

International Political Economy: A Maturing Interdiscipline

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The world is “globalized.” Among developed countries, international trade now accounts for nearly 38 percent of gross domestic product (GDP). For developing economies, imports plus exports comprise nearly 49 percent of all national output. Over the last two decades, global flows of foreign direct investment have more than doubled relative to GDP. As journalist Thomas Friedman (2000, 9) has famously described it, globalization now allows “individuals, corporations, and nation-states to reach around the world farther, faster, deeper and cheaper than ever before.”

The field of international political economy (IPE) pre-dates the current era of globalization, but not by much; perhaps more accurately, it was created by scholars trying to grasp the fundamentals of this nascent age. Nonetheless, this young field is rapidly maturing. From a range of early perspectives, a dominant approach, referred to as Open Economy Politics (OEP), now structures and guides research.² Although political scientists are more apt to identify themselves as “international political economists,” OEP bridges the disciplines of political

¹ I am grateful for comments on an earlier draft of this essay from J. Lawrence Broz, Jeffrey Frieden, Gordon Hanson, and Marc Muendler.

² The term comes from Bates (1997).

science and economics and provides a vehicle for synthesizing the interesting work being done in both areas. Although there remain some significant differences between disciplines, and scholars are too often unaware of parallel developments in the other field, IPE is emerging as a true interdiscipline.

This chapter provides an overview of IPE. It begins with an outline of the early origins of the field, and then provides one of the first comprehensive statements of the OEP approach. It concludes by identifying areas for future research.

Origins

As a distinct field, IPE focuses on the politics of international economic exchange. Unlike some of the other areas surveyed in this handbook, IPE is a substantive topic of inquiry, rather than a methodology in which economic models are applied to political phenomena – although scholars are, in fact, increasingly drawn to such methods. The field is primarily informed by two sets of key questions. First, how, when, and why do states choose to open themselves to transborder flows of goods and services, capital, and people? In other words, what are the political determinants of what we now call globalization? In this first set of questions, openness is the dependent variable, or outcome to be explained, and politics (defined broadly) is the independent or causal variable. Economic theory posits that free and unrestricted international commerce is, with limited exceptions, welfare improving; many politically naïve analysts, in turn, expect countries to evolve toward free trade. By contrast, IPE begins with the

reality that openness is historically rare, politically problematic, and a phenomenon that needs to be explained.

Second, how does integration (or not) into the international economy affect the interests of individuals, sectors, factors of production, or countries and, in turn, national policies? Here, government policy is the dependent variable and how the actor is situated in the international economy is the independent variable. In reality, of course, these two sets of questions are themselves integrated. For pragmatic purposes, however, nearly all analysts study just one half of the causal circle.

Although these questions were central to political economists of the late 18th and early 19th centuries, they fell into an intellectual limbo with the split between economics and political science into two separate disciplines in the late 19th century. As economics underwent the “marginalist” revolution and slowly transformed itself into an axiomatic science and political science turned to the study of formal-legal constitutions and institutions, both disciplines grew increasingly introspective. Questions concerning the political foundations of markets and the economics of politics were left to languish -- or were happily consigned to ostracized Marxists.³ Some scholars addressed questions relevant to IPE – witness E. E. Schattschneider’s (1935) famous study of the political logrolling that produced the Smoot-Hawley Tariff or Wolfgang Stolper and Paul Samuelson’s (1941) definitive proof of the distributional implications of liberalizing trade – but their studies were primarily oriented toward their respective

³ For an analysis of the early years of political economy and its trajectory, see Caporaso and Levine (1992).

disciplines and failed, at the time, to generate much interdisciplinary interest. What little cross-disciplinary research that emerged remained highly descriptive (Bauer, Pool, and Dexter 1972, Preeg 1970).

IPE emerged as a new and distinct interdisciplinary field beginning in the late-1960s and early-1970s as a result of two contradictory, real world developments. Together, these trends forced scholars to grapple anew with the same questions that had occupied earlier political economists. First, the success of the postwar international economic regime constructed at Bretton Woods and embodied in the postwar institutions of the International Monetary Fund, World Bank, and General Agreements on Tariffs and Trade (GATT), ushered in an era of increasing economic interdependence. By the end of the 1960s, as the tariff cuts negotiated at the Kennedy Round of the GATT took full effect, trade as a percentage of all economic activity began to rise rapidly in all advanced countries, leading to a new focus on the political impact of deepening economic ties (Cooper 1968, Keohane and Nye 1972). This new era was expected by some to transform the nature of international politics, with economic historian Charles Kindleberger (1969, 207) famously proclaiming that “the nation-state is just about through as an economic unit” and political scientists Robert Keohane and Joseph Nye (1977) unveiling a new model of international politics characterized by “complex interdependence.” We now recognize this surge of interdependence as the nascent phase of the present era of globalization, more frequently dated from the removal of capital controls in many developed

economies in the early 1980s. Many today still believe that globalization carries the same transformative potential (see below).

Second, at nearly the same time that interdependence was “taking off,” the political foundations of this open international economy began to crack, revealing for all that economic exchange rested on unstable political ground.⁴ In August 1971, facing the huge dollar “overhang” first theorized by economist Robert Triffin (1960) and the consequences of a decade of fiscal and monetary mismanagement, President Richard Nixon formally ended the convertibility of the dollar into gold, closing the door on the Bretton Woods regime (Gowa 1983). Two years later, the postwar exchange rate regime collapsed when the major currencies began to float against one another. Contributing to this monetary instability, the Arab boycott begun during the 1973 Middle East war transformed oil into a coercive weapon. Breathing life into the Organization of Petroleum Exporting Countries (OPEC), first formed in 1960, the factious states began to operate effectively as a cartel, raising oil prices fifteenfold between 1973 and 1980. Envyng OPEC’s success, even while suffering under higher oil prices, the developing world called for a New International Economic Order through which other commodity producers hoped to exercise similar market power with the acquiescence or hopefully support of Northern consumers. Finally, in response to the growth of imports unleashed by liberalization and rising interdependence, American industry began clamoring for increased or renewed trade protection. Trying to satisfy industry without undermining its commitment to free trade, the

⁴ An early and forceful statement of this insight was Gilpin (1972).

United States adopted a series of innovative non-tariff barriers to trade including “voluntary export restraints,” directed primarily at Japan (Goldstein 1988).

As international economic relations were politicized, it became apparent that international exchange was not an autonomous sphere -- a natural phenomenon beyond political machinations -- but was itself a product of the pulling and hauling of politics within and between countries. Just as property rights later came to be understood as both central to economic growth and a product of redistributive politics within countries, early international political economists realized that an open international economy rested on highly contested national policy decisions. As analysts struggled to understand the simultaneous growth and conflict in international markets, the field of IPE was born.

Early Currents⁵

Perhaps the earliest approach to IPE was *dependency theory*, developed largely by Latin American scholars writing in the 1960s and popular in North America and Europe in the 1970s.⁶ Described even by its adherents as a school rather than a single theory (Palma 1978), the many variants of dependency theory are unified by the idea that the economy and prospects for development in poor countries (the periphery) are conditioned by a global economy dominated by already developed states (the core). In the view of Andre Gunder Frank (1966),

⁵ An alternative typology divides theories into Marxist, Liberal, and Realist approaches. See Gilpin (1975).

⁶ The cornerstone of dependency theory is Cardoso and Faletto (1979), first published in Spanish in 1967. An early approach was Prebisch (1964). See also Marini (1972), Furtado (1973), and Sunkel (1969).

one of the more strident advocates of the approach, today's poor countries are not just undeveloped, as had been the case for the core centuries earlier, but are underdeveloped by an international economy that is forever biased against them. It follows that underdeveloped countries cannot follow the same path as the already industrialized states, as posited by modernization theory, but that they must pursue new and more autonomous strategies of development.

Despite its early prominence, dependency theory waned by the 1980s for two reasons. First, its proponents failed to develop a unified, logically consistent, and empirically robust theory of underdevelopment, or at least one that could compete in rigor and explanatory power with neoclassical economic theories of growth and development. Second, the theory was essentially falsified by the rise of the so-called newly industrializing economies, who despite all expectations of dependency theory "took off" in the 1970s using an export-led growth strategy (see Haggard 1990). Nonetheless, dependency theory taps into issues of international inequality, uneven growth, and national control over international economic forces that remain central to contemporary debates about globalization. Even if the theory is broadly rejected, the real world concerns that lent it credence endure.

A second early approach to IPE is hegemonic stability theory (HST), again more a school than a unified theory.⁷ Based largely on the experiences of Great Britain in the mid-19th and the United States in the mid-20th centuries, the key

⁷ HST is reviewed in greater detail in (Lake 1993).

intuition behind this approach is that a single hegemonic state is necessary and sufficient for international economic openness to arise.

One variant of HST, which I have elsewhere called leadership theory, derives largely from the economic literature on collective action (see Pahre 1999). Kindleberger (1973, 305) first identified a series of what we would now call international market failures that caused the Great Depression of the 1930s, and concluded “that for the world economy to be stabilized, there has to be a stabilizer, one stabilizer.” Economists Beth Yarbrough and Robert Yarbrough (1992) extend this basic insight to argue that an international division of labor necessarily produces greater relationship specific assets and the risk of costly opportunism. Building on Oliver Williamson’s (1985) work on markets and hierarchies, they treat hegemony as a form of hierarchy necessary to enforce contracts and maintain international order so that international exchange and investment can occur. Leadership theory nonetheless fails to demonstrate that privileged groups able and willing to provide international public goods necessarily have to consist of one and only one state (see Lake 1988, Snidal 1985). In principle, at least, small groups of countries are equally capable, undermining the theoretical case for the observed correlation between hegemony and stability.

A second variant, what I call hegemony theory, posits that large dominant states possess strong preferences for free and open international exchange and, in turn, coerce, induce, or persuade other states into opening their markets to foreign trade and investment (Gilpin 1975, 1977). Rather than focusing on

collective action problems, hegemony theory posits that states have different preferences over international economic policy and outcomes are a result of strategic bargaining. Hegemony theorists argue that either states have more complex utility functions, including not just national wealth but power and stability (Gowa 1994, Krasner 1976), or their large internal markets and increasing returns to scale industries give hegemons strategic trade advantages that they attempt to lock-in by encouraging others to adopt free trade (Lake 1988). Although plausible, these alternative intuitions have yet to produce a body of well-specified theory. Nor has hegemony theory successfully challenged orthodox international trade theory, especially the axioms that in a world of constant returns free trade remains the optimal policy for nearly all countries nearly all the time and that small countries benefit disproportionately from free trade.

As America's hegemony declined in the 1970s and 1980s, both variants of HST expected the international economy to become more fragile and, ultimately, to collapse into renewed protectionism and exclusive economic blocks (Gilpin 1987). The rising problems and tensions in the international economy, and America's own slide into new forms of protectionism, gave backing to this view. Yet, the open international economy did not fall apart – and, indeed, new and unprecedented forms of macroeconomic policy cooperation emerged in the late 1970s. In the early 1980s, scholars turned to regimes and institutions to explain the unexpectedly robust international economy (Keohane 1984, Krasner 1983). By the early 1990s, the Soviet Union had collapsed, the European and Japanese

economies had slipped into a decade of stagnation, and the United States was once again hegemonic – but HST was nearly forgotten. Central to this approach, however, was the recognition that not all countries are “created equal,” that some are more important to the openness of the world economy than others, and that large countries have particularly large effects on others. Although seldom appreciated by theorists building new models of interstate economic cooperation, the intuitions and set of ideas that motivated HST are now reprised in OEP’s focus on terms of trade effects within the international economy (see below).

A final early approach to IPE focuses on domestic interests largely in the advanced industrialized economies and, especially, in the United States.⁸

Practical observers of politics and, of course, scholars as early as Schattschneider (1935) had emphasized the importance of interest groups in trade policy. Yet, domestic theories of international political economy emerged only recently. An early foundation was Kindelberger’s (1951) essay on Group Behavior and International Trade, followed by, in political science, Peter Gourevitch’s (1977) study of the first great depression and, in economics, Richard Caves (1976) evocative rendering of different models of trade policy-making. In the ferment of the early years of IPE, political scientists built on these works to construct a demand-side or societal-based theory of trade policy (see Cassing, McKeown, and Ochs 1986, Frieden 1988b, McKeown 1984, Milner 1988). At about this same time, economists developed a parallel “endogenous

⁸ Complementing this domestic interest group approach, at least in political science, is a domestic structures model that seeks to characterize and capture institutional variations across developed countries (Ikenberry, Lake, and Mastanduno 1988, Katzenstein 1978).

tariff theory,” which also emphasizes the importance of domestic interests and lobbying (Baldwin 1985, Grossman and Helpman 1994, Lavergne 1983, Magee, Brock, and Young 1989, Pincus 1975). Key to much of this work was the differential ability of actors to solve their collective action problems and then build majority coalitions with, ultimately, importers triumphing politically over exporters, producers over consumers, and concentrated over diffuse interests. Less important than how groups define their interests (see below) is how they are structured and organized for political action. This early work on domestic interests nonetheless created the foundation for our contemporary approach to IPE.

The State-of-the-Art

Out of these early currents, and as a direct descendent of the domestic interest approach, OEP emerged and came to dominate the study of IPE in the 1990s. OEP adopts the assumptions of neoclassical economics and international trade theory. But by incorporating political variables more explicitly into its analysis, OEP provides a bridge between modern economics and political science – although the span is not yet fully closed.

OEP begins with firms, sectors, or factors of production as the units of analysis, derives their interests over economic policy from each unit’s position within the international economy, conceives of institutions as mechanisms that aggregate interests (with more or less bias) and condition the bargaining of competing societal interests, and, finally, introduces when necessary bargaining at the international level between states with different societally-produced

interests. Few theories give equal weight to all steps in this analysis. Most focus on one step – for instance, how institutions aggregate societal interests – and treat others in “reduced form,” or as analytic simplifications that are unmodeled in the theory at hand.⁹ In principle, the broadly shared assumptions allow the components to be connected together into a more complete whole, although in practice synthesis remains imperfect for reasons I will explain below.

Interests

The fundamental building block of OEP is interest, or how an individual or group is affected by a particular policy. In what may now be regarded as the canonical model (Grossman and Helpman 1994, 2002), actors that benefit from a policy are expected to expend resources in the political arena to obtain that policy (as a shorthand, to lobby) up to the point where the marginal cost of that effort equals the marginal benefit (defined either as “more” of the policy or an increased probability of obtaining a fixed policy). Conversely, actors that lose from a policy are expected to lobby against it. In short, politics is fundamentally about winners and losers from alternative policies.

Theories differ in what they assume to be the relevant unit of analysis. Although nearly all theories are fundamentally individualist, for pragmatic purposes theorists bundle individuals into groups that can be reasonably assumed to share (nearly) identical interests. In other words, when a policy affects a set of individuals in the same way, they are typically treated as if they constitute a homogenous group or, for purposes of analysis, a single actor. In

⁹ OEP is a subset of strategic choice theory, discussed in Lake and Powell (1999).

some OEP theories, individuals are primary but in most firms, sectors, or factors of production are taken to be the relevant units.

OEP uses economic theory to deduce what types of individuals can be reasonably assumed to share identical interests.¹⁰ A key divide within the approach is between the Ricardo-Viner or specific factors theory of international trade, which assumes that, typically, capital and labor are fixed in particular occupations and, thus, will tend to have similar interests over trade policy, and the Heckscher-Ohlin theory of international trade, which assumes that all factors are mobile across occupations and, therefore, capital, land, and labor will possess opposing interests. Stephen Magee (1980) attempted to discern which assumption was more appropriate by studying the lobbying behavior of capital and labor in the trade bill of 1973, and found support for the specific factors approach in his observation that capital and labor almost always testified on the same side of the proposed legislation. This implied that sectors were the appropriate unit of analysis for theories of trade policy.¹¹ More recently, Michael Hiscox (2002) has used cross-industry variations in rates of return as a proxy for factor mobility. In his small sample of industrialized countries, he finds that for the late 19th to the mid-20th centuries, as mass production was introduced, factor mobility for capital and labor generally increased, and from the mid-20th century until today factor mobility has generally decreased, which in turn is broadly confirmed by the changing structure of political interests on trade over the last

¹⁰ Alternatives attempt to derive groups and interests from institutional structure (Verdier 1994) or see interests as socially constructed (Abdelal 2001, Simmons and Elkins 2003).

¹¹ Baldwin and Magee (2000) find more support for the Heckscher-Ohlin model.

century. This implies that the relevant units evolved from sectors, to factors, and back to sectors over the course of the last century or more.

Having defined the relevant unit of analysis, OEP goes further to derive interests – preferences over alternative policies – from the distributional implications of different economic policies and, in turn, how a group is located relative to others in the international economy.¹² Firms vary by whether they are in the tradeable or non-tradeable sectors, produce import-competing or export-competing goods, use imported components, and so on. By knowing a firm's production profile (Gourevitch 1986), OEP predicts how it will be affected, for instance, by policies to increase international openness. Sectors vary by similar characteristics. Factors of production, in turn, vary by their scarcity relative to the world economy (Rogowski 1989, Stolper and Samuelson 1941). Using Mundell's (1957) equivalence condition -- that flows of goods and factors across international borders are equivalent in their effects on relative rates of return -- we can derive expectations about how factors will be affected by a large range of economic policies and, thus, identify their interests over those same policies. Although OEP first derived these distributional implications for trade policy, and the deductions remain clearest for this issue, the same method has now been used to identify the distributional effects of international finance and exchange rate policies (Frieden 1988a, 1991, 1997, O'Mahony 2003). The distributional implications of foreign direct investment, and especially the ownership of assets

¹² On studying preferences more generally, see Frieden 1999.

and production that such investment implies, remain the research frontier (Pinto 2004).

Deducing interests from economic theory was a fundamental innovation for OEP, one that makes the approach unique in political economy. Rather than treating them simply by assumption or inferring them from the political actions we often want to explain, interests are derived from a prior, falsifiable, and empirically robust theory -- putting the whole approach on a sound deductive footing. It is on this innovation that the distinctive nature and, indeed, explanatory power of OEP rests.

Institutions

Institutions aggregate conflicting societal interests, with varying degrees of bias, and condition the bargaining between opposing groups. In weakly institutionalized political systems, like the international system or “failed states,” coercive strength is expected to determine political outcomes; on average, and simplifying somewhat, we expect the side with the most guns to win. In highly institutionalized settings, like most domestic political systems, established rules and procedures generally reflect group strength over the long term. But because they often do other valuable things for society, like enhance the credibility of commitments, institutions can develop an independent standing and structure, channel, and sometimes offset brute force in the short term. At any moment, institutions serve to define what political power means in a particular society, whether the competition over policy will be conducted via votes, normally expected to favor labor, via contributions and bribes, often in capital’s

comparative advantage, or via ideas and argument. In short, institutions determine the rules of the political game.

Political scientists and, increasingly, economists are studying in detail how institutions aggregate interests. The findings are surveyed elsewhere in this volume (sections I-IV), and will not be reviewed extensively here. But among the more relevant findings for IPE are:

- Large constituencies – at the extreme, a single electoral district for the entire country – incline policy towards the general welfare, assumed to be the free flow of goods, services, and factors of production, while small constituencies bias policy toward more protectionist groups (Rogowski 1987).
- The more veto points within a political system (actors with the authority to block the enactment of policy), the more likely the status quo is to prevail, reducing the credibility of any promise to adopt political or economic reforms (Cowhey 1993) and, at the same time, reducing the ability of a government to respond effectively to external shocks (MacIntyre 2001).
- Proportional representation systems produce policy stability and inflexibility, implying less credible commitments to reform and less ability to respond effectively to external shocks, whereas majoritarian electoral systems tend toward policy flexibility and instability, with the opposite effects on credibility and effective response (Rogowski 1999).

Our understanding of how institutions aggregate interests is far more advanced for democracies than for democratizing or autocratic states. Interest aggregation

in non-democratic or newly democratic states remains an important area for future research.

Institutions also condition the bargaining between groups, largely by setting the reversion point for policy in the absence of some compromise and defining possible sidepayments, cross-issue deals, and logrolls. For instance, Peter Katzenstein (1985) argues that the small open economies of Europe developed corporatist institutions to facilitate economic adjustment, capital-labor cooperation to moderate wage demands, and compensatory social welfare systems to ease the costs to individuals of economic adversity. Dani Rodrik (1997) and Geoffrey Garrett (1998), and others have generalized this argument to all states, finding substantial evidence of an “embedded liberal” compromise (Ruggie 1983) in which social welfare policies are the “price” capital pays for economic openness. Similarly, multimember electoral districts, as in Japan, promote particularistic interests and policies, creating socially inefficient rent-seeking and economic inflexibility (Ramseyer and Rosenbluth 1993).

OEP recognizes, in a way that the earlier domestic interests approach did not, that interests are not enough. However well specified, interests are refracted through political institutions that often have an independent effect on policy choices. The focus on institutions is not, of course, unique to OEP, and in fact it is this emphasis that ties OEP into the larger literature on political economy reviewed elsewhere in this volume. What remains distinctive about OEP, however, is its insistence on explicit theorizing of both interests and institutions.

International Bargaining

With domestic interests aggregated through institutions into a national “policy” – or, more accurately, a national interest or ideal point – states then bargain when necessary to influence one another’s behavior and to determine the joint outcome of their actions.¹³ This is the third and final step in the OEP approach.

International bargaining commonly arises when the policies of one state create externalities for others. In many situations, externalities arise from the collective choices of many small economic actors. In these so-called market failures, individually optimal choices lead to collectively suboptimal results. These are well studied dilemmas, even if they remain difficult to resolve.¹⁴ In other situations, however, understanding the externality requires relaxing the “small country” assumption of traditional international trade theory, which holds that any individual state’s production or consumption is sufficiently small relative to world supply and demand that its actions cannot affect world prices. Under this assumption, the unilateral actions of states do not affect the welfare of others and, it follows, unilateral free trade is the first best policy. In a world of “large” countries, on the other hand, unilateral actions can affect world prices (for at least some commodities) and, as Kyle Bagwell and Robert Staiger (2002) demonstrate, negotiated movements toward freer trade can be superior.¹⁵

¹³ This includes unilateral actions that impose costs or benefits on others. In this case, the absence of overt negotiations can still be understood as bargaining.

¹⁴ Among others, see Frey (1984, Chapter 7) and Sandler (1997).

¹⁵ Empirical work on the magnitude of these terms of trade effects is rare and controversial. Whalley (1985, 246) notes that tariff levels reached during the Great Depression might well have been “optimal.” Given the costs of retaliatory policies adopted by many states following the Smoot-Hawley Tariff of 1930, this is implausible.

Although important, externalities are not a necessary condition for international bargaining to arise. Even when they are not directly affected by the actions of others, states may promote international norms and may be willing to pay some price to gain adherents or alter the behavior of possible violators. The effort to promote the “Washington Consensus” on development may be one example of norm driven behavior in the IPE (Stiglitz 2002), and attempts to regulate child sex tourism a possible second (Martin 2003).¹⁶ Nonetheless, most theories of IPE continue to assume that bargaining occurs mostly as a result of some material externality.

Much research in OEP focuses on how international institutions, like their domestic counterparts, structure bargaining and affect outcomes. There are essentially two approaches that, as Stephen D. Krasner (1991) reminds us, capture different but complementary dimensions of the bargaining game. The first, often referred to as neoliberal institutionalism, sees institutions as sets of rules that facilitate cooperation. By providing information, creating issue linkages, and reducing transactions costs, institutions help states reach Pareto-improving bargains (Bagwell and Staiger 2002, Keohane 1984). Current research has moved well beyond the sterile debates that dominated political science in the

¹⁶ We can convert normative principles into externalities simply by adding into an individual’s utility function a desire, say, not to see children exploited. Yet when there is no direct or indirect impact on a person’s welfare other than through the unobservable normative principle, the concept of externality is stretched almost to the breaking point. Nearly any observed behavior can then be “explained” by appeal to externalities.

1990s over whether international institutions “matter,” and now focus on how institutions are designed to achieve the aims of member states.¹⁷

A second approach focuses on bargaining over the gains from cooperation. If the first approach sees institutions as moving states closer to the Pareto frontier, this school emphasizes (the zero sum) movement along the frontier. As in most bargaining models, the key variables in this redistributive game are the relative cost of the reservation point to the parties, their time horizons (discount rates), and their ability to make credible threats and promises. James Fearon (1998) demonstrates that a long “shadow of the future,” which in the first approach promotes cooperation via the folk theorem, can also inhibit cooperation by raising the stakes over which the parties are bargaining.

In focusing on distributional conflict, this second line of inquiry implies that cooperation may not necessarily improve social welfare. The logic parallels ideas first developed in the “Chicago school” of economic regulation (Peltzman 1976, Stigler 1971). Groups may use their national governments to create international institutions that limit competition and produce rents they can appropriate. Robert Bates (1997) describes the International Coffee Organization as a cartel of large coffee producers allied with the large coffee roasters in developed countries that limited supply and raised prices at the expense of coffee consumers. John Richards (1999) finds similar cartel-like behavior in the international aviation regime.

¹⁷ See the special issues of *International Organization on Legalization and World Politics*, edited by Judith Goldstein, Miles Kahler, Robert O. Keohane, and Anne-Marie Slaughter (Vol. 54, No. 3, Summer 2000), and *The Rational Design of International Institutions*, edited by Barbara Koremenos, Charles Lipson, and Duncan Snidal (Vol. 55, No. 4, Autumn 2001).

This third level of OEP, however, remains less than fully integrated into the other levels. Clearly, as Robert Putnam (1988) and Helen Milner (1997) have shown, domestic interests and institutions can affect international bargaining and cooperation. The “Schelling conjecture” that domestic constraints improve a leader’s bargaining strength abroad generally appears to hold (Milner 1997, Tarar 2001). But as these examples suggest, the levels of OEP are typically assumed to cumulate in one direction -- from interests to institutions to international bargaining. Less attention has been paid to how international institutions affect the constellation of domestic interests or institutions.

Perhaps most important, domestic interest models, the bedrock of the OEP approach, continue to rest exclusively on the small country assumption. To the extent that terms of trade effects are present – by no means a constant -- and actions and agreements at the international level do affect relative prices, the strategic horizons of groups within countries are lengthened. No longer are groups merely struggling against domestic policy rivals, and taking the rest of the world as fixed, but they are pursuing their aims in combination with other similarly strategic actors at home and abroad. As Scott James and David Lake (1989) have shown in the case of Britain’s repeal of the Corn Laws in 1846, these strategic linkages existed even in the most important unilateral trade liberalization in history.¹⁸ The terms of trade effects on others were not the primary reason behind repeal. But British free traders nonetheless understood that eliminating

¹⁸ The definitive study of the repeal of the Corn Laws from an OEP approach is Schonhardt-Bailey (forthcoming). Nye (1991) argues that repeal was not a dramatic policy reversal and that, in fact, French tariffs were lower than Britain’s throughout this period.

tariffs on grain would benefit farmers in the American mid-West and, hopefully, lead them to defect from their protectionist coalition with the Northeastern industrialists for a free trade coalition with the cotton-exporting South. With repeal, this realignment that did, in fact, occur and led to the passage of the dramatically freer trade Walker Tariff by Congress later that same year.

Integrating terms of trade effects into models of domestic interest formulation is, in my view, the most important research frontier in OEP. As noted above, HST and the concerns that gave rise to that theory resonate with contemporary attempts to theorize more rigorously about how national actions affect relative international prices and how these prices, in turn, alter domestic interests and policy. Although the prior focus on hegemony failed to mature into sound theory, this earlier work may yet prove to be fertile soil for new models of international bargaining in IPE.

Beyond the State (of-the-Art)

There are many research frontiers in IPE, including those already noted above. In this closing section, I highlight three topics that are emerging as important areas of research that will, I expect, attract considerable attention in the years ahead. The issue areas, moreover, are not now linked to OEP, but are compatible with that approach and would benefit from a self-conscious application of its insights.

Endogenous State Formation

International trade theory assumes that state size is fixed and exogenous, even though the size of a country's internal market is a primary determinant of

the relative gains from international exchange. We also know that state size is highly variable across countries and over time. Indeed, the average size of states more than doubled over the 19th century, paralleling the rise in overseas empires, and then shrank back to previous levels (Lake and O'Mahony 2003), all the while approximating a log-normal distribution (Cederman 2003). Relaxing the assumption of static borders, allowing states to vary in size, and explaining the observed variations is a critically important question not only for policy makers who are concerned with the future of states, but also for analysts attempting to understand better political and economic outcomes.

In recent years, several models have been introduced to explain the size of states. This literature is reviewed more extensively in the essay by Enrico Spolaore in this volume. The best known of these models, developed by Alberto Alesina and Spolaore (2003), rests on the intuition that the per capita costs of government fall with state size, while preference heterogeneity and, thus, dissatisfaction with the uniform policies of the central government increases with size. Larger states distribute the costs of public goods over more taxpayers, create greater military power to fight or deter others, prosper from larger internal markets, and insure against regional economic fluctuations, but are limited by more citizens who desire different baskets of these goods. Alesina and Spolaore predict that democratization, trade liberalization, and the reduction of warfare will lead to a world of smaller states, whereas protectionism, autocracy, and wars will produce larger states.

The models developed thus far are, for the most part, functionalist and expect only that states will evolve toward their most efficient size. At most, political institutions vary, in a gross way, from democratic to autocratic ideal types. Richer and, hopefully, more empirically robust models can be built on the insights of OEP. Rather than relying on highly abstract assumptions that restrict preferences to vary in an orderly way over an even plane, OEP suggests which groups in which countries ought to be most supportive of, say, broader confederations or, conversely, of secession and smaller states. Extending Mundell's (1957) equivalence theorem further, the central tenets of OEP appear to imply that scarce factors of production should prefer smaller and more abundant factors should favor larger states, contingent on the level of international openness. Similarly, institutions that privilege one group or another should also influence state size in systematic ways. Analyzing the distributional implications of state size may well propel this nascent literature in important new directions.

Global Governance

Many analysts expect globalization to transform the structure of global governance. Continuing a theme first raised by interdependence theorists in the early 1970s on the imminent demise of the nation-state, globalization today is seen as forcing a convergence of state institutions and practices, often in a lowest common denominator "race-to-the-bottom," and prompting significant shifts in sites of political authority upwards to newly empowered supranational institutions, downwards to revitalized regions, provinces, and municipalities, and

laterally to private corporations and non-governmental organizations that acquire previously “public” responsibilities.

These trends are poorly documented – often resting on just a couple of vivid anecdotes – and controversial. Explanations tend toward the journalistic, of which Friedman’s (2000) description of globalization as a “golden straightjacket” is perhaps the best known. Like models of endogenous state formation, the evolving structure of global governance is typically explained in functional or efficiency terms.

Once again, however, OEP provides a more political way of understanding and, hopefully, explaining trends in governance. As Miles Kahler and David Lake (2003) suggest, OEP provides a useful foundation for theory-building.

Paraphrasing the Prussian military strategist Carl von Clausewitz, they begin from the premise that governance is politics by other means. If economic integration produces distributive outcomes that favor some groups and disadvantage others, political actors will possess distinct preferences over policies toward globalization itself (more or less economic openness) and policies to redistribute the benefits of globalization. Since institutions shape the politics of choice and the outcomes observed, concerned parties will attempt to align governance structures with their interests. That is, the politics of designing, building, and overturning institutions of governance at all levels is really about policy choices. Thus, debates about convergence, or its absence, and alternative sites of political authority are typically struggles over institutions that will produce results favoring some groups or interests at the expense of others. In this way,

issues of global governance can be brought into the purview of OEP, with the nature and effects of institutions themselves being the object of struggle rather than policy per se.

Kahler and Lake (2003) outline how OEP can be applied to questions of global governance, but there are many fruitful areas for continuing research. Critical questions focus on the coalitional and institutional characteristics that allow the losers from policy at the national level to succeed in shifting policy to another arena. When is a political minority at one level likely to be a majority at another? Do institutions like “supremacy” and “direct effect,” which have been so important in allowing disaffected groups to sidestep their national legislatures and affect policy through the European Court of Justice, generalize outside the European Union (Alter 1998)? Overall, it is obvious why the losers would want to shift the site of governance, but why would the national-level winners allow this to occur? Specifying when and how such shifts in the sites of governance occur remains a serious task.

Political Economy of Conflict

In recent years, political scientists have drawn upon similar work in economics (Hirshleifer 1987, Chap. 10) to construct what is widely known as the rationalist approach to war (RAW). This emergent literature is reviewed in Section XI of this volume. Briefly, RAW describes war and civil war as “bargaining failures.” Like strikes (Ashenfelter and Johnson 1969) or court battles (Schweizer 1989), wars are costly to all participants and, therefore, Pareto-improving bargains that the parties would prefer to actually fighting must always

exist. Violence arises when 1) at least one party possesses private information with incentives to misrepresent its knowledge, 2) at least one party cannot make a credible commitment to the possible bargain, or 3) the issue under dispute is indivisible, sufficiently lumpy to preclude satisfactory division, or not amenable to sidepayments (Fearon 1995). RAW has revolutionized the study of war and civil war and stimulated important new research agendas.¹⁹

This approach, however, typically treats states – or, in the case of civil wars, the “sides” – as unitary actors. For many disputes, this may be a reasonable assumption. As above, the test of this analytic simplification is whether it is plausible to assume that all individuals who comprise the relevant unit share relatively similar preferences. OEP suggests several ways, however, in which the core logic of RAW can be usefully applied at a more disaggregated group level. First, the issues under dispute may have distributional implications for groups within states (sides). Depending on the relative scarcity of land, for instance, traditional aristocracies may have more or less intense preferences for territorial expansion -- providing a firmer footing for Schumpeter’s (1951) famous explanation of imperialism as the product of “atavistic elites.” In addition, although the state (side) as a whole might lose from fighting, particular groups may benefit, especially if they succeed in redistributing the costs of war onto others. Even groups that themselves receive no direct benefit from the forcible resolution of a dispute may still gain from forming a redistributive majority coalition (Snyder 1991, Solingen 1998).

¹⁹ Reviewed in Reiter (2003).

Second, war may impose differential costs on groups within a state (side). As Rogowski (1989) notes, war typically represses international trade, lowering returns to the abundant factor of production and, over time, decreasing its political power (Lobell 2003). Similarly, if there is a single “best practice” in warfare, not only will states (sides) whose factor endowments are favored by the technology have a lower relative cost for war but mobilization will penalize some groups and benefit others disproportionately (Rowe 1999). The current revolution in military affairs, for example, promotes a capital intensive form of warfare that benefits rich, developed countries overall and disproportionately rewards owners of capital within those states.

The basic notion that issues in dispute and war itself have differential effects on groups has long been prominent in the literature on conflict. But until now, analysts have identified groups inductively and have lacked any theoretical means for identifying appropriate groups and their interests. OEP provides a solid foundation on which to rebuild this old insight in new and, hopefully, more productive directions. RAW, in turn, has not yet begun to incorporate group differences into its theoretical core. Marrying OEP to RAW promises to open new and important research avenues.

Conclusion

In three short decades, but a moment in academic time, IPE has grown into a true interdisciplinary, combining some of the best of political science and economics. From a welter of competing approaches, IPE has now centered on, if you will, a hegemonic approach that structures knowledge, generates puzzles,

and identifies areas likely to yield profitable future research. Despite its successes, OEP is not perfect. Many refinements and extensions are possible and, indeed, can be expected in the years ahead. Nonetheless, OEP is a powerful approach that promises future rewards.

The sources of this success are three-fold, and may be usefully emulated by other sub-fields and approaches. First, OEP is disciplined by a strong empirical foundation. From its inception, IPE has focused on historical trends in the international economy, both political and economic. Analysts have generally been careful not to mistake a single cross-section for all possible states of the world, but have mined the rich history available to them to test their theories. In turn, considerable attention has been devoted to developing appropriate indicators of trade protection, non-tariff barriers to trade, exchange rate regimes, and so on. Where IPE was originally constrained to case studies or, at best, statistical tests based on very limited data, some of the best new research employs very large time series datasets and powerful econometric tools. Whatever the method, however, IPE remains a strongly empirical science.

Second, OEP emphasizes deductive rigor. Political scientists, especially, have benefited from powerful theories developed in economics. Economists, in turn, have been prompted to take politics and political institutions seriously, and to integrate realistic understandings of political processes into their models. Scholarly debate has forced all to clarify the assumptions they make, revealing strengths and limitations, and to state propositions in clear and falsifiable ways, thereby opening arguments to empirical test. By working within agreed standards

of scientific inquiry, scholarly interactions and cumulative knowledge are facilitated.

Finally, OEP draws upon and is integrated into broader bodies of theory. Theorists have grounded their analyses in the pure theory of international trade, theories of collective action, and theories of political institutions – all developed in larger disciplines and for other purposes. This not only links OEP to broader research programs and facilitates cross-fertilization, but prevents analysts from reinventing the wheel each time they sit down at their computers.

Norms of theoretical rigor disciplined by empirical facts are now deeply inculcated in scholars of IPE. For the same reasons that substantial intellectual progress has occurred in the past, I remain optimistic about the future of this emerging interdiscipline.

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