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# Does North America Have the Right Stuff? An Analysis of Compatibility and the Potential Deepening of North American Integration

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# Does North America Have the Right Stuff? An Analysis of Compatibility and the Potential Deepening of North American Integration

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*This article assesses the current and future levels of North American integration. Econometric models that compare integration around the world indicate that integration deepens when countries have similar domestic, political, and economic institutions, and are economically asymmetrical. It is theorized that similar domestic institutions reduce transaction costs and uncertainty of success for firms while economic asymmetry provides incentives for and coordination among member states. In addition, institutional homogeneity also affects the level of integration. Currently, the North American partners lack high levels of these conditions, which explains the low level of integration. The analysis concludes with policy recommendations to improve the necessary conditions for the deepening of economic integration.*

**Keywords:** North American Free Trade Agreement, Power Asymmetry, Integration, Institutional Homogeneity.

*Este artículo evalúa los niveles actuales y futuros de integración de Norteamérica. Modelos econométricos que comparan la integración alrededor del mundo indican que la integración se profundiza cuando los países tienen instituciones domésticas políticas y económicas similares, y económicamente asimétricas. Se especula que instituciones domésticas similares reducen los costos de transacción e incertidumbre de éxito para las empresas mientras que la asimetría económica provee incentivos para, y coordinación entre, los estados miembros. Además, la homogeneidad institucional afecta también los niveles de integración. Actualmente, los socios Norteamericanos carecen de altos niveles de tales condiciones, lo que explica el bajo nivel de integración. El análisis*

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*concluye con recomendaciones de políticas para aumentar las condiciones necesarias para profundizar la integración.*

Since the implementation of the North American Free Trade Agreement (NAFTA), there has been little progress in deepening North American integration. In fact, the call for repeal and “renegotiation” of NAFTA has been more the norm during the election cycles in all three countries. However, the need to solve highly salient and commonly held problems has not diminished. This article will address the potential North America has in solving problems in a trilateral manner, that is, through the deepening of integration. If the three do not have “the right stuff,” then we are faced with the possibility of bilateral rather than trilateral cooperation, or more likely, a set of unilateral actions, which can produce suboptimal results. This study will examine the potential for further integration in North America through a review of theory and an empirical analysis of regional integration cases around the world. In the process I identify important variables that contribute to integration’s development and assess North America’s current position and future potential.

Why is it important to assess North America’s integration potential? Regional integration is one method countries use to solve commonly held problems, such as migration, security, and development. Migration, security, and development can be viewed as interrelated problems because they have in common the quest for a stable environment where individuals’ and states’ objectives can be realized. Individuals will choose to exit when they perceive the lack of economic opportunities and/or physical security in their home countries and believe that there are ample quantities of these two items in a neighboring country (Chang 1998). States seek to control immigration to maximize security and development in their countries (Nannestad 2007; Rudolph 2003). Political development also helps in the area of security by reducing the likelihood of civil conflict (Collier and Hoeffler 2002) and external threats (Kugler *et al.* 1997). Economic development reduces the likelihood that individuals will seek the exit strategy. It also increases the likelihood that states will experience domestic stability and favorable relations with neighboring states. Economic development therefore becomes the linchpin in solving the associated problems of migration and security.

The solution to the migration–security–development issue can therefore be conceptualized as a collective good because benefits are spread to all those involved, although not necessarily equally. However, collective goods are achieved through collective action, which is often difficult to carry out (Olson 1965). What are the main problems for achieving collective action and what form would this action take? Although there are many views associated with the collective action problem (Olson 1965; see also Ostrom 1990), I will focus on transaction costs with attention on how homogenous institutions lower such

costs. Transaction costs are costs borne by firms when they operate in a foreign political and economic environment. Differences between the home and foreign environment increase costs because of the need for firms to adjust. Also, with increased transaction costs comes uncertainty of success since they will be departing from what is known to what is unknown. These extra costs can discourage firms from requesting that politicians deepen integration, thereby leading to little to no action. In assessing North America's current and future state of integration, it is important to examine the compatibility of the three partners in light of transaction costs.

Collective action can take the form of regional integration. Regional integration is the establishment of collective decision making among states for the intention of establishing and regulating market flows (Haas 1958; Lindberg 1970). Market flows are the entries and exits of the factors of production (except land), as well as goods and services. The degree of integration refers to the degree of collective decision making. At one end is an intergovernmental arrangement where states make common decisions but are autonomous in regulating those decisions. If a regional authority does exist, it serves at the pleasure of the individual states. On the opposite end is the supranational arrangement, where regional institutions do exist and make decisions alongside intergovernmental arrangements or supersede member states' authority.

The remainder of this article examines the conditions that promote regional integration around the world with a focus on the compatibility of regional partners. Over the last 50 or so years, scholars have theorized integration's development. While there is no agreed upon set of conditions, certain variables are continually stressed by various authors (Feng and Genna 2003; Genna and Hiroi 2004). After theoretically isolating the important variables, I test the strength of their relationships through econometric analysis. Next, I discuss the implications of the data analysis for the current and potential progress of North American integration. I conclude with policy recommendations to deepen integration.

### **The Literature on Regional Integration**

Over the past 50+ years, various schools of thought emerged regarding regional integration. The oldest, neo-functionalism, posits that regional integration arises due to increasing technological, economic, and other complexities and problems that states can no longer effectively solve unilaterally and therefore enter into cooperative arrangements to cope with various functional needs (Haas 1958; Mitrany 1975). Once a cooperative arrangement is formed, the theory states that integration would deepen through a "spillover" process (Haas 1958). Through this mechanism, cooperative action in one functional area increases demands for cooperative arrangements in other functional areas because: (1) successful integration in one area would

gain supporters in other areas; and/or (2) further integration in another area would allow integration in the original area to fully succeed. Although neo-functionalism was highly lauded in its day, it has been criticized for the difficulties in generating testable hypotheses because many of the variables in question are not easily operationalized. Neo-functionalism also has difficulty determining, *a priori*, the functional areas that will be integrated. In addition, functional needs do not necessarily predetermine the direction of change that states may choose to pursue (Pentland 1973).

Institutionalism inherited the thinking of the neo-functionalist school by arguing that international institutions facilitate cooperation by overcoming collective action problems. They do this by making international commitments more credible through increasing transparency, enforcement of cooperation, promotion of issue linkages, and strategies of reciprocity (Axelrod and Keohane 1986; Martin 1992; Simmons 2000). Keohane (1984) further states that international regimes help cope with market failures and other problems that are difficult to manage at the national level. Institutionalists have studied the impact of the European Union institutions on the decision-making process, such as the agenda-setting power of the European Parliament (Garrett and Tsebelis 1996; Tsebelis 1994). Garrett and Weingast (1993) argue that institutions also provide precedents around which actors' behaviors converge.

Institutionalism has stimulated important research, but applying this research to understanding non-European regional integration has been limited because of the weak supranational institutional developments outside Europe. Moreover, the degree of institutionalization itself is a variable that needs explanation, but institutionalism, except for resorting to the functionalist argument of efficiency gains, has difficulty explaining the emergence of supranational regional institutions. Furthermore, researchers have criticized institutionalism for its focus on absolute gains, neglecting the possibility of absolute losses (Oatley and Nabors 1998) and relative gains (Grieco 1988).

However, another take on the institutional argument can be more useful if the focus is on state-level institutions and how the variation in domestic institutions influences the degree of regionalism. Feng and Genna (2003) reexamine the concept of institutions by including the established set of preferences in key areas of liberalization. They find that the homogeneity of institutions among member states not only facilitates integration, but that integration promotes greater homogeneity among members.

Power theories stress the distribution of power among states as a central factor influencing international outcomes. Among these theories, neo-realism argues that international cooperation develops from symmetric gains among actors (Grieco 1988; Waltz 1979). Grieco (1997) advanced a "relative disparity shift" hypothesis. Disadvantaged states that experience a shift of relative disparity in the capabilities within a region are more likely to oppose regional integration, but relative stability of capabilities tends to improve integration.

However, many neo-realists claim that the variation of gains is not important if cooperating actors are political and military allies (Gowa 1994; Gowa and Mansfield 1993; Mansfield and Bronson 1997).

Another power theory, hegemonic stability theory, argues that the presence of a hegemonic state—that is capable and committed to promoting economic liberalism—is a necessary condition to sustain liberal international commerce (Gilpin 1987; Krasner 1976). The erosion of hegemony, by contrast, tends to give rise to protectionism. In line with this argument, a thesis was advanced that the existence of one or more powerful states committed to integration is the key to the successful evolution of regional economic institutions (Gilpin 2001; Mattli 1999).

Like other power-centered theories, power transition theory focuses on the distribution of power in the international system. Power transition scholars assume that the international system is a hierarchic order presided over by the preponderant power (Organski 1958; Organski and Kugler 1977, 1980; Tammen *et al.* 2000; see Lemke 1996, 2001 for application to local hierarchies). The preponderant power establishes a set of *status quo* arrangements with the help of willing allies either at the global, regional, or both levels. A *status quo* arrangement is the set of preferences under which all states operate. The theory stresses the satisfaction with these preferences and the dynamics of a power transition that occurs when a subordinate power approaches and exceeds the capabilities of the preponderant power. Efrid and Genna (2002) extend the theory and argue that regional integration is likely to develop after a power transition between two satisfied states because the formerly less powerful country has a vital interest in deepening the arrangements that it believes contributed to its rise. Genna and Hiroi (2004, 2005, 2007) modified the theory by stressing the impact of trade dependence.

The final group of regional economic integration research stresses the importance of domestic politics and intergovernmental bargaining (Frieden 1991, 1998; Milner 1988, 1997; Moravcsik 1997, 1998; Rogowski 1989). This literature emphasizes the distributional consequences of integration for domestic societal groups and the desire of political leaders to hold onto power. At its core, scholars working with this approach contend that governments' economic foreign policies are strongly influenced by the conflict between those groups that expect to lose from integration and those that anticipate benefiting. Economic policies often reflect the preferences of the more powerful and better-organized interest groups in society. Moreover, domestic political institutions are argued to shape the patterns of interactions between domestic groups and the interests represented in government policies (Garrett and Lange 1995; Putnam 1988). However, the alignment of preferences that come out of the domestic bargain is also important. According to Haggard (1997), the difference between the developments of East Asian and Latin American regional integration is due to the convergence or divergence of preferences of member countries about the direction and extent of integration.

### Conditions of Regional Integration

The literature provides several important variables for explaining the levels of integration. The power theories indicate that the asymmetric distribution of power is a more favorable condition for integration than a grouping of similarly powerful actors. This is due to the ability of the preponderant power to coordinate efforts and distribute incentives to other members. In other words, the region must include a capable leader. Next is the compatibility of actors. Having a powerful regional neighbor alone cannot help the development of integration if there is wide preference disagreement. Although the powerful country could force preferences on others in the region, the outcome would resemble an empire rather than a voluntary association of countries.<sup>1</sup> To form a cohesive unit, political and economic environments must be similar to reduce transaction costs. Without compatibility, firms will assume a cost of having to adjust to foreign environments. Therefore, firms would prefer that regional integration develop between compatible actors so that the costs are low. The inclusion of firms in this explanation follows theories described in the previous section involving interactions between domestic groups and the interests represented in government policies.

Institutional homogeneity can deepen integration for two reasons. One is the perceived reduction of the costs due to the effects that identity politics has on cooperation. Prior research has demonstrated that states that have a similar political identity also have similar policy preferences (Souva 2004). Institutions can be defined as the set of rules and procedures that are deemed appropriate by the political leaders (March and Olsen 1984). Given this definition, individuals are assumed to make decisions based on institutional values (Peters 1999). Similar institutions breed ideological similarities since they share a “co-evolutionary process” (Denzau and North 1994). Norms and institutions reinforce one another, and therefore a country’s institutions are viewed as the expected expression of their norms (Maoz and Russett 1993). Similar institutions, therefore, will correlate with similar preferences.

The identity factor also provides a decision-making shortcut that would facilitate cooperation because it greatly simplifies a rather complex set of cognitive processes. Research into the dynamics of in-group and out-group behavior has shown that cooperation is easier among those that share an identity than those that do not (Tajfel 1978). Simply being viewed as “one of us” will elicit the type of cooperation that would also include resource allocations (Tajfel 1978). This holds not only for individuals but for states as well. For

<sup>1</sup> In fact, regional integration is understood as a voluntary association and therefore different from empires. Although this impact that would result from large power asymmetries could exist, discussion of this lies beyond the scope of this article.



example, Werner and Lemke (1997) demonstrate that alliances are more likely among similar states. With a similar identity, actors believe that cooperation is easier because of lower transaction costs.

A material mechanism is another reason for why similar institutions can improve the deepening of integration. Entrepreneurs are faced with two realities; parts of their business enterprises are controllable and others are not. The controllable parts are those within their firms and operations. They include personnel, marketing, physical operations, etc. Those that they cannot control are found outside the firm. These factors are the political, economic, and social factors of a country. For example, a firm cannot control the economic climate at any given time. Also, they cannot control the institutional arrangement of a foreign country. There have been examples of large firms influencing regulations, especially in small countries, but firms in general can at best lobby for their preferences at the margin. They are not believed to have the ability to produce revolutionary institutional change in a given country. Given this, firms are less likely to demand regional integration with neighbors that do not share similar institutions because needing to adapt to new environments introduces greater costs and uncertainty.

In sum, power preponderance and compatibility are the main conditions associated with the deepening of regional integration. A regional leader is needed for guiding the processes using available capabilities. Compatibility promotes the idea that states are similar enough in either perceived or material terms not to add additional transaction costs.

### **Hypothesis Testing**

I test the hypotheses using a panel time series linear regression technique that assumes correlated panels. Since such data properties produce inaccurate standard errors, a correction method is used (Beck and Katz 1995). AR(1) autocorrelation is assumed and the unit of analysis are the regional integration organizations from 1975 to 2004. The time frame is bounded by data availability. The variables measuring regional integration, power preponderance, and institutional homogeneity are lagged by five years given the hypothesized direction of association.<sup>2</sup> Five-year lags were chosen to reduce endogeneity problems, to work with some data issues (see below), and to focus on a long-term examination. Control variables (see below) are lagged by one year while the regional dummy variables are not

<sup>2</sup> Lagged dependent variables were not used because as Achen (2001) points out, lagged dependent variables will dominate the results, thereby destroying the effect of other variables when included with heavily trending exogenous variables and disturbance, regardless if the lagged dependent variable has any true causal power or not. In addition, the interest in this study is not in the change or growth in the level of integration, but the level of integration at a given time period. The lagged independent variables were included to better account for causality.



lagged.<sup>3</sup> The remainder of this section describes the variables used in the model with the following specifications:

$$\text{Integration}_t = \alpha_1 + \gamma_1 \text{Power Preponderance}_{t-5} + \gamma_2 \text{Institutional Homogeneity}_{t-5} + \gamma_n \text{Controls}_{t-1} + \varepsilon_t$$

Theoretically there may be a mutual dependence between integration and institutional homogeneity (Feng and Genna 2003). Since institutional homogeneity at one time period promotes greater levels of integration at a future time period, we should also see an effect of the level of integration promoting greater institutional homogeneity:

$$\text{Institutional Homogeneity}_t = \omega_1 + \beta_1 \text{Power Preponderance}_{t-5} + \beta_2 \text{Integration}_{t-5} + \beta_n \text{Controls}_{t-1} + \mu_t$$

The operationalization of regional integration is a systematic coding so that the analysis can distinguish varying levels while still comparing similar attributes. This is done by using a multidimensional measurement referred to as the integration achievement score (IAS), which was first developed by Hufbauer and Schott (1994) and later refined and applied in Efrd and Genna (2002; see also Efrd, Genna, and Kugler 2003; Feng and Genna 2003; Genna and Hiroi 2004). The calculation of the IAS in Hufbauer and Schott's work involves a smaller number of regional integration organizations for a single year, 1994. The updated score adds greater precision to their method, includes a greater number of regional integration projects, and involves an expanded time frame. It gauges the level of regional integration by looking at six categories commonly attributable to regionalism: (1) trade in goods and services; (2) degree of capital mobility; (3) degree of labor mobility; (4) level of supranational institution importance; (5) degree of monetary policy coordination; and (6) degree of fiscal policy coordination. Each of the six categories is also broken down into five levels along a Guttman scale (see Appendix Table A1).

The measure is an equal-weighted average of the six categories. The potential range of the score is from zero to five. Zero represents no formal regional integration in place and five represents a complete merger of markets, including all economic factors, and political decision making. The data used to code the IAS come primarily from the *Europa World Year Book* (1976-2005) and are cross-referenced with other specialized sources. Values are assigned to each category based on evidence that agreements have actually been

<sup>3</sup> The reasoning for lagged the controls by one year, instead of five, comes from the nature of the variables themselves (please see the section describing these variables). However, since this may affect the error structure, alternative estimations were calculated with all variables at five-year lags. The results were robust using these alternative models.

implemented. Of the various macro geographic regions, the level of integration in Africa is the lowest. Levels of Asian and North and South American integration are higher than those in Africa, with the highest levels found in Europe.<sup>4</sup> Since the data display a trend through time, a stationarity test was conducted. The results indicated that the data are stationary. Therefore no variable transformation is needed.

Power preponderance is relatively simple to operationalize using gross domestic product (GDP) data (in constant U.S. dollars) from the World Development Indicators (World Bank 2005). I calculate the variable by dividing the GDP of the largest economy by the sum of the GDPs of all remaining members.

I operationalize institutional homogeneity using three separate indicators. Two tap into the member states' political structures while one measures economic institutions. In each instance, I take the standard deviation of member states' composite indices for each regional integration organization. Since this calculation indicates that lower values correspond to higher levels of homogeneity, the measure actually captures the idea of institutional heterogeneity. To add clarity to the results and interpret them consistently with the hypotheses, I multiplied each standard deviation by negative one. The first is the democracy scores of the *Polity IV* data set (Marshall and Jaggers 2005). Each country's democracy score is an index of four authority dimensions: competitiveness of executive recruitment, openness of executive recruitment, executive constraints, and competitiveness of political participation (Gleditsch and Ward 1997). The second indicator comes from the World Bank's *Database of Political Institutions* (DPI; Beck *et al.* 2001). An index was created using three variables: "Legislative Indices of Electoral Competitiveness," "Executive Indices of Electoral Competitiveness," and "Checks and Balances." A confirmatory factor analysis of the three variables indicated a strong association with a single latent variable ( $\alpha = .83$ ). The values for each country were summed and a standard deviation was taken for each regional integration organization.

The final indicator, one that measures economic institutions, is taken from the *Economic Freedom of the World* (EFW) data set (Gwartney *et al.* 2009). The EFW index includes: (1) the size of the government (expenditures, taxes, and enterprises); (2) legal structure and security of property rights; (3) access to sound money; (4) freedom to trade internationally; and (5) regulation of credit, labor, and businesses. Since item 4 is a proxy for regional integration, it was removed from the index. The data are yearly starting from 2000. Prior to 2000, the data are reported in five-year intervals beginning in 1975. The gaps in time were filled by interpolating averages, but recall that panel error correlation and AR(1) will be used. If a country experienced an extraordinary change in regime

<sup>4</sup>Space limitations prohibit a listing of all values of regional integration organization through time. Data are available from the author upon request.

or other social, political, and economic instability during the five-year gap, it was coded as missing. Like the other measures of institutional homogeneity, the final value is the standard deviation of all the member countries in each organization.

The data analysis also includes the following control variables. The first is the presence of an ongoing crisis between members of the regional integration association. Intuitively, one would suspect that integration would not deepen under such circumstances. The data come from the *International Crisis Behavior* data set (Brecher and Wilkenfeld 2000). The variable has a value of zero for the absence of an ongoing crisis and one otherwise. The second control, which is also found in the *International Crisis Behavior* data set, is the presence of a new crisis during the year. Like ongoing crisis, a new crisis may threaten current or future integration efforts. The variable has a value of zero for no new crisis and one otherwise. The age of regional integration organization was also included because older organizations are more likely to have deeper integration. Integration may deepen because of the political will or persistent effort. The number of members was also included. Larger memberships may encounter greater collective action problems, which makes coordination among member states challenging. Finally, regions could possess specific attributes that may influence the level of integration. I include regional dummy variables for Europe, Latin America,<sup>5</sup> the Middle East, and Africa. Asia is the baseline region. (Appendix Table A2 displays summary statistics of variables used in the analysis.)

## Results

The regression models estimate the relationship of regional integration around the world with power asymmetry and institutional homogeneity, as well as the association power asymmetry and integration have on institutional homogeneity while controlling for other factors. Overall, the results support the hypotheses except for those involving the homogeneity of political institutions based on Polity IV measurements.

Table 1 presents the estimation results. The three institutional homogeneity variables were included separately to determine the robustness of the results. I discuss the models in pairs with the first including integration as the dependent variable followed by the specific institutional homogeneity variable as the dependent variable. Model 1 supports the hypotheses that a regional leader and homogeneous institutions among member states are positively associated with the level of integration. The power preponderance variable is significant at the 95 percent confidence level (one-tail test). If the regional leader is *as large as* all other member states combined (a ratio equal to one) then the level of integration is small. At the maximum value of the power preponderance

<sup>5</sup>I code NAFTA in the Latin America regional dummy.

Table 1. Ordinary Least Squares (AR1) Regression with Correlated Panels Corrected Standard Errors

	(1) IAS	(1) EFW	(2) IAS	(2) DPI	(3) IAS	(3) Polity
Power preponderance (t-5)	.030** (.013)	.002 (.009)	.022** (.011)	.069 (.068)	.014* (.010)	.102 (.101)
IAS (t-5)	—	.057** (.034)	—	.858*** (.200)	—	.594 (.127)
Institutional variables						
EFW index standard deviation (t-5)	.098** (.054)	—	—	—	—	—
DPI index standard deviation (t-5)	—	—	.017** (.007)	—	—	—
Polity IV standard deviation (t-5)	—	—	—	—	.002 (.003)	—
Controls						
ICB ongoing crisis (t-1)	-.004 (.022)	-.001 (.018)	-.010 (.028)	.223* (.157)	-.002 (.019)	.038 (.116)
ICB new crisis (t-1)	.001 (.017)	.017 (.014)	-.001 (.018)	.149 (.126)	-.007 (.013)	-.016 (.213)
Regional organization age (t-1)	.016*** (.002)	-.002 (.003)	.015*** (.002)	.013 (.012)	.019*** (.002)	.020 (.060)
Regional organization	-.008*** (.003)	-.006*** (.003)	-.007*** (.002)	-.043*** (.012)	-.005* (.003)	-.061*** (.017)
Membership size (t-1)						
Europe	1.39*** (.086)	.109 (.135)	1.42*** (.086)	.787 (.757)	1.26*** (.090)	2.44 (1.58)
Latin America	.614*** (.098)	.084 (.109)	.635*** (.088)	.800 (.553)	.570*** (.097)	1.38 (.946)
Middle East	.387*** (.138)	.189 (.172)	.428*** (.140)	1.28*** (.462)	.277** (.152)	1.79 (4.95)
Africa	.199** (.079)	.142** (.089)	.183** (.089)	.657 (.404)	.184** (.092)	2.05*** (.522)
Constant	.433*** (.078)	-0.751*** (.080)	.437*** (.073)	-4.45*** (.313)	.313*** (.065)	-5.27*** (.603)
Observations	534	530	534	530	534	530
R <sup>2</sup>	.335	.239	.346	.277	.271	.058

Notes: Standard errors in parentheses; \*\*\* p < .01, \*\* p < .05, \* p < .1 (one-tailed tests; except regional dummies which are two-tailed); the standard deviation variables were transformed (the negative of the standard deviation) so that the indices now measure institutional homogeneity.

variable found in the data (~11), the effect would be .33 or a ten-fold increase from the value of parity. At the smallest value of preponderance found in the data (~.17) the effect would be .0051 or an 83 percent decrease from parity. The EFW measure for institutional homogeneity is significant at the 95 percent confidence level. From the variable's lowest value to its highest value, the level of integration increases by 99.8 percent. The next column displays the results with the EFW measure for institutional homogeneity as the dependent variable. The integration score does help explain the level of homogeneity, but power preponderance does not. This finding, in association with the first model, points to power preponderance affecting the level of homogeneity indirectly, that is, through its effect on the level of integration.

Model 2 replaces the EFW measure with the DPI measure, with similar results. At the highest value of preponderance, the model estimates a ten-fold increase in integration from parity. The DPI measure demonstrates a 100 percent increase in the integration score as the value increases from the variable's lowest to its highest value. When the DPI measure is exchanged for the integration score as the dependent variable, power preponderance is not statistically significant, but the integration score is highly significant. Again this points to a direct effect of integration on homogeneity and an indirect effect of power preponderance on homogeneity.

However, in model three, the institutional homogeneity variable, the standard deviation of the Polity IV score, is not statistically significant. The Polity IV index essentially measures the level of democracy for each member state. Such a broad measure of institutional compatibility does not have enough nuances to help us explain the relationship between homogeneity and integration. Also, as one would expect, neither power preponderance nor the integration score has statistically significant explanatory power for the level of institutional homogeneity.

### **Implications for North American Integration**

This study indicates that the optimal conditions for regional integration to develop are the presence of a preponderant power and compatibility among the member states. The condition of power asymmetry was demonstrated with the finding that the larger the GDP ratios (between the regional leader and the sum of all other members), the greater the regional integration score. The necessary condition of institutional compatibility was demonstrated by the findings using the EFW and DPI indices, but not with the Polity IV index. The findings also show an effect on institutional homogeneity by the lagged levels of integration but no direct effect by power asymmetry. Recall that these tests demonstrate a *general relationship* and not one that is exclusive to North America. Assuming that North American integration is not unique and is therefore comparable with all other cases, the general results give us an opportunity to see how North America compares with all other cases of

**Table 2. North American Integration Scenarios**

Scenarios	Integration Score
2004	1.34
Low end values	1.17
High end values	1.50
Institutional homogeneity (15 years)	2.32
Institutional homogeneity (30 years)	2.55

regional integration. From this comparison, it becomes possible to make recommendations for deepening integration. The next step is to examine the estimated models in the North American case.

One of the key variables, power asymmetry, is clearly present in the region. The GDP ratio between the United States and Canada during 1989-93 was between 9.8 and 10.8. After the implementation of NAFTA, the ratio between the United States and the other two partners varies between from 6.8 to 8.4. The data indicate a fairly wide variation in the homogeneity variables. The standard deviation of NAFTA's DPI values ranges from 2.08 to .58. The range of the standard deviation of EFW during this time was 1.17 to .90. This section will examine the effect that these variables have on North American cooperation.

Table 2 displays calculated North American integration scenarios using varying values of power preponderance and institutional homogeneity indicators. Model 2 of Table 1 is the equation used to determine the calculated values because of its slightly larger  $R^2$  (.346). We begin with a baseline examination before discussing potential scenarios that could deepen North American integration. The 2004 estimated value for NAFTA is 1.34 while the actual value is 1.67. Therefore, we will need to keep in mind that the model underestimates the integration score's value when examining future estimated values. The next entry includes North American values at the low end of the range for all the independent variables, while the third entry includes high-end values.<sup>6</sup> The point is to determine the bounded values of integration given historical precedence before expanding to other scenarios. At the historically lowest values, the predicted integration score is approximately 1.17. Using the European Union as a substantive comparison, the European Union scored a value of one just before the implementation of the Treaty of Rome (1957). At this time the European Union was a partial free trade area that also allowed foreign capital withdrawal. Regional institutions were limited to information gathering and had advisory roles. At NAFTA's historically highest values, the estimated score is 1.50. This value

<sup>6</sup>Note that these entries represent hypothetical scenarios; the actual data do not have these combinations of values.

represents a substantive change in the level of integration because it requires a one-point increase in at least three categories of composite index. Appendix Table A1 allows the reader to explore the potential scenarios. For example, the score increase could represent a change to a full free trade area, the ability for full access for foreign investment and capital withdrawal (except for national government procurement), and the ability for regional institutions to amend member state proposals.

The next entries in Table 2 provide results given improvements to institutional homogeneity between the three countries at different ages of NAFTA. I keep the power ratio at seven and also hold the membership at three. *If* the three had achieved perfect homogeneity when NAFTA turned 15 years old (in 2009), it is estimated that the value would be 2.32. Recall that the model underestimates the values, so this is a conservative estimate. What could such a value represent? Let us again use the European Union as a comparative example. It achieved this value in 1972 as the member states began their earliest efforts in developing the common currency. The European Union was a customs union, provided full access for foreign investment (except for national government procurement), allowed capital withdrawal from member states, labor mobility among nationals of member-states, included regional institutions that had the ability to amend proposals, and required member states to commitment to maintain parity in currency values. Therefore, a one-point increase in the integration score represents a great deal of change from NAFTA's 2004 score. Thinking into the future, what would NAFTA look like if member states achieve perfect institutional homogeneity when it turns 30 years old (in 2024)? The estimated value is 2.55, which is similar to the value of the European Union in 1975.<sup>7</sup> In 1975, the European Union improved integration since 1972 by allowing European institutions to veto proposals.

The predicted values all pivot on the notion that institutional homogeneity would take place. However, what are the current differences and what would need to change? In 2004 the three countries had an EFW index standard deviation of .90 and a DPI index standard deviation of .58. The DPI values for the three countries only differed in one area, a slightly larger value for Mexico's checks and balances score. I will therefore focus attention on the EFW index since this is where we see the greatest variation among the three. Recall that the EFW index includes four components.<sup>8</sup> Of these, the three partners display the largest standard deviations in two components (standard deviations in parentheses): the legal structure and security of property rights (2.12) and regulation of credit, labor, and business (1.38). I will examine each of these components to account for the large differences.

<sup>7</sup>The actual value was 3.167.

<sup>8</sup>The original EFW index uses five components, but the component that captures the freedom to exchange with foreigners was excluded due to its approximation to integration.



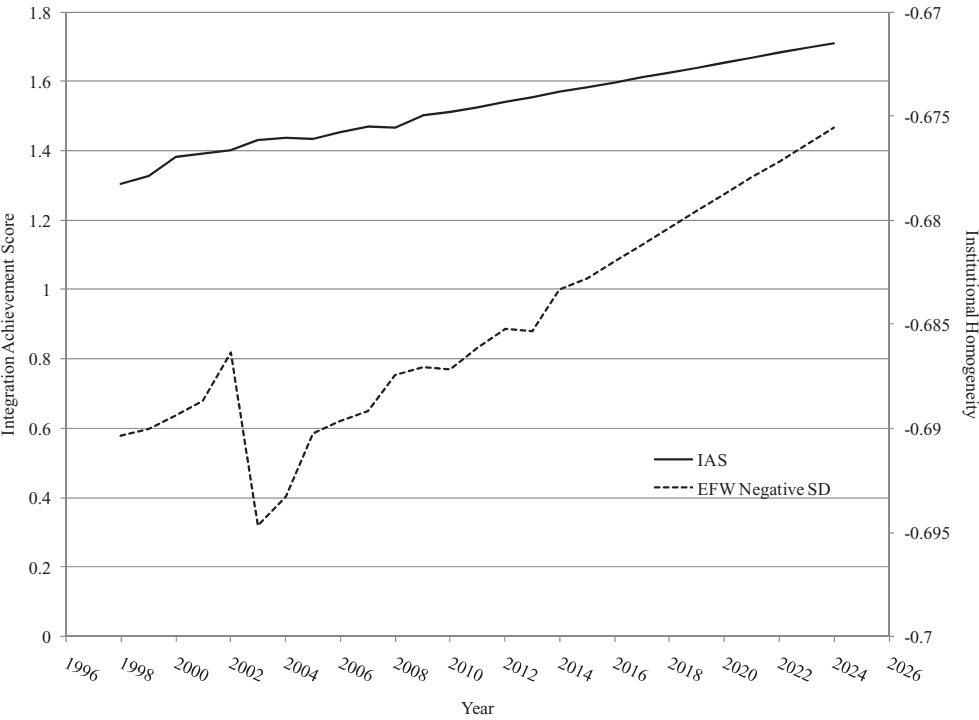
In the areas of legal structure and security of property, there is a large disparity between Canada and the United States, on one side, and Mexico, on the other. With regard to the judicial system, the northern partners have greater judicial independence than their southern partner. Also, Canada and the United States score high on the impartiality of the courts and integrity of the legal system while Mexico is coded at the lower end of the scale. Without independence, impartiality, and integrity, cooperation can be hampered by the uncertainty of rulings. This uncertainty is not a moral judgment of the Mexican judicial system but instead an “unknown” or extra costs for those that come from diverse systems, such as those in Canada or the United States. This uncertainty is a salient concern given the issue of protecting intellectual property, where we see the same pattern: Canada and the United States are higher on this scale than Mexico.

The second highest gap between the partners is in the area of regulation of credit, labor, and business. Of these three subcomponents, the smallest gap is in the area of credit market regulation. While Mexico does score lower than either Canada or the United States, the difference is not very large. The large differences are found in labor and business regulation. Regarding labor, there is a large divergence among all three with respect to the flexibility in hiring and firing. The flexibility in this area refers to the mix of government regulation and private contracts. The more a private contract is the source behind these decisions, the higher the score. The United States scores high on this scale, followed by Canada with a value in the mid-range. Mexico scores near the bottom. This divergence introduces risk among firms and therefore uncertainty of success. The other large difference is in business regulation. With this indicator, we return to the familiar pattern of greater similarity between Canada and the United States and a gap between them and the southern partner. The level of regulation in Canada and the United States is very small compared with Mexico. Price controls and high levels of bureaucratic control are prevalent in Mexico, as is the need to provide “irregular payments” to government officials.

The above description exposes the problem of North America’s unbalanced compatibility; we see a greater amount of compatibility between Canada and the United States than Mexico and the United States. The northern partnership scores indicate a high level of institutional homogeneity, while the southern partnership displays less homogeneity. Since North America is a trilateral partnership, the findings lead us to expect that the southern partnership would be the limiting factor when it comes to deepening integration unless we witness institutional homogenization. In other words, most policy recommendations are going to spotlight the changes needed in the southern relationship.

But are such recommendations realistic? Figure 1 plots the simulated and simultaneous estimations of integration and institutional homogeneity based on equations 1-IAS and 1-EFW in Table 1. I calculated the lines using

**Figure 1.**  
**Simulated North American Integration and Institutional Homogeneity over Time**



predicted levels of integration and homogeneity, but using actual values of power asymmetry and the statistically significant control variables. The estimations clearly trend upward with increases in integration promoting greater homogeneity and *vice versa*. Note that the actual increases of both are not large over this time period. Also note, as described above, small increases in values actually translate into substantive advances. With this said, the estimations do not predict a “North American Union” in the next 15 or so years. Instead, we should expect a steady but gradual set of changes in the level of integration as well as institutional homogeneity. However, the very small changes in values are substantively large given the effect on integration. At a minimum, the next 15 years can introduce one of the following changes to North American integration: (1) the creation of a customs union; (2) unrestricted capital mobility except for large-scale mergers and acquisitions; (3) full right of movement for all North American workers; (4) the ability for a regional institution to amend proposals; (5) a commitment to a fixed currency exchange rate; or (6) consultations among the three governments regarding fiscal policies. Neither the theory nor the results can predict with any

certainty which of the six changes will occur, only that one of these changes is likely to occur.

Finally, the only downward part of the line plotting homogeneity was in the early 2000s. Recall that the models include five-year lags. This dip was due to the entry of Mexico into the partnership that existed between Canada and the United States. Therefore, this is the effect of the new power asymmetry values. Interestingly enough, this dip is also found in the actual homogeneity values.

### **Conclusion**

The literature on regional integration has fashioned various theories and empirical findings. The conditions distilled in this article are power asymmetry and partner compatibility. First, I evaluated the empirical validity of these conditions and then compared the general models with the North American experience. My goal was to assess North America's potential for deepening integration; does it have the "right stuff" to develop agreements that furthers integration? The rationale is that collective action through trilateral agreements would be the most effective way to solve the migration–security–development issue.

The general findings confirm that specific conditions are needed. First is the presence of a regional leader. The statistical results show that greater asymmetry is associated with greater levels of integration in general. The presence of the leader was theorized to be necessary to solve some problems of collective action (coordinate efforts and distribute incentives). However valid this variable is in general, it does not extensively help us to explain North American integration since the United States has been a regional (and global) preponderant power for some time.

The second condition was compatibility of members. The results indicate that domestic institutional homogeneity is a good predictor for integration. It is in this area that we see a good deal of variation among the North American states. Compatibility is stronger in the northern partnership than the southern partnership, which produced an unbalanced compatibility problem. Therefore, the policy recommendations are geared to improving the compatibility between Mexico and Canada–United States if further integration is desired.

The final condition is the feedback effect institutional homogeneity has on integration. Once integration gets under way through the aid of power asymmetries and institutional homogeneity, the latter condition influences the demand for higher levels of integration. What we witness is a reinforcing mechanism that promotes a virtuous cycle. In the North American simulations we see that these trends are not quantitatively large but have a substantive meaning.

One set of recommendations involves homogenizing institutions. There are two points here. The first is the effort to improve democratic institutions in Mexico. Mexico is already on upward trajectory in this area but still falls short. Given the high levels of corruption, democratic institutions have credibility problems. Also, the Mexican president's powers are not as constrained as those of the executives from Canada and the United States. The second recommendation is to reduce the differences involving legal structures, the security of property rights, and regulation of labor and business. Regarding the legal structures, the deepening of integration would benefit from the Mexican judiciary becoming more independent, impartial, and increasing its integrity. Also, there will need to be some sort of convergence in the protection of property rights. Regarding the regulation of labor and business, there needs to be a convergence in the regulation of workers' rights regarding hiring and terminating employment. Work also needs to be done in converging business regulations and the reduction of the use of bribes in Mexico.

Overall, North America does not have "the right stuff" to improve integration at the moment. While a power asymmetry is in place, the compatibility of three partners is unbalanced. But a two-pronged policy of improving homogeneity while increasing integration can very well promote a virtuous cycle that continues to unite the economies and decision making of the three countries. The need to solve problems like the migration–security–development issue requires collective action because unilateral action thus far has proven to be unsuccessful. The limiting factor of the three issues is development, which integration has the potential to solve. By recognizing that the problem is a commonly held one, the three partners can begin to seek out the conditions, and make the appropriate adjustments, for cooperation to develop. Otherwise we will see future elections that mechanically focus on solutions that do not produce results.

## Appendix

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**Table A1. Integration Achievement Score (Coding System)**

1. Trade in Goods and Services
    - 0 = No agreements made to lower tariffs and nontariff barriers
    - 1 = Preferential trade agreement
    - 2 = Partial free trade area
    - 3 = Full free trade area
    - 4 = Customs union
    - 5 = No barriers among member countries
  2. Degree of Capital Mobility
    - 0 = No agreements made to promote capital mobility
    - 1 = Foreign direct investment allowed in limited form
    - 2 = Capital withdrawal allowed
    - 3 = Full access for foreign investment and capital withdrawal, except for national government procurement
    - 4 = Full capital mobility except for large scale mergers and acquisitions
    - 5 = Full capital mobility without restriction
  3. Degree of Labor Mobility
    - 0 = No agreements made to promote labor mobility
    - 1 = Right of movement granted for select professions
    - 2 = Full right of movement
    - 3 = Transferability of professional qualifications granted
    - 4 = Transferability of pensions and other retirement devices
    - 5 = Full freedom of movement
  4. Level of Supranational Institution Importance
    - 0 = No supranational institutions
    - 1 = Establishment of nominal institutions
    - 2 = Information gathering and advisory role
    - 3 = Ability for institutions to amend proposals
    - 4 = Ability for institutions to veto proposals
    - 5 = Supranational institutions operate as primary decision node
  5. Degree of Monetary Policy Coordination
    - 0 = No monetary policy coordination
    - 1 = Consultation regarding policy
    - 2 = Commitment to maintain parity
    - 3 = Coordinated interventions
    - 4 = Regional central bank establishment
    - 5 = Single currency
  6. Degree of Fiscal Policy Coordination
    - 0 = No fiscal policy coordination
    - 1 = Consultation regarding policy
    - 2 = Commitments regarding deficit spending and taxation
    - 3 = Sanctions regarding breaking commitments
    - 4 = Uniform tax code
    - 5 = Single budget
-

**Table A2. Summary Statistics of Variables**

Variable Name	N	Mean	SD	Min	Max
Integration achievement score	622	0.910	0.794	0	3.667
Power preponderance	622	1.634	2.031	0.169	10.848
EFW index standard deviation	622	-0.751	0.313	-1.569	-0.003
DPI index standard deviation	622	-3.405	2.054	-9.940	0
Polity IV standard deviation	622	-3.435	2.717	-36.506	0
ICB ongoing crisis	622	0.024	0.154	0	1
ICB new crisis	622	0.076	0.265	0	1
Regional organization age	622	16.331	13.811	0	59
Regional organization membership size	622	11.273	10.741	0	54
Europe	622	0.093	0.291	0	1
Latin America	622	0.175	0.380	0	1
Middle East	622	0.085	0.279	0	1
Africa	622	0.354	0.479	0	1

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