economic and political decision-making (Munk, 2001; Axelrod, 1980; Hoppman, 1998; Thompson, 2001). The debate over rational choice theory has been raging in political science for some time and has been joined by those investigating the impact of institutions in areas such as economic and political development. Of particular interest is new research into the “informal” side of North’s definition of institutions; namely, the sanctions, taboos, customs, traditions, and codes of conduct that also shape our decision-making. Critics of rational-choice approaches to institutional analysis point out that it is often informal sets of institutions that undergird and support the formal structures that are so frequently the focus of empirical studies (Helmke and Levitsky, 2004). In fact, in order to fully understand the “institutional scaffolds” (North, 2005) that so deeply structure our decision-making, we need to approach investigations of institutional development from both a formal and informal point of view. As Weyland has also argued, rational choice institutionalism’s focus on self-interest as the prime motivating force for decision-making has led investigators toward incorrect inferences about actor preferences. Specifically, researchers have either inductively inferred actor preferences by looking at their actions or deductively inferred them by looking at the incentive structures set up by institutions (Weyland, 2002). In either case, argues Weyland, researchers miss key factors that shape both political outcomes and institutional development, particularly in regions such as Latin America and Africa where formal institutional development is weak.

Even with respect to the study of formal institutions, the identification of preferences among decision-makers is a tremendous challenge. Within neoclassical economics, such preferences are said to be everywhere. The assumption of rationality by decision-makers posits that they will make choices that will allow them to reach a higher level of ordinal utility. The problem is that the use of ordinal utility curves tells us very little about the actual preference sets of decision-makers.

## Irrationality and Mental Models

Donald McCloskey has reminded us that neoclassical economics is really all about choice under a series of constraints (1996). These constraints come in many forms, but include limited time and imperfect information. The reality of the human condition is that individuals have limited computational capacity and are able only to

selectively search through all possible alternatives or evaluate their consequences. In addition, the search for information is incomplete, often contains inaccuracies, is based upon partial information (i.e. the role of prior knowledge or levels of expertise), and often terminates with the discovery of satisfactory, although not necessarily optimal, courses of action (Simon, 1985). Herbert Simon has argued that the self-interest assumption in human rationality breaks down amidst the range of other motives for human decision-making, including significant, even necessary, levels of altruism (1993; 1991).

In order to reach strong conclusions about economic activity, the neoclassical economic model makes a number of simplifying assumptions about decision-makers, including a basic self-interested rationality. Yet, even economists have challenged this broad notion of rationality as the basis for economic activity, arguing that the “market” always functions rationally through the efficient allocation of capital and other factors of production, while individuals frequently engage in all kinds of sub-optimal behavior (Becker, 1962).

The disciplines of psychology and cognitive science have pointed to additional weaknesses in assuming rationality on the part of individuals within a rational market. For many kinds of observed behavior, we might conclude that we are witnessing a kind of satisficing behavior resulting from constraints on time and information.<sup>1</sup> Yet, psychology and cognitive science have suggested additional weaknesses in this assumption, including an inability to apply self-interested rationality with the information we have before us. In fact, the rationality assumption has been under attack by psychologists for more than 50 years. Herbert Simon, in his influential 1955 article “A Behavioral Model of Rational Choice,” argued from empirical evidence that individuals are just sufficiently rational to achieve some *minimum* level of a desired outcome, but not sufficiently rational to achieve some *maximum* level of a desired outcome (Simon, 1955). Studies of human reasoning have even identified instances in which information relevant for making self-interested assessments is ignored (although not intentionally), as well as instances in which differences in the mere presentation of information influence our decision processes. Further, under conditions of uncertainty, human decision-making is strongly influenced by pre-

<sup>1</sup> Satisficing (a portmanteau of “satisfy” and “suffice”) is a *decision-making* strategy which attempts to meet criteria for adequacy, rather than to identify an optimal solution. A satisficing strategy may often be (near) optimal if the costs of the decision-making process itself, such as the cost of obtaining complete information, are considered in the outcome calculus.

The word “satisfice” was coined by Herbert Simon. He pointed out that human beings lack the cognitive resources to maximize: we usually do not know the relevant probabilities of outcomes, we can rarely evaluate all outcomes with sufficient precision, and our memories are weak and unreliable. A more realistic approach to rationality takes into account these limitations: This is called *bounded rationality*.

conceived stereotypes, beliefs, and personal experiences into which we regularly try to place new and imperfect information.

In short, the use of heuristics (rules of thumb) allows us to simplify a complex world, but can also lead to important errors of bias in the decision-making process (Tversky and Kahneman, 1974; 1981). By themselves, the limitations on cognitive processes suggested by psychology and cognitive science give us pause to reconsider the role of individual rationality within the neoclassical model. These limits render human decision-making intendedly rational but only limitedly so.

Over the past decade, researchers have begun to incorporate the insights of psychologists and cognitive scientists into analyses of the ways in which institutions shape our social, political, and economic lives. One early effort by Denzau and North from 1994 argued that humans developed and made extensive use of “mental models” as a means to simplify and order the uncertain world around them. From these models flowed a series of beliefs and ideologies concerning the world around us that served as heuristics for decision-making.

In order to understand decision making under conditions of uncertainty, we must understand the relationships of the mental models that individuals construct to make sense out of the world around them, the ideologies that evolve from such constructions, and the institutions that develop in a society to order interpersonal relationships (Denzau and North, 1994: 4).

More recently, North has suggested that explorations of human neurological processes by cognitive scientists may hold the keys to unlocking the ways in which humans learn about, structure, and adapt to the complexities of the world around us (North, 2005). North argues further that the institutional “scaffolds” that human societies have created are a complex product of cultural development, our individual and collective consciousness, and the richness of a society’s artifactual heritage—beliefs, institutions, tools, instruments, and technology. This heritage plays immediate roles in shaping the choices within societies (North, 2005: 23-65). The more complex the scaffolds are, North suggests, the more successful a society is likely to have been in transforming pervasive uncertainty into risk (North, 2005: 36). However, as North himself concedes, neuroscience is still a long way from uncovering the mechanisms by which our cognitive processes begin erecting these scaffolds (North, 2005: 38).

If how institutions shape our individual and collective decision-making is tied to elements of consciousness deeply embedded in widely held belief systems and culture, then looking at institutions in terms of the incentive structures they set out is as important as what we think those institutions mean. In other words, the sub-

jective meaning of the institutions we construct may be as important as the concrete incentive structures institutions actually generate.

## **PART V: POST-9/11 NAFTA AND INSTITUTIONAL CHANGE**

The dynamics of meaning underlying institutions and cognitive processes have risen in prominence within the NAFTA area. As the Agreement has matured the incentives set by its institutional structures in areas such as dispute settlement have generated expectations on the part of all three countries about the conduct and resolution of future disputes. As a result of a couple of high-profile disputes among the NAFTA parties, namely Canada-U.S. softwood lumber and the U.S.-Mexico trucking services dispute, fissures have emerged between what NAFTA means versus what NAFTA actually says. The long-running softwood lumber dispute is the quintessential case in which the advent of the Canada-U.S. Free Trade Agreement (CUFTA) and NAFTA were seen by many Canadians as bringing about the increasing application of the rule of law to such disputes. It was hoped by some that impartial arbitral panels under the CUFTA and NAFTA would facilitate the reduction of asymmetries of power and the role of politics in determining who was right and who was wrong in bilateral disputes (Anderson, 2006).

Yet, over the past 15 years of NAFTA, Canadians and Americans have come to view aspects of NAFTA very differently. In Canada, the softwood lumber dispute has become a litmus test of Canada-U.S. relations writ large. In the context of this narrow dispute, NAFTA itself is increasingly depicted in the media as a contractual arrangement that the United States regularly violates. For Canadians, NAFTA has become a set of institutions infused within all the obligations, written and unwritten, that flow from contracts. Yet, like a contract, NAFTA's design has involved fights over the meaning and purpose of every clause.

In short, NAFTA may have come to symbolize a range of things in Canada-U.S. relations that the agreement itself was never designed to resolve. Furthermore, it may be that the agreement has taken on a symbolic life of its own that in institutional terms transcends its narrow wording and has become part of the "scaffolding" that has been erected in North America.

All of this brings us back to the final implementation of NAFTA in January 2008 and the countless panels, articles, and political pundits talking about "next steps" in North American integration. In the time since NAFTA began its implementation phase in 1994, the debate over what was next was largely oriented around dramatically deeper institutional arrangements along the lines suggested by neoclassical

trade theory. Yet, the intellectual case for and against unions (customs, monetary, or political) in North America has been replaced since September 11, 2001 by a different set of imperatives linking security to economics (Anderson and Sands, 2007). If, over the past 15 years, North America had been moving toward a customs or monetary union, we would have likely seen a debate similar to that seen during the NAFTA debate, over the effects of liberalization and integration as predicted by neoclassical trade theory. And, like the NAFTA debate, it would have been one centered (and correctly so), on how many more widgets were being produced and traded in North America or on how a single currency was making their production more efficient.

Yet, as this paper has argued, this would have been only part of the story of institutional change in North America. These debates never took place, and instead have been supplanted by a set of imperatives aimed at reconciling the need for enhanced security while advancing the economic openness that facilitates growth. The North American Security and Prosperity Partnership (SPP) launched in 2005 aims to do this, not through a major negotiation, but through an incremental process of institutional development addressing more than 300 different issue areas (Anderson and Sands, 2007). The range of post-9/11 institutional change affecting economic activity in North America has been piecemeal and profound. It has ranged from the restructuring of federal bureaucracies in Canada (Public Safety) and the United States (Department of Homeland Security) to the reorientation of U.S. immigration and customs inspection procedures that have altered the incentives for the movement of goods, capital, and people within North America (Anderson, and Sands, 2007).

In part because these institutional changes do not involve the major political or organizational shifts that a customs or monetary union would entail, we have few of the predictive guideposts offered by neoclassical trade theory as to the impact of institutional change. The politics of trade liberalization in the past decade suggest that a major new integration project, such as a customs or monetary union, is not in the offing any time soon. Since more *ad hoc*, piecemeal approaches to North America are more likely for the time being, a robust research agenda focused on how institutional change in North America is constructing the scaffolds that shape how we think about economic relations seems prudent. Yet, with a few exceptions, our analyses remain focused on how many widgets are crossing borders.

## CONCLUSION

In the 15 years since NAFTA was concluded, public policy in North America has generally focused on next steps in the integration process. It was not a question of if,

but rather when and how, North America would continue down the path toward greater degrees of integration. The parameters of the public debate have largely swirled around the “benefits” that have accrued to all three countries. The number of widgets that cross borders is important, but fails to consider how NAFTA has institutionalized governance by helping construct the cognitive scaffolds that shape the way we think about economic relations in North America. NAFTA is almost entirely a set of institutions. The contrasts between the limited integrative ambition of the North American economic space and that in the European Union are vast. Nevertheless, NAFTA has facilitated a shift toward a more cohesive North American community that continues to deepen. NAFTA’s provisions are almost entirely observer-dependent and involve the collective (trilateral) assignment of status and function to make them work. Institutions have longevity only to the extent that we can collectively assign status and function to them. Without this collective intentionality, institutions fall apart and cease to shape the incentive structures by which we make decisions.

In recent years, several high profile disputes have suggested divergences in the status and function each NAFTA country assigns to the dispute settlement mechanisms narrowly, and perhaps NAFTA more broadly. As security and economics become increasingly intertwined, those contemplating next steps in North American integration may be missing the mark in pursuit of customs or monetary unions. Borders are important –and obvious– places to focus policy makers’ attention. However, if we can begin thinking about North American governance in terms of institutions as outlined here, we could move the debate over “next steps” in North American integration away from dramatic and controversial projects such as customs or monetary unions, away from narrow debates over how many widgets cross the border, or how long it takes them to do so, and toward the design of institutional scaffolds reflective of how people actually think about economic relations in North America.

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