

# TOWARD AN OPEN WORLD ORDER: A CONSTITUTIONAL ECONOMICS APPROACH

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That freedom cannot be maintained without order is hardly disputed. That order cannot be maintained (for long) without freedom may be more difficult to understand, or easier to forget, but is equally true.

—Jan Tumlir (1977, p. 19)

## Introduction

Some economists argue that the absence of an international government is a serious hindrance to an open world order. In this paper, I explore the nature of an international order and argue that an adequate legal framework within nations provides the necessary institutional structure for the emergence of an international order. Moreover, the advantage of being an attractive partner for international transactions creates an incentive for nations to create sound legal institutions. However, it will be seen that the relaxation of constitutional constraints on the national political process has made it difficult to maintain an open world order. Increasing governmental regulations that tend to be biased against international transactions

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are at the source of the constitutional crisis affecting national and international economic order.

The paper also discusses the potential role of international policy commitments in restoring an open world order. I assert that international agreements can have a function similar to national constitutional rules. In the realm of foreign trade policy, such agreements can be understood as a set of policy commitments exchanged among governments, with the goal of suppressing national policies that reduce access to foreign markets. After the introduction of international commitments into domestic law, national courts would be charged with their enforcement. This idea has been most prominently advocated by Jan Tumlir whose constitutional economics approach to a stable world order has strongly influenced my thinking.<sup>1</sup>

Constitutional economics focuses on the crucial distinction between rules and outcomes.<sup>2</sup> The main argument is that social interactions are conditioned not only by resource constraints but also by the set of rules or institutional arrangements that govern the choices of individual actors. Rules define the framework within which these ordinary choices are made. Rules shape the structure of incentives and therefore have an important influence on outcomes. The analysis implies that if the limits to individual behavior are well defined and the rights are recognized and accepted, social interaction will proceed in an orderly fashion. An order will emerge within which the interdependent behavior of separately motivated individuals is reconciled to generate patterns of outcomes that are tolerable to the participants. Mutual agreement on defined rights facilitates voluntary exchanges that coordinate specialized activities and enhance the individual welfare of all parties to the agreement.

In the following section, the concept of an international economic order is developed. The potential contribution of international institutions toward orderly international transactions is discussed in the third section, and the fourth section draws some conclusions for further analyses of the institutional structure for an open world order.

<sup>1</sup>See Tumlir (1977, 1979, 1980, 1983a, 1983b, 1984, and 1985). A survey of his main ideas is given by Hauser, Moser, Planta, and Schmid (1988). Other authors who take a similar approach to world economic order are Abbott (1985); Hauser (1986, 1988); Hauser, Moser, and Schmid (1987); and Petersman (1986, 1988). See also Dorn and Niskanen (1989).

<sup>2</sup>See Buchanan (1975), Brennan and Buchanan (1985), and Vanberg and Buchanan (1988). A survey of constitutional economics is given by Buchanan (1987a, 1987b), and by Gwartney and Wagner (1988, chaps. 1–2).

## The Concept of International Order

In a world economy with more than 100 independent countries, people derive their productivity from a high degree of specialization based on comparative advantages. As Adam Smith pointed out, the ability to exploit individual talents is made possible by the greater number of exchanges generated by the extension of markets.

### *International Order as a Reflection of National Order*

The conditions that facilitate exchange on the national level are equally important for international transactions. First, the property rights involved have to be clearly demarcated. The limits to individual behavior have to be well defined and mutually recognized. Second, the property rights should not be subject to unpredictable changes resulting from governmental interventions. Constitutional limits that require a large majority for redefining property rights are necessary to reduce uncertainty about the legally enforceable bundle of rights.

International transactions are characterized as exchanges that take place between individuals living in different jurisdictions that have no common enforcement agent or common government. The link between the different jurisdictions is provided by their respective courts. If each court enforces international contracts treating the claims of foreigners equally to those of its own citizens, the courts facilitate nonsimultaneous international exchanges. The contracting parties know that in case of a disagreement they can use national enforcement agencies to settle disputes.

But what happens if the property rights are assigned differently in the involved countries? What law applies? Almost every country has established rules that instruct the courts when to exercise jurisdiction and when to apply foreign law in cases involving foreign elements. These rules constitute what is known as private international law. Before they enter an agreement, it is important that the contracting parties know what law will be applied in what situations; when the different property right assignments are known, the parties can take them into account. Hence, different property rights do not necessarily hinder international exchanges.<sup>3</sup>

<sup>3</sup>Even if the different property right assignments and rules are known, the problem of peculiar circumstances remains. Contracts do not include provisions for every contingency that arises *ex post*. Such contingency may make the contract meaningless or impossible to carry out. The task for lawyers is either to imagine what the parties would have agreed on if they had known the circumstances or to apply an existing rule that solves the case at hand. These rules may vary from jurisdiction to jurisdiction, perhaps to the surprise of the contracting parties. Consequently, international contracts are characterized by a higher degree of uncertainty, given the fact of incompletely specified contracts. I am indebted to Lytton Stoddard who brought this point to my attention.

The point of my argument is that international transactions need not rely on an international enforcement agency. The lack of a world government is not a genuine problem for the emergence of international order. The different national institutions can be used to protect the claims of individuals involved in international exchanges. If individuals can decide for themselves from whom to buy, if currencies can be exchanged easily, if national constitutional rules prevent government from unpredictable interference with property rights assignment, and if courts enforce international contracts, then an open world order can be expected to emerge. Such an order is the reflection of different national constitutional regimes and will greatly enlarge individuals' opportunities to engage in voluntary exchange.

### *International Order as a Public Good*

Before analyzing the reasons for the deterioration of the international order, its public good characteristics have to be discussed. Some economists and political scientists argue that an open international order is an international public good that will not be supplied by any government, except in the case of a leading power—a so-called “hegemon.” In the absence of a hegemon, an international government is needed to provide the open world order.<sup>4</sup> The conclusion that national enforcement structures can provide the appropriate legal framework for international order obviously contradicts this argument. The question is, “What are the incentives to create the appropriate institutions within nations?”

To analyze the public good aspect of international order, we must assume that governments enforce contracts among their citizens. Given this setting, I will consider the benefits for individuals when their own government also enforces contracts between members of the society and nonmembers.

The first situation to examine is one in which keeping track of individual compliance in international contracts is costless. Everyone knows how often someone has failed to fulfill contracts. In this case, each individual bears the costs of defaulting in the sense that if a person does not fulfill a contract, it will be more difficult for him to conduct further transactions with any foreigner. Individual interest

<sup>4</sup>A prominent proponent of this argument is Kindleberger (1987, p. 7), who identifies international public goods with “an open trading system, including freedom of the sea, well-defined property rights, standards of weights and measures that may include international money, or fixed exchange rates.” He argues (p. 2) that the underproduction of these international public goods is a “serious problem in international political and economic relations in the absence of international governments.” For a review of the discussion, see Conybeare (1984).

in being an attractive partner for international transactions would generate by itself an incentive to honor contracts with foreigners.”<sup>5</sup> In this instance, there is no need for governmental enforcement of international contracts.

It is obvious that monitoring individual compliance records in a worldwide setting is costly. Let us assume the extreme case in which keeping track of individual compliance is impossible. It is not feasible to know in advance who are the “cooperators” and who are the “defectors.” If one citizen can refuse to carry out contractual obligations in international transactions without being punished by a national enforcement agent, foreigners will take into account, in future transactions involving members of this society, that this enforcement institution does not protect foreign claims appropriately. Foreigners, therefore, will be more reluctant to enter a contract with members of this society than when their claims are strictly enforced. The nonenforcement or infrequent enforcement of foreign claims reduces the “compliance capital” of all citizens acting under the same enforcement institution. The noncompliance of some members creates negative externalities for other members of the same society. The defaulting citizen produces a national public bad.

These negative externalities indicate that gains may be captured through exchanges that reduce the externalities. We would expect that institutions emerge to lower the high costs of monitoring. For example, people may specialize in monitoring, or trade associations may be formed that guarantee the compliance of their members. Another way to increase compliance capital is for individuals to agree to have their government enforce foreigners’ claims the same way it enforces the claims of its own citizens. Equal treatment of foreigners by the national enforcement agent elicits the expectation that contracts will be uniformly enforced. Over time, foreigners will build up trust in the national enforcement institution and, as a result, be more likely to make contracts. Just as brand names stand for a certain quality of goods, the national enforcement process stands for the probability of compliance by its citizens in international transactions.

Creating a credible national enforcement agency is a public good. Moreover, it is a *pure* public good at the national level because individuals secure no private, personal reward in the case where they are forced to keep contracts with foreigners, or they would have

<sup>5</sup>Vanberg and Buchanan (1988) call this kind of self-enforcing contract “trust rules,” because individuals can realize cooperative gains by following rules in dealing with each other. This discussion is an extension of Buchanan’s original argument (1975, p. 108) on the public good aspect of obeying laws.

observed the contract voluntarily. By the imposition of utility losses on defectors, the national enforcement institution brings about the trust that makes all citizens more attractive partners for international exchange.

The public good is national because members of this society are made better off independent of the enforcement structure in foreign countries. Of course, the equal treatment also benefits potential foreign partners. They will certainly prefer to deal with people living in a society that forces them to comply in international exchanges. However, foreigners can be made even better off if they provide the same kind of enforcement structure in their own countries.

All in all, individuals find it in their own self-interest to acquire a reputation for honoring international contracts. There is an incentive for citizens in each nation to create institutions that enforce foreign claims. Therefore, we would expect that the institutional framework for an open world order would emerge spontaneously. The absence of a world government is not a sufficient reason to predict an underproduction of the necessary legal framework for international contracts.

#### *Relaxation of National Constitutional Constraints*

Thus far I have focused on the enforcement structure of international contracts. National "protective states," in the sense used by James M. Buchanan (1975), can provide an adequate legal framework for international transactions. Furthermore, the advantage of being attractive partners for international exchange creates an incentive to supply these legal institutions at the national level. However, the use of national collective actions for the benefit of special interests interferes with voluntary international exchanges and erodes the necessary framework for an open world order.

According to Tumlir (1977, p. 14), "The problem of the international order is not an essentially international problem. The difficulty, rather, is that virtually all the core countries are passing at present through a difficult crisis of democratic home governance." Concurrently with the accumulation of governmental economic responsibility (for macroeconomic goals as well as for particular structural results), there has been a relaxation of constitutional constraints on governmental activities.<sup>6</sup>

<sup>6</sup>Two illustrations of this tendency as it relates to written rules are the termination of substantive due process for economic regulation in the United States (see Siegan 1980; Epstein 1985) and the change in the practice of the Swiss Federal Court, namely to start considering "social rights" as a limit of economic freedom. Furthermore, unwritten rules that once served as constraints on the political process, such as adherence to a federally balanced budget, no longer prevail (see Buchanan 1986, pt. 4).

These institutional changes increased governmental activities, especially on the federal or national level. Whereas the capacity of local governments to tax and to redistribute is limited by competition with each other, that form of competition is less effective among federal governments because exit and entry across nations are very costly. Therefore, federal governments left unconstrained have the proclivity to accumulate regulation and taxation.

The major instruments for federal governments are nationwide taxation and pure in-country regulation on the one hand, and monetary and trade policies on the other hand. Of course, the distinction between regulation and trade policy is arbitrary. (In the following discussion, trade policy is defined as those kinds of taxation and regulation that affect transactions between domestic persons and foreigners in a discriminating way.)

The reason to distinguish between in-country policies and trade policies is that the political exchange processes from which they emerge are different. Winners and losers of pure in-country policies belong to the same jurisdiction and have the same participation rights. In contrast, governmental interventions in the realms of trade and monetary policy have spillover effects to foreign individuals. Foreigners, however, have a relative disadvantage with respect to influencing the domestic political process: They do not have the right to vote. They can only contribute to campaigns and support domestic lobby groups. Therefore, as long as trade regulations and pure in-country regulations are close substitutes, a vote-maximizing regulator will prefer those programs that export part of the costs to foreigners.<sup>7</sup> Consequently, a biased structure of regulation toward interventions at the border can be expected.

Through this structural bias, monetary as well as trade policy is affected. Interfering with convertibility and influencing the exchange rate are some policy options for governments in the realm of monetary policy. The major advantage of trade policies, however, is that they allow governments to discriminate against specific groups.

The pattern of trade regulation is analyzed in the literature on the political economy of protectionism.<sup>8</sup> Informational asymmetries, high transaction costs for organizing broad interest groups, and the institutional design for political representation of regional constituencies

<sup>7</sup>A similar argument is made by Maloney, McCormick, and Tollison (1984) in the context of regulation of export production given an inelastic foreign demand.

<sup>8</sup>Surveys of this literature from a theoretical perspective can be found in Baldwin (1982) and Frey (1984, ch. 2). A review of recent models is given by Ursprung (1987). Empirical results are summarized and discussed in Anderson and Baldwin (1981), Lavergne (1983), and Frey (1984, chap. 3).

are some of the factors that contribute to a biased structure of trade policy. The wealth effect of trade measures on protected industries (capital owners, management, and workers) is highly visible, is concentrated, and can be defended against potential entrants by sophisticated regulation. Although the political institutions, within which protection is granted, vary among different countries, econometric evidence indicates that concentrated declining industries with a large number of low-wage employees get more protection than other groups.<sup>9</sup> Because of the difficulties in organizing consumer interests, producers of consumer goods are especially successful.

The main contribution of this literature is that trade policy can be explained as a struggle between interest groups *within* nations. Or as Ludger Schuknecht (1989) puts it, in a game theoretic framework protection results from an *intranational* prisoner's dilemma and not from divergent "interests of countries," however defined. Trade policy instruments are major means for interest groups to extract rents from other domestic groups.<sup>10</sup> This redistributive rent seeking creates spillover effects on foreigners—mainly as an unintended consequence of the domestic struggle.

The use of trade policy for redistribution within nations renders international transactions difficult. The erection of entry barriers for large markets causes individuals to give up their self-chosen specialization. Furthermore, the threat of protection creates a genuine uncertainty regarding access to major markets. In such a situation, long-term commitments through investment and specialization become more risky.

## Contribution of International Policy Commitments to an Open World Order

### *Constitutional Function of International Agreements*

In a world with domestically unconstrained or inadequately constrained governments, international agreements can have an important function. Such agreements can be understood as a *set of policy commitments exchanged among governments*. Some of these provisions have the character of general rules. They are largely in a negative mode and seek to suppress certain national policies that have

<sup>9</sup>See Anderson and Baldwin (1981), Marvel and Ray (1983), and Ray and Marvel (1984).

<sup>10</sup>See Rowley and Tollison (1986) for a rent-seeking approach to protection. The Australian "transparency" literature (e.g., Laird and Sampson 1987) has been arguing for a long time that trade policy is part of domestic rather than international politics.

large spillover effects on other countries.<sup>11</sup> If these international rules are properly enforced, they impose restraints on the domestic political process. In that case, international agreements reduce the risk of governmental interventions in international private transactions and, thus, contribute to an open world order. The following analysis of the function of international agreements proceeds on the presumption that such agreements are enforced. The issue of enforcement is discussed in the following subsection.

Because domestic trade policies create spillover effects on other countries, conflicts among governments arise. International agreements are one way to reduce these externalities and, hence, to avoid conflicts. Different kinds of international rules are possible. A national-treatment commitment is an obligation to treat foreign goods the same way as domestic goods. This rule corresponds to complete free trade because no discrimination between nationally produced and imported goods is allowed. The principle of nondiscrimination (or most-favored-nation clause) is a weaker commitment. It requires that a government does not discriminate between foreign suppliers. To put it differently, a government promises that it will extend the favored treatment of any third country to all other participating countries.

The existing international trade agreement, the General Agreement on Tariffs and Trade (GATT), includes the principle of nondiscrimination together with the provision that a bound tariff is the only permitted instrument for protection.<sup>12</sup> The principle of nondiscrimination still allows individuals to buy from the cheapest foreign source, as long as tariffs are nonprohibitive. Although the GATT prohibits quantitative restrictions, the principle of nondiscrimination itself makes it politically difficult to erect quantitative trade barriers. The only way not to violate this rule would be by auctioning off quotas. Furthermore, this procedure would have to be repeated regularly to reflect changes in the comparative advantages of foreign suppliers. As such, the amount of protection is highly visible and, therefore, politically more costly for rent-seeking industries. Government's ability to respond to protectionist pressure is further reduced by the GATT requirement of a bound tariff. A bound tariff is an unattractive instrument for protection-seeking industries. Once the initial rent is consumed, the industries are again exposed to changes in world prices.

<sup>11</sup>The purpose of the negative ordinance is emphasized by Tumlin, for example, (1977, p. 7, and 1985, p. 10).

<sup>12</sup>GATT (1986), Articles I and XI.

International trade rules can limit the range of domestic collective choices. If effectively enforced, these rules change the outcome of the domestic political process. They contribute to an international order if the overall level of interventions in international transactions can be reduced and if internationally compatible instruments are chosen. In this sense, international agreements have a function similar to national constitutional rules. They provide a framework of self-imposed restraints on policy options that reduce government's discretion to intervene in private affairs. Therefore, international commitments can reinforce the constitutional protection of property rights within each nation. The restricted ability of governments to interfere in international exchange strengthens the property rights of consumers and importers. Both groups can buy to a larger extent from their individually preferred suppliers. In the words of Tumlir (1983b, p. 80), "The international economic order can be seen as the second line of national constitutional entrenchment."

*Enforcement as a Major Weakness of International Constraints*

The main problem with international policy constraints is their enforcement. Institutional devices have to be developed that sanction those governments that violate the rules.

One possibility is a horizontal system in which countries that are harmed by foreign policies retaliate by imposing sanctions on defaulting governments. For example, the GATT allows the erection of roughly equivalent barriers against imports from offending countries.<sup>13</sup> Some authors (e.g., Dixit 1987 and Richardson 1986) favor the strategic use of retaliation in trade policy, and recommend Robert Axelrod's (1984) "tit for tat" strategy. A country should start with a free trade policy, but as soon as other countries erect barriers to trade, it should retaliate with certainty. At the same time, the retaliating country should send out credible signals that it will restore free trade as soon as the other countries abandon their protective measures.

To be consistent, the reliability of retaliation as an enforcement device for international rules has to be considered from the payoff structure confronting the involved governments. For governments that try to maximize political support, retaliation is not an attractive instrument. It requires interference with international transactions in response to interventions by foreign governments. In the first stage, the retaliating government harms its own citizens, in addition to those already negatively affected by trade policies of foreign countries. Even in a successful case, sanctions will be taken only if

<sup>13</sup>GATT (1986), Article XXIII.

the retaliating government gains more political support from removing foreign restrictions than it loses from the harm it imposes temporarily on domestic groups.

A successful sanction depends on the ability of the retaliating government to harm a politically important group in the country with the rule-violating government. Given this presupposition, retaliation is only an effective instrument for large countries. In addition, there is the inherent danger that retaliation is just an excuse for granting protection to politically important domestic groups. Therefore, retaliation is an unreliable enforcement mechanism for international agreements and, furthermore, is likely to increase instability. Nobody knows what international transactions may be subject to retaliating measures.

A more promising strategy for the enforcement of international agreements is their introduction into national law, as suggested by Tumlrir (1983b, p. 82): "One can imagine the international economic policy commitments of a government to be undertaken in the form of self-executing or directly effective treaty provisions, creating immediate private rights enforceable against one's own government. . . . These rights would be enforceable in national courts only, with no sacrifice of legal sovereignty." According to this proposal, individuals would get direct access to existing domestic procedures for judicial review by national courts.

In the realm of trade policy, the basic principle of international trade commitments can be introduced into national law, like the national-treatment requirement or the principle of nondiscrimination. Of course, this approach is difficult to realize as soon as international agreements develop into complex regulations, leaving open a large range for discretionary interpretation.

The use of domestic institutions for the enforcement of international commitments can be effective in maintaining an international order, because its erosion is mainly caused by domestic political struggles. In the case of protectionism, the direct access to national courts by those individuals harmed by domestic trade policies strengthens their positions and helps to correct the asymmetries in the political process.

### *Emergence of International Policy Commitments*

A fundamental question remains: How is it possible that international policy commitments emerge, and why can such restraints not be imposed unilaterally?

The traditional argument is that international rules reduce spill-over effects of national policies and, therefore, are more effective

than unilateral commitments. However, the public choice perspective offers a further argument.<sup>14</sup> The international dimension creates *new coalitions in the domestic political process*. Obvious examples are international trade negotiations. A multilateral move toward freer trade will find support from export-oriented industries that want access to new markets. In such a context, the producers interested in protection encounter the producers interested in export expansion. Such a multilateral trade liberalization on a reciprocal basis confronts different producer interests in the domestic political process. From this point of view, reciprocity in trade negotiation is not a mercantilistic concept; it is essential for overcoming the asymmetric, producer-biased structure of interest groups within nations. Domestic reforms and deregulation may get easier to implement with the support of export-oriented interest groups generated by simultaneous deregulation of foreign markets.

From this perspective, international trade negotiations can be understood as an *exchange of domestic political support among governments*. To reduce trade barriers, a government needs policy commitments by other governments that create enough political support within the first government's constituency to implement the step toward trade liberalization. The agenda of a multilateral trade negotiation is an important prerequisite for a successful outcome. The issues have to be bundled in such a way as to achieve political support in the most important trading nations. In addition, (temporary) subsidies for the losers may be necessary to produce enough domestic support for the results of international trade agreements.<sup>15</sup>

## Conclusion

In this paper, I have argued that international order is merely a reflection of national constitutional orders. The domestic enforcement institutions have a two-fold task: first, to provide the legal framework for international contracts and second, to enforce the multilaterally chosen limits on domestic collective activities.

A constitutional perspective offers a fruitful approach for a positive analysis of existing international arrangements, such as the GATT. The question to ask is: To what extent and in which respects do

<sup>14</sup>See Roessler (1978) and Hauser (1986, p. 20).

<sup>15</sup>This point needs more precise modeling than is possible in this paper. Especially, one should elaborate on the benefits for national politicians from constraining their discretion. The skeptical view, put forward by Vaubel (1986), is well founded. Whereas he explains the behavior of international bureaucratic organizations, I focus on international policy commitments in the form of general and durable rules.

existing international agreements restrain domestic policymakers? Or, to put it differently, how do international agreements strengthen the national constitution of economic policy? Of course, such an analysis has to be based on a comparative assessment of the working properties of alternative arrangements.

To achieve an open world order the international route may be a promising strategy, as the public choice perspective suggests. Political entrepreneurs could use international arrangements to implement more rule-oriented domestic policies and, at the same time, contribute to a more open world order.

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