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Research Handbook in International Economic Law

Edited by **Andrew T. Guzman** and **Alan O. Sykes**

RESEARCH HANDBOOK IN INTERNATIONAL ECONOMIC LAW

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Preface

The *Research Handbook in International Economic Law* provides a broad survey of issues in the regulation of international economic activity. Our primary goal in producing the book is to provide an up to date and accessible survey of the law and policy issues in each area. Each of the authors is an expert in his or her field, and each chapter offers both a survey of the state of the law and an analysis of current issues. Several chapters are devoted to the regulation of international trade, evidencing the extent to which international cooperation in that area has outstripped most others. Other chapters discuss international investment, commercial law, tax, finance, competition policy, intellectual property, environmental law, telecommunications, and private dispute settlement.

Individually the chapters offer thoughtful and sophisticated discussions of these individual areas. Collectively they illustrate the wide range of strategies that have been and should be adopted to meet the challenge of regulating international business activity. They also demonstrate how varied international cooperation is across fields. It is highly developed and formalized in, for example, international trade and tax. In other areas, such as competition policy, there is only modest cooperation among states. In some areas, such as dispute resolution, there is heavy reliance on domestic institutions to make inter-national transactions possible, while in other areas such as the environment there is greater emphasis on international instruments.

Given the diversity of relevant issue areas it should not surprise us to observe that states have chosen to adopt a variety of strategies in their interactions. It is our belief, however, that a better understanding of issues across all of these areas will give a richer sense of the regulatory choices that are available and inspire new and more effective ways of managing international activity. We hope that this book will facilitate that endeavour.

Andrew T. Guzman
Alan O. Sykes

1. International trade: barriers to trade

Michael Trebilcock and Michael Fishbein

1. History and background to the GATT

1.1. Classical free trade theory

In *The Wealth of Nations*, published in 1776, Adam Smith argued that the gains that could be realized from specialization in domestic economic activity could be extended to international economic activity:[1]

> The tailor does not attempt to make his own shoes, but buys them of the shoemaker. The shoemaker does not attempt to make his own clothes, but employs a tailor . . . What is prudence in the conduct of every private family, can scarcely be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage.[2]

Smith's Theory of Absolute Advantage essentially stated that countries should export those products which they could produce more efficiently than other countries and import those products which they could not. For example, if countries with tropical climates can produce bananas or pineapples more cheaply than countries with temperate climates, the latter should purchase these products from the former. Conversely, if countries with industrialized economies can produce hydro-electric plants or communications systems more efficiently than countries who enjoy a cost advantage in producing tropical fruit, the latter should buy these products from the former. In Smith's view, international trade is merely a means by which to broaden the division of labor by expanding the size of the market. It is important to note that according to Smith's theory, *unilateral* trade liberalization would be an advantageous policy for a country to pursue. Even if other countries did not liberalize their trade policy, a country which did liberalize its trade policy could realize economic gains by importing products made more efficiently by foreigners.

[1] For a comprehensive account of the intellectual history of free trade theory, see: Irwin, Douglas (1996), *Against the Tide: An Intellectual History of Free Trade*, Princeton, NJ: Princeton University Press.

[2] Smith, Adam (1776), *The Wealth of Nations*, reprinted (1937) New York: Modern Library Edition, at 424.

A key question raised by Smith's theory of Absolute Advantage is what relevance international trade has to a country which has no absolute advantage, i.e. a country which cannot produce any product more efficiently than its trading partners. This question was addressed by David Ricardo's theory of Comparative Advantage, set out in his book *The Principles of Political Economy*, published in 1817. Consider the following scenario famously postulated by Ricardo: Portugal can produce a given quantity of wine with 80 units of labor, and a given quantity of cloth with 90 units of labor. England can produce the same quantity of wine with 120 units of labor, and the same quantity of cloth with 100 units of labor. Thus, Portugal enjoys an absolute advantage over England in both wine and cloth. Ricardo argued that trade between the two countries was still mutually advantageous. England is able to export cloth which it took 100 units of labor to produce in exchange for wine which it would have required 120 units of labor to produce. Similarly, Portugal, by exporting wine which it took 80 labor units to produce, gains cloth which would have taken 90 labor units to produce. Both countries are rendered better off through trade.

Ricardo's insight was that the crucial question is the relative or comparative advantage of one country *vis-à-vis* another in producing a product. In other words, the issue is not whether Portugal can produce both wine and cloth more efficiently than Britain, but rather Portugal's relative efficiency in producing cloth versus producing wine compared to Britain's relative efficiency in producing the same goods. In an international trade context, this generalizes to the proposition that a country should specialize in producing and exporting goods in which its comparative advantage is greatest, or comparative disadvantage is smallest, and should import goods in which its comparative disadvantage is greatest.

Although Ricardo's theory still constitutes the basis of conventional international trade theory, it has been refined by subsequent analysis. One deficiency in Ricardo's theory is that it assumes that countries will specialize completely in those products in which they have comparative advantage, without taking into account the possibility of decreasing returns to scale. Hecksher and Ohlin's Factor Proportions Hypothesis recognized that most products were a function of multiple factors of production (in the case of wine, land and labor), and that combining factors of production at ever-increasing levels of output did not necessarily lead to increasing production in constant proportions. For example, bringing more land into the production of wine may result in utilizing less productive land which requires more intensive use of labor. In recognition of these considerations, the Factor Proportions Hypothesis states that countries will tend to specialize in producing goods that use their abundant factors of production more intensively, and will import goods that use their scare factors more intensively.

The Factor Proportions Hypothesis does not, however, provide an adequate explanation of manufacturing activities in advanced industrialized economies. Casual observation suggests that firms in different countries often specialize in different segments of the same or closely related product markets, simultaneously importing and exporting products in these sectors. The Product Cycle Theory, developed by Raymond Vernon, incorporates the idea that products undergo a variety of stages in their life cycle, and firms in different countries will specialize in their manufacture depending upon the particular stage the product is in.[3] Highly developed economies will tend to specialize in the manufacture of products in the early stages of development, where financial capital and specialized human capital are at a premium. In the later stages of the product cycle, as production technology becomes standardized, it is adopted by producers in other countries, typically countries with low labor costs. At this point in the product cycle, comparative advantage shifts to these countries. Moreover, as is evident in the increasingly globalized production chains for many products (e.g. automobiles, computers), different countries may have a comparative advantage in different stages of the production process.

1.2. Qualifications to the case for free trade

The development of the current international trade regime has been animated by the classical theory set out above. However, a great deal of the debate in international trade law today centers around how far the law should be permitted to deviate from the classical theory.[4]

One qualification to the case for free trade is the concept of reciprocity. Recall that classical trade theory views unilateral trade liberalization as advantageous for the liberalizing country. From this perspective, the emphasis placed on reciprocity in trade liberalization commitments in the General Agreement on Tariffs and Trade (GATT) seems anomalous.[5] However, it is clearly better for the liberalizing country if its trading partners also liberalize, since the first country will realize additional benefits on the export side in addition to the benefits on the import side. One strategy might be for the first country to refuse to remove any of its existing trade restrictions on imports unless its trading partners agree to do the same. This may result in a classic Prisoner's Dilemma game, whereby trading partners who recognize that it is

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[3] See Vernon, Raymond (1966), 'International Investment and International Trade in the Product Cycle', *Quarterly Journal of Economics*, 80(2), 190–207.

[4] Lowenfeld, Andreas (2002) *International Economic Law*, Oxford: Oxford University Press, at 5. Also see Irwin, *supra* note 1.

[5] Bagwell, Kyle and Robert W. Staiger (2002), *The Economics of the World Trading System*, Cambridge, MA: MIT Press, at 7.

in the first country's interests to liberalize no matter what the trading partners do will withhold concessions in the hopes of gaining the benefits of the first country's liberalization for free. The dominant strategy becomes protectionism, and such individually rational action leads to an inefficient collective outcome of restrictive trade policies.[6] Trade agreements incorporating reciprocal tariff reductions thus offer governments a means of escape from a Prisoner's Dilemma.[7]

Reciprocity is also important from a political economy standpoint. Certain domestic producer interests may oppose any governmental effort to liberalize trade policy on the import side. If it is to be politically tenable for a government to engage in such liberalization, it will likely need concessions from its trading partners on the export side in order to enlist the countervailing political support of export-oriented producer interests. In fact, according to Bagwell and Staiger, one of the main functions of trade agreements is that they represent credible commitments by governments that they will not protect certain industries.[8] In summary, while the concept of reciprocity plays a marginal role in classical trade theory, it is nonetheless crucial to an understanding of the institutional arrangements that govern international trade.[9]

A second qualification to the case for free trade is the concept of the so-called Optimal Tariff. On this theory, countries that account for a large proportion of international demand for a particular good may exercise monopsony power by imposing a tariff which effectively forces exporters from other countries to reduce the price of their products and absorb the tariff. Consumers pay the same price for the good as before, and the government gains revenue from the tariff. However, empirical evidence suggests that there are very few cases where one country is able to exercise the degree of monopsony power necessary to successfully implement such a policy.

A third qualification is infant industries.[10] In the early stages of a country's economic development, a case may be made that import restrictions are justified in order to permit domestic industry to develop by selling to a protected domestic market. Ideally, such protection is temporary and the infant industry

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6 Hoekman, Bernard M. (2002), *The Political Economy of the World Trading System: The WTO and Beyond*, New York: Oxford University Press, at 109–10.

7 Bagwell and Staiger, *supra* note 5, at 3.

8 Bagwell and Staiger, *supra* note 5, at 4.

9 Indeed, it is rare for countries to make tariff concessions without getting tariff concessions from other countries in return. One notable exception is the Special and Differential Treatment (SDT) given to certain developing countries under the GATT, which entails unilateral tariff concessions on the part of developed countries with regard to certain products exported by the developing countries. SDT is discussed in greater detail in Section X of this chapter.

10 See Irwin, *supra* note 1, Chapter 8.

eventually develops the scale and sophistication to compete not only in a liberalized domestic market but also in international export markets. A case in point is the 'special and differential status' accorded less developed countries (LDCs) under the GATT, which permits them to protect domestic industries and engage in import substitution trade policies to some extent. A variant of the infant industry argument is Strategic Trade Theory, which argues that governments can assist domestic firms in establishing strategically dominant pre-emptive positions in industries where economies of scale imply that there is room for only a limited number of firms in international markets, in part by maintaining entry barriers to potential foreign competitors or subsidizing domestic firms.[11]

However, the case for protection and/or government-led promotion of domestic industries may be critiqued on a number of grounds, chiefly: (i) private capital markets may be better equipped than governments to identify the long-term growth potential, if any, for an infant industry, and should thus be relied on rather than government to 'pick winners'; and (ii) the vulnerability of governments to capture by rent-seeking special interests with regard to the decision to promote and sustain an infant industry through trade-restrictive policies.[12] Nevertheless, according to some commentators, a number of the high-performing East Asian economies have deployed infant-industry protection policies or strategic trade theory successfully; other developing countries much less successfully. It is also true that many currently developed countries early in their development adopted extensive infant-industry protection policies (e.g. the US, Canada, Germany).

A final qualification to the case for free trade relates to the revenue-raising potential of customs duties. In industrialized countries, personal and business taxes constitute the vast majority of government revenue. However, in less developed countries with poor internal taxation systems, import and export duties are often an important source of government revenue and may be difficult to replace in the short term.

1.3. Institutional history of international trade policy

While liberal international trade is commonly viewed as a post-World War II phenomenon, it has a much longer genesis. During the latter half of the

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[11] See Krugman, Paul (ed.) (1986), *Strategic Trade Policy and the New International Economics*, Cambridge, MA: MIT Press; Helpman, E. and Paul Krugman (1989), *Trade Policy and Market Structure*, Cambridge, MA: MIT Press; Richardson, David J. (1969), 'The Political Economy of Strategic Trade Policy', *International Organization* 44(1), 107–35; Irwin, *supra* note 1, Chapter 14.

[12] See Baldwin, Robert (1969), 'The Case Against Infant Industry Protection', *Journal of Political Economy*, 77(3), 295–305.

nineteenth century, nations such as France, Germany, and Britain negotiated bilateral trade treaties amongst themselves and with other European nations. In particular, Britain's resolute commitment to the principle of free trade was reflected in its unilateral removal or reduction of hundreds of tariffs on imported goods, beginning in the mid-nineteenth century with the repeal of the Corn laws and lasting until the early years of the twentieth century. However, a severe recession in Europe in the 1870s resulted in many countries retreating from liberalized trade. The onset of World War I and the attendant disruption in trade relations, followed by the collapse of the world economy in the late 1920s, prompted many countries to adopt policies of extreme protectionism. The most dramatic illustration of such policies was the enactment of the Smoot-Hawley Tariff by the United States Congress in 1930, which raised average duties to 60% on imported goods and provoked retaliatory measures by most of the USA's trading partners. As a result of these 'beggar-thy-neighbor' policies, international trade ground to a virtual standstill. Although Congress signalled a shift in policy by passing the Reciprocal Trade Agreements Act in 1934, which gave the President authority to negotiate bilateral trade liberalization agreements, the outbreak of World War II shattered any hope of renewed international trade.

As World War II wound down, post-war planners set their minds to the task of reconstructing the world economy after the war. As part of the Bretton Woods Agreement in 1944, they proposed the formation of the International Trade Organization (ITO) to oversee a new multilateral system of liberalized international trade. However, the ITO never came into existence due to strong opposition to it from the US Congress, which feared that the ITO would entrench excessively on domestic sovereignty. Instead, a provisional agreement negotiated in 1947 amongst 23 major trading countries as a prelude to the ITO, the General Agreement on Tariffs and Trade (GATT), became by default the permanent institutional basis for today's world trade regime, now comprising 150 members.

Under the GATT, eight 'rounds' of negotiations have now been completed. The first six of these rounds, up to and including the Kennedy Round which concluded in 1967, focused mainly on reciprocal reductions in tariffs on manufactured goods.[13] More recent rounds, including the Tokyo Round ending in 1979 and the Uruguay Round ending in 1993, have increasingly focused on non-tariff barriers to trade, such as government procurement policies, subsidy policies, customs valuations policies, and technical standards. From an institutional perspective, the Uruguay Round was particularly impor-

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[13] The success of these rounds is evident in the fact that average world tariffs on manufactured goods have dropped from 40% in 1947 to 5% today.

tant in that it resulted in the creation of the World Trade Organization (WTO), the overarching governing body that had been missing from the world trade regime since the failure of the ITO.

Recent developments in the GATT/WTO system have seen increasing strains being put on the world trade regime by a multitude of factors. The inclusion of several new issues in trade negotiations that had previously been considered outside the ambit of the GATT, such as foreign investment, intellectual property, and trade in services, has entailed a greater focus on domestic policy divergences as potential distortions of international trade, and thus raised concerns about the degree to which GATT/WTO commitments on these issues may constrain domestic sovereignty. Contentious issues such as trade in agricultural products, which had previously largely escaped GATT discipline, are now being addressed. As well, less developed countries (LDCs) have shown an increased willingness to form coalitions in order to advance their collective interests during negotiations, as exemplified by the formation of the 'Group of 21' voting bloc of LDCs at the Cancun Ministerial meetings of the current Doha Round.

1.4. Governance and dispute settlement in the WTO

WTO dispute settlement is governed by Articles XXII and XXIII of the GATT, as well as the WTO Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU), and is discussed in greater detail elsewhere in this text by Professors Horn and Mavroidis.

The Agreement Establishing the World Trade Organization ('WTO Agreement') sets out various provisions for adjusting GATT commitments over time.[14] Article X:1 of the WTO Agreement requires that any proposal to amend a WTO agreement must be tabled for a minimum of 90 days before the agreement can be amended. Amendments to WTO agreements are voted on by the Ministerial Conference of the WTO. Article X:2 sets out specific provisions of WTO Agreements that can only be amended by unanimous agreement of all Members. All other provisions can be amended by a two-thirds majority of the Ministerial Conference; however such amendments are only binding on the Members who have voted in favor of the amendment (Article X:3). This feature of the WTO Agreement is subject to Article X:5, which stipulates that the Ministerial Conference may decide by a three-fourths majority that an amendment is of such a nature that any Member which has not accepted it within a period specified by the Ministerial Conference in each case shall be

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[14] For a recent review of institutional challenges facing the WTO, see Report of the Consultative Board to the Director-General of the WTO (2004), *The Future of the WTO: Addressing Institutional Challenges in the New Millennium.*

free to withdraw from the WTO or to remain a Member with the consent of the Ministerial Conference. Finally, Article IX:2 grants exclusive authority to the Ministerial Conference and the General Council to adopt authoritative, binding interpretations of the various WTO Agreements, provided that the proposed interpretation receives the support of three-fourths of the Members.

Article XXVIII of the GATT permits Members to renegotiate their GATT commitments. Every three years, Members may enter into negotiations with other concerned Members to modify or withdraw concessions previously made (Article XXVIII:1). Such negotiations must include provisions for compensating concessions to affected parties and must seek to maintain a general level of reciprocal and mutually advantageous concessions not less favorable to trade than that existing prior to such negotiations (Article XXVIII:2).

A further method by which Members may 'adjust the bargain' is through the imposition of safeguard measures, provided for in Article XIX of the GATT.[15] Safeguards are 'emergency' tariffs or quotas imposed on foreign goods when imports of those foreign goods are occurring at levels much higher than expected, harming domestic producers. Article 2.1 of the Agreement on Safeguards authorizes safeguard measures if the foreign product is being imported 'in such increased quantities, absolute or relative to domestic production, and under such conditions as to cause or threaten to cause serious injury to the domestic industry that produces like or directly competitive products'. The Agreement on Safeguards also provides that safeguards may only be imposed after a proper investigation by domestic trade authorities (Article 3), that safeguards must be imposed only to the extent necessary to prevent or remedy serious injury and to facilitate adjustment (Article 5), and for a limited period of time (Article 7). Safeguards are discussed more fully by Professor Sykes elsewhere in this volume.

Finally, Article IX:3 of the WTO Agreement provides that in exceptional circumstances, the Ministerial Conference may decide to waive a WTO obligation of a Member, provided that any such decision shall be taken by three-fourths of the Members.

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[15] See Sykes, Alan (2003), 'The Safeguards Mess: A Critique of WTO Jurisprudence', *World Trade Review*, 2(3), 261–96. For the most recent case law on safeguards, see *US – Definitive Safeguard Measures on Imports of Certain Steel Products*, Report of the Appellate Body, WT/DS259/AB/R (2003). For a critique of this jurisprudence, see Sykes, Alan (2004), 'The Persistent Puzzles of Safeguards: Lessons from the Steel Dispute', *Journal of International Economic Law*, 7(3), 523–64.

1.5. Interaction between national and WTO law

Article II:2 of the WTO Agreement provides that all legal instruments concluded under the WTO regime are binding on all Members, and Article XVI:4 obligates all Members to 'ensure the conformity of its laws, regulations, and administrative procedures with its [WTO] obligations'. However, WTO law does not generally have direct effect on the domestic legal systems of Members. No Member that is found to be in violation of a WTO agreement is compelled to amend its domestic law; the violating Member retains the option of amending its law, paying compensation, suffering retaliatory trade sanctions, or withdrawing from the WTO.[16]

In the US, EU, and Japan, WTO law does not have direct effect and domestic law prevails over WTO law in the event of a conflict.[17] The implementation of WTO obligations is achieved only through the passage of implementing legislation by the domestic legislature which incorporates these WTO obligations into the domestic legal order. For example, in the United States, implementation of the Uruguay Round Agreements and their attendant obligations was achieved only by Congressional and Presidential approval of the Uruguay Round Agreements Act.[18]

2. Tariffs and other border measures

2.1. Economic effect of border measures

Governments can take various measures at the border to inhibit trade. There are three main types of border measures: tariffs, quantitative restrictions (quotas), and trade remedy laws. A tariff is a tax on foreign goods entering the country, payable by the importer of the goods to the government. A quota is a definitive limit on the volume of imports that will be permitted to enter the

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[16] Bhala, Raj and Kevin Kennedy (1998), *World Trade Law*, Charlottesville, VA: Lexis Law Publishing, at 54.

[17] See Matsushita, Mitsuo, Thomas G. Schoenbaum, and Petros C. Mavroidis (2003), *The World Trade Organization: Law, Practice, and Policy*, Oxford: Oxford University Press, at 99–110.

[18] In the context of domestic US trade politics, it is crucial to understand the role of 'fast-track' or 'trade promotion authority'. This refers to legislation passed by Congress which grants the President authority to enter into trade negotiations and also provides for a special legislative approval process, under which any resulting implementation legislation is considered as an 'all-or-nothing' package with no Congressional amendments permitted. According to Matsushita et al., *supra* note 17 at 100, trade promotion authority is 'essential' for serious trade negotiations, since it reassures negotiating partners that any agreement they conclude will not be subject to Congressional amendments, which would force negotiations to be reopened.

domestic market. Finally, trade remedy laws involve countries taking unilateral action under domestic trade laws, usually by imposing duties, where they believe that their domestic industry is being materially injured because of unfair foreign trading practices such as dumping or subsidization, or by import surges. Trade remedy laws are discussed in greater detail by Professor Sykes elsewhere in this text, while tariffs and quotas will be discussed below.

A tariff has the economic effect of generating a deadweight social loss.[19] The tariff reduces the supply of the good available in the domestic market which is levying the tariff, permitting domestic producers to raise prices. Domestic producers gain from the increase in prices, but due to the price increase some consumers in the domestic market are priced out of the market for the good. The gain to producers is not large enough to offset this loss to consumers, resulting in a deadweight social loss. In foreign markets, the supply of the good in question may be increased, since the prohibitive tariff results in an oversupply of goods that would otherwise have been exported. In this case, prices fall, consumers gain and producers lose. However, the gain to consumers is less than the loss to producers, again resulting in a deadweight social loss.

The economic effects of tariffs can be contrasted with other forms of border measures. For example, quotas (depending upon their design) may have the effect of insulating domestic producers from most forms of foreign competition and thus reducing incentives for these firms to become more efficient. This is because highly efficient foreign competitors are either shut out of the market altogether or are limited to a minor share. In contrast, a tariff may still be surmounted by highly efficient foreign firms, who then provide effective competition for domestic firms and create incentives for these domestic firms to become more efficient. A further contrast between tariffs and quotas relates to who benefits from their imposition. Under a tariff, the government collects all the revenues from the tariff. Under a quota, domestic or foreign holders of quotas will collect scarcity rents from the quota by raising prices. Governments often collect no revenue from a quota, although in some cases they may collect rents from auctioning quota rights.

2.2. GATT disciplines dealing with border measures

A central purpose of the GATT is to reduce and bind tariffs.[20] Tariff bindings reflect commitments made by Members not to raise tariffs on a given product

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19 See Ruffin, Roy J. and Paul R. Gregory (1983), *Principles of Economics*, Glenview, IL: Scott Foresman and Company, at 350–1.

20 Matsushita et al., *supra* note 17 at 114.

above the 'bound' rates set out in the Schedules of Concession annexed to the GATT. Article II of the GATT obligates Members to accord tariff treatment 'no less favorable' than that provided for in their tariff bindings set out in the Schedules. A Member may not impose a tariff that is higher than that provided for in its Schedule without compensating affected Members.[21] However, a Member may reduce tariffs below the bound rates if it so chooses.

The preamble to the GATT commits Members to enter into 'reciprocal and mutually advantageous agreements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international commerce'. Article XXVIII further provides that

> (M)embers recognize that customs duties often constitute serious obstacles to trade and that negotiations *on a reciprocal and mutually advantageous basis*, directed to the substantial reduction of the general level of tariffs are of great importance to the expansion of international trade. (emphasis added)

The following GATT disciplines and negotiating practices are important with regard to the reduction of tariffs and associated border measures.

2.2.1. Most-favored nation principle Under Article I of the GATT, with respect to customs duties or charges of any kind imposed by any country on any other member country, any advantage, favor, privilege, or immunity granted by such country to any product originating in any other country shall be accorded immediately and unconditionally to a like product originating in the territories of all other Members. Thus, if country A makes tariff concessions to country B, A's concessions must apply equally to all other Members.[22] This principle is known as the most-favored-nation principle (MFN), and is often referred to as the cornerstone of the multilateral trading system.

A key interpretive issue regarding Article I:1 is the concept of 'like product'. The importance of the definition of 'like product' is that advantages accorded to one product must be accorded to another product in accordance with the MFN principle only where that other product is a 'like product'. Therefore, trade disputes involving the MFN principle often turn on the extent to which products can be differentiated from one another. When determining whether products are like, panels have taken into account factors such as tariff

[21] *Ibid.*

[22] There are several exceptions to this principle, the most notable of which is an exception for the formation of regional trading agreements (RTAs). This exception will be discussed in Section II. C of this chapter.

classifications, physical characteristics, end-uses, and consumers' tastes and habits.[23]

MFN is often seen as an important instrument under the GATT for encouraging the reduction of tariffs and other border measures among Members. In the view of some commentators, the MFN principle acts as a 'multiplier' of trade liberalizing policies.[24] The MFN obligation may also impact positively on the bargaining game between Members in the context of trade negotiations. First, the MFN obligation protects the value of concessions already made by Members. For example, if country A receives concessions on certain duties from country B, the MFN principle assures A that B cannot make more favorable concessions on these duties to country C at a later date, thus eroding the value of the original concessions to A. Any further concessions made by B must also be extended to A. According to Schwartz and Sykes, if country A did not have this assurance, it would value the original concession less and offer less in return for it, the end result being that fewer tariff reduction deals would be struck in the first place.[25] Second, the MFN principle eliminates the ability of Members to threaten the discriminatory withdrawal of previous trade concessions. Without the MFN principle, a subset of trading nations could threaten to form a discriminatory arrangement amongst themselves (in the form of granting each other more favorable tariff treatment) unless other nations made certain concessions. The possibility of such threats, as well as the attendant counter-threats, retaliations, and so on, would make for a more unstable trading regime. But with the MFN principle in place, nations are unable to take such action (subject to an exception for free trade areas and customs unions, discussed below).[26]

However, the MFN principle also has its critics. It is argued that the MFN clause may facilitate free-riding by Members, inhibiting mutually beneficial deals from being struck.[27] It is theoretically possible for some Members to reap the benefits of trade concessions made by other nations, which are

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[23] Key cases involving the determination of 'like product' in the context of Article I include: *Spain – Tariff Treatment of Unroasted Coffee*, GATT BISD (28th Supp.) (1982), and *Indonesia – Certain Measures Affecting the Automobile Industry*, Report of the Panel, WT/DS55/R (1998). Also see Won Mong Choi (2003), *'Like Products' in International Trade Law: Towards a Consistent GATT/WTO Jurisprudence*, London: Oxford University Press.

[24] Jackson, John H. (1997), *The World Trading System: Law and Policy of International Economic Relations*, 2nd edn, Cambridge, MA: MIT Press, at 159.

[25] See Schwartz, Warren F. and Sykes, Alan O. 'The Economics of the Most-Favored Nation Clause', in Jagdeep S. Bhandari and Alan O. Sykes (1997), *Economic Dimensions in International Law: Comparative and Empirical Perspectives*, Cambridge: Cambridge University Press, at 62.

[26] Schwartz and Sykes, *supra* note 25 at 62.

[27] Schwartz and Sykes, *supra* note 25 at 59.

extended to other Members through the MFN principle, without making any concessions of their own. In practice, free-riding has generally not been a major problem in GATT tariff negotiations. Typically, tariff negotiating rounds conclude with a 'settling-up' session where concessions that have been tentatively negotiated are subject to threats of withdrawal or revision unless non-reciprocating countries who are seen to be 'free-riding' reciprocate with sufficient concessions of their own.

2.2.2. Bargaining structures under GATT tariff negotiations A matter of some importance to negotiating rounds under the GATT is the precise format of the negotiations themselves. In the first five GATT negotiating rounds, negotiations proceeded on a product-by-product basis. Participants adopted a Principal Supplier Rule, under which countries who were principal suppliers of goods into international markets would prepare 'request lists' of goods on which they wanted importing countries to make tariff concessions, and also prepared 'offer' lists of tariff concessions they were prepared to make in return. Because of the MFN principle, requests for tariff concessions were usually made by a principal supplier of goods to a principal importer of goods, thus essentially bilateralizing tariff negotiations. The rationale for this is easy to see – a major supplier of a product would have no interest in negotiating with a minor importer of that product, since any concessions made by the major importer would have to be generalized to all Members, with the payoff being only the comparatively small benefit derived from the concession made by the minor importer. Only a major importer could make concessions valuable enough to be worthwhile to a major supplier.

Product-by-product negotiations had some significant drawbacks. First, due to the bilateralization of tariff negotiations discussed above, smaller countries were essentially frozen out of the negotiations. Second, focusing negotiations on particular products encouraged domestic producer interests to actively resist tariff concessions on products in which they were interested. Third, a product-by-product focus (as opposed to across-the-board tariff cuts) was highly transaction cost-intensive.

During the Kennedy and Tokyo Rounds, Members negotiated on the basis of linear, across-the-board tariff cuts with provision for exceptions on a product-by-product basis. Finger argues that the linear approach results in an 'internalization-coverage trade-off', whereby the coverage of products included in tariff reductions is broader, but the ability of Members to free-ride was enhanced, thereby creating incentives for shallower tariff cuts.[28] A further

[28] See Finger, J.M. (1979), 'Trade Liberalization: A Public Choice Perspective', in Amacher, R., G. Haberler and T. Willet (eds) *Challenges to a Liberal International Order*, Washington, DC: American Enterprise Institute.

difficulty with the linear approach is agreeing on an appropriate formula for linear cuts. For example, Members with low average tariffs argued that it was unreasonable to expect them to cut tariffs by the same percentage as Members with high average tariffs.[29] In both the Kennedy and Tokyo Rounds, a complicated linear-cut formula was eventually agreed to which required proportionally greater cuts of high tariffs than of lower ones. Despite the problems noted above, the Kennedy and Tokyo Rounds were successful in substantially reducing average tariff levels by about 35% in each round.

In both the Kennedy and Tokyo Rounds, efforts were also made to negotiate tariff reductions in certain sensitive areas on a sector-by-sector basis.[30] These negotiations were largely a failure. One of the main reasons is that negotiating trade liberalization in a sectoral context lends a zero-sum quality to the negotiations. The political room for maneuver inherent in cross-product or cross-sectoral exchanges of concessions, as entailed in product-by-product or linear negotiations, is largely absent.[31]

2.2.3 Remaining tariff barriers At the beginning of the Uruguay Round of trade negotiations, Laird and Yeats identified a number of tariff issues that remained outstanding.[32] Among the most important of these outstanding issues were the following: (i) despite low average tariffs, many countries continued to levy high tariffs on particular products ('tariff peaks'); (ii) specific tariffs (i.e. a fixed charge per unit instead of a percentage of the product's value) were still common and had an adverse effect on the exports of developing countries; (iii) the use of the cost-insurance-freight (CIF) method of valuation for customs purposes instead of the free-on-board (FOB) method discriminated against geographically disadvantaged developing countries; (iv) the question of how to liberalize tariffs for products that are also covered by significant non-tariff barriers (such as quotas); and (v) the application by

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29 To see this, consider Country A with average tariffs of 60% and Country B with average tariffs of 10%. A 50% cut still leaves Country A with significant tariff barriers at 30%, but cuts down Country B's tariff barriers to a mere 5%. It is arguable that the tariff cut made by Country B will have a greater impact on its domestic industry than the tariff cut made by Country A.

30 These negotiations included steel, chemicals, and forest products.

31 Where sectoral negotiations did succeed in an agreement, such agreement tended to involve managed rather than liberalized trade, essentially resulting in a cartelization of the global industry. A prime example of such an agreement is the Multi-Fiber Arrangement (MFA) negotiated in the 1970s.

32 See Laird, Samuel and Alexander Yeats (1987), 'Tariff Cutting Formulas – and Complications', in J.M. Finger and Andruzej Olechavski (eds), *The Uruguay Round: A Handbook on Multilateral Trade Negotiations*, Washington, DC: The World Bank, at 89.

developed countries of escalating tariffs depending on the stage of production in order to protect domestic value-added processing industries, often at the expense of developing countries who would benefit from being able to engage in such value-added processing.

Substantial reductions in tariffs were achieved in the Uruguay Round, such that the average tariff levied by developed countries on industrial goods fell from 6.3% to 3.8% (compared to over 40% at the outset of the GATT). Both developed and developing countries agreed to bind a higher percentage of their tariffs, and to allow a higher percentage of goods to enter tariff-free. Significant progress was also made in reducing escalating tariffs on processed goods. Pursuant to the Agreement on Agriculture, quotas in agricultural products must be converted into tariffs and reduced over a six-year period. Despite this progress, however, a number of important tariff issues remain outstanding. Tariffs continue to be higher in several categories, such as textiles and clothing, leather, rubber, footwear and travel goods, fish and fish products, and transport equipment. Non-tariff barriers remain in the agricultural sector. Many of these categories, including textiles, footwear, and agriculture, are areas where developing countries have significant export interests.

2.2.4. Quantitative restrictions (quotas) Article XI prohibits the use of quotas or import or export licenses on the importation or exportation of goods into or out of any Member state. The theory behind this absolute prohibition was that if quantitative border restrictions could be avoided, and barriers to trade were expressed solely in the form of tariffs, the relative transparency of tariffs relative to quotas would make possible their reduction in subsequent negotiating rounds. However, Article XI historically proved largely unsuccessful in this goal. First, there are a number of important exceptions to Article XI. Articles XII and XVIII permit Members to impose quotas if they are experiencing balance of payments problems, or in the case of Article XVIII, if a developing country wishes to protect an infant industry. Second, since the 1980s there have been a number of bilateral 'voluntary' export restraint agreements (VEAs) negotiated in clear violation of Article XI. These agreements entail quantitative restrictions placed on the exporting country and are usually negotiated under threat of unilateral action by the importing nation (although the Agreement on Safeguards negotiated during the Uruguay Round now largely prohibits the use of VEAs). A prime example of such a 'voluntary' export agreement is the Multi-Fiber Arrangement (MFA), governing trade in cotton textiles. The MFA was formally established in 1974, between nine importing developed countries and 31 exporting developing countries. It limits exports by the developing countries to developed countries, through a variety of special safeguard measures, quotas, and voluntary restrictions. The effect of the MFA on developing countries has been severe. It has been estimated that

if *all* trade restrictions on LDC textile and clothing imports were lifted by the EU, Japan, and the United States, the gains to LDCs 'would be no less than 50.8 per cent of total possible gains related to all trade'.[33] The Uruguay Round Agreement on Textiles and Clothing provides for the gradual removal of the restrictions provided for under the MFA. The MFA has had seriously harmful implications for developing countries, and is discussed in greater detail in the section on developing countries below.

Trade in agriculture is another area where despite Article XI, quotas have historically played a major role. The Uruguay Round Agreement on Agriculture (discussed in greater detail below) represents a significant step, however, toward the elimination of quantitative restrictions on agricultural products and their replacement with tariffs.

2.3. Regional trade agreements

As noted in this section, the MFN principle is often viewed as an important tool in the GATT for encouraging tariff reduction. However, Article XXIV(5) provides an important exception to the MFN principle. Article XXIV(5) states that the terms of the GATT shall not prevent Members from forming a customs union or a free trade area or from adopting an interim agreement necessary for the formation of a customs union or free trade agreement. Therefore, Members may enter into regional trade agreements (RTAs) which extend more preferential terms of trade amongst the members of the RTA than are extended to other WTO Members. In other words, Members who join an RTA can favor their trading partners within the RTA over other WTO members. This is subject to the RTA meeting two conditions: (i) trade restrictions are eliminated with respect to 'substantially all the trade' between the contracting parties; and (ii) customs duties shall not be higher thereafter than the duties prevailing on average throughout the constituent territories prior to the formation of the RTA. Furthermore, Article XXIV(7)(a) requires that any Member deciding to enter an RTA shall notify other Members and provide them with any necessary information. Since 1947, 184 RTAs have been notified to the GATT/WTO. Prominent RTAs include the North American Free Trade Agreement (NAFTA), the European Union (EU), Mercosur (Argentina, Brazil, Paraguay, and Uruguay) in Latin America, APEC (Asia Pacific Economic Co-operation) in Asia and the Pacific Rim, and CARICOM (the Caribbean Common Market).

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[33] Abreu, M. de P. and W. Fritsch (1989), 'Market Access for Manufactured Exports from Developing Countries: Trends and Prospects', in J. Whalley (ed.) *Developing Countries and the Global Trading System, vol I*, London: Macmillan, at 117.

It is useful to briefly distinguish between the two types of RTA discussed in Article XXIV. A free trade area involves substantial liberalization of trade between the contracting parties, but leaves the contracting parties free to adopt their own trade and tariff policies with respect to the rest of the world. A customs union involves not only liberalization of trade between the contracting parties, but also requires that the contracting parties adopt a common external tariff and common external customs border with regard to the rest of the world. Once a product enters a customs union, it has free movement from one contracting party to the next. The most well-known examples of each are NAFTA (a free-trade area) and the EU (which incorporates a customs union as part of its overall system of economic integration).

There is vigorous debate amongst trade scholars about whether RTAs should be viewed as a step toward complete global free trade, or a step away from this goal. Regionalism and its implications are discussed in greater detail by Professor Trachtman in Chapter 4.[34]

2.4. Issues in the domestic administration of tariffs

Each country's customs authorities are responsible for administering domestic customs law, including the enforcement and collection of tariffs. This includes calculating and collecting any applicable duties owed. Calculating duties requires a number of steps, including valuing the good, categorizing the good in the appropriate tariff classification, and identifying the good's country of origin. Each stage in this process is a potential barrier to trade, as domestic customs procedures can either make the process prohibitively complex or can skew the process to bring about higher tariff rates.

Most tariffs are calculated on an *ad valorem* basis, requiring the importer to pay a certain percentage of the good's value in duty. Therefore, the determination by customs authorities of a good's value is of great importance. The

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[34] See also Bagwell, Kyle and Robert W. Staiger (2001), 'Reciprocity, Non-Discrimination, and Preferential Trade Agreements in the Multilateral Trading System', *European Journal of Political Economy*, 17(2), 281–325; Bhagwati and Panagariya (1996), 'Preferential Trading Areas and Multilateralism – Strangers, Friends, or Foes?' in Bhagwati and Pabagariya (eds), *The Economics of Preferential Trade Agreements*, Washington, DC: AEI Press, at 1–78; Krueger, Anne O. (1990), 'Free Trade is the Best Policy' in Robert Lawrence and Charles Shultze (eds), *An American Trade Strategy: Options for the 1990s*, Washington, DC: Brookings Institution; Schott, Jeffrey J. (1989), *More Free Trade Areas?*, Washington, DC: Institute for International Economics; Aho, Michael and Sylvia Ostry (1990), 'Regional Trading Blocs: Pragmatic or Problematic Policy', in William Brock and Robert Hormats (eds) *The Global Economy: America's Role in the Decade Ahead*, New York: American Assembly.

current international rules on the valuation of goods for customs purposes are found in the Uruguay Round Agreement on Implementation of Article VII of the GATT. The intent of this agreement is to provide a uniform system of valuation that constrains arbitrary administrative discretion. The Uruguay Round Agreement establishes 'transaction value' as the primary standard of valuation. Transaction value is defined as the price paid or payable for the goods when sold for export to the country of importation, plus certain additions such as the cost of packaging and other items provided free of charge to the buyer in connection with the goods. Other items such as the cost of transportation, handling, and insurance can be deducted from the transaction value. There are circumstances, however, where the transaction value cannot be used. This includes a situation where there is some restriction on the disposition or sale of the goods that affects the value of the goods. Note that transactions between related persons, such as parent and subsidiary corporations, are eligible for the use of transaction valuation provided that the relationship is 'arm's-length' (i.e. it did not affect the price). In the event transaction value cannot be used, the Uruguay Round Agreement provides a number of alternative methods of valuation, for example the transaction value of identical or similar goods exported to the same country at the same time. The Uruguay Round Agreement expressly prohibits certain methods of valuation, such as the use of arbitrary or fictitious values, or the use of the selling price in the country of importation.

Since there is variation in the levels of tariffs applied to different products, the classification of a given imported good into a product category impacts upon that good's tariff treatment. A country can use tariff classification as a protectionist or discriminatory tool in order to minimize the value of tariff concessions it has made. If a country has made tariff concessions in a given product category, it can subdivide that category such that certain goods fit into the category on which concessions have been made and certain goods do not. In order to deal with this problem, the Harmonized Commodity Description and Coding System (HS) was developed and implemented beginning in 1987. The basis of the HS is that goods should be classified according to their intrinsic nature (i.e. by what they are and not how they are used) and should only fall into one category. The HS includes a mandatory six to ten-digit classification system and legal notes that are binding on users. The notes provide definitions of terms and phrases essential to the process of classification, set guidelines for the types of goods to be included in each category, list specific goods to be included or excluded in certain categories, and include explanatory and interpretive notes.

Tariff treatment is also often contingent on the country of origin of the product. For example, Canada's tariff schedule includes five different tariff

rates, the applicable rate being dependent upon the country of origin.[35] Given the modern commercial reality of global production chains, where the procurement of raw materials, processing, assembly, and packaging for a single product may take place in different countries, establishing the country of origin is often difficult. A further layer of complexity is added when one considers that goods are often shipped to one country via another. There is currently no comprehensive international agreement on rules of origin. Part IV of the Uruguay Round Agreement on Rules of Origin sets out plans for a transition to a harmonized system of origin determination based on where the good was wholly obtained or where it underwent its last 'substantial transformation'. The WTO Committee on Rules of Origin is currently working toward the completion of such a harmonized system.[36]

3. Subsidies

3.1. Description of subsidies

There is a great deal of debate among economists and trade scholars about what constitutes a subsidy, which subsidies should be prohibited and which should be permitted, and how to distinguish between 'good' and 'bad' subsidies.[37] Generally speaking, though, a subsidy can be roughly defined as any type of financial contribution by government to a domestic firm or industry which confers an advantage over foreign competition, either in domestic or export markets.[38] Under the Uruguay Round Agreement on Subsidies and Countervailing Measures (SCM Agreement), a subsidy has two elements: (1) a financial contribution from government, and (2) the financial contribution must confer a benefit on the recipient.[39] Additionally, for many of the strictures of the SCM Agreement to apply the subsidy must be *de jure* or *de facto* specifically targeted at a particular company or industry.

Some examples from subsidization cases that have come before the WTO

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[35] The tariff rates include an MFN rate for GATT members, a NAFTA rate, a GSP rate for developing nations, a preferential Commonwealth rate (predating GATT), and a General rate for non-members of GATT.

[36] For continued information on the progress of this Committee's efforts, see the link for 'Work in the Committee on Rules of Origin', available online: http://www.wto.org/english/tratop_e/roi_e/roi_e.htm. Accessed February 13, 2005.

[37] See Sykes, Alan O. (2003), 'The Economics of WTO Rules on Subsidies and Countervailing Measures', John M. Olin Law & Economics Working Paper No. 186 (2nd Series). Online: http://www.law.uchicago.edu/Lawecon/WkngPprs_176-200/186.aos.subsidies.pdf. Accessed August 16, 2004.

[38] For the precise legal definition of a subsidy, see Article 1.1 of the Uruguay Round Agreement on Subsidies and Countervailing Measures (SCM Agreement).

[39] Matsushita, *supra* note 17, at 268.

Appellate Body may be helpful in illustrating this definition. In a case between Canada and Brazil dealing with aircraft subsidization, the Appellate Body found that below-market-rate export credits provided by the Brazilian government to aircraft exporters constituted an illegal subsidy.[40] In the long-running softwood lumber dispute between Canada and the United States, the United States had alleged that 'stumpage rates' (essentially the price per tree) charged by the Canadian government to Canadian softwood lumber producers is below a market rate, and thus constitutes an illegal subsidy.[41] Under the SCM Agreement, once a Member is found to be conferring illegal subsidies that are injuring the industry of another Member, the injured Member may either impose countervailing duties on subsidized imports in order to neutralize the effect of the subsidy, or may bring a complaint before the WTO dispute settlement body. Countervailing duties are addressed in greater detail in this text by Professor Sykes.

3.2. GATT disciplines dealing with subsidies

3.2.1. Article VI Article VI of the GATT authorizes Members to levy countervailing duties on imports that are injuring domestic industries due to subsidization by a foreign government. Countervailing duties are defined as 'a special duty levied for the purpose of offsetting any bounty or subsidy bestowed directly or indirectly upon the manufacture, production or export of any merchandise'. In order for a countervailing duty action to succeed, the effect of the subsidization must be to cause or threaten to cause material injury to an established domestic industry or to retard materially the establishment of a domestic industry. If countervailing duties are authorized, they should be no more than an amount to offset the estimated subsidy determined to have been granted.

3.2.2. Uruguay Round Agreement on Subsidies and Countervailing Measures A Subsidies Code negotiated during the Tokyo Round was not signed by all Members; rather it was accepted only by the Organisation for Economic Cooperation and Development (OECD) nations and a small number of the most advanced developing nations. It proved largely ineffective and was superseded by the Uruguay Round Agreement on Subsidies and

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[40] See *Brazil – Export Financing Programme for Aircraft*, Report of the Appellate Body, WT/DS46/AB/R (1999).

[41] For an overview of the softwood lumber litigation, see the website of the Canadian Department of Foreign Affairs and International Trade. Online: http://www.dfaitmaeci.gc.ca/eicb/softwood/wto_challenges-en.asp. Accessed February 13, 2005.

Countervailing Measures (SCM Agreement), which together with GATT Article VI and Article XVI governs subsidies today.[42] [43] Unlike the Tokyo Round Agreement, the SCM Agreement binds all Members. Significantly, the SCM Agreement was the first GATT agreement which explicitly defined subsides. Under Article 1.1(a), a subsidy is deemed to exist if there is a financial contribution by government or any public body where the government practice involves a direct transfer of funds (e.g. grants, loans, and equity infusion); potential direct transfers of funds or liabilities (e.g. loan guarantees); government revenue that is otherwise due but is foregone; government procurement of goods or services other than general infrastructure; government payments to a funding mechanism or direction to a private body to carry out any of the foregoing functions.

However, it is important to note that not all subsidies caught by the above definition are necessarily in contravention of the SCM Agreement. Two other requirements must be met. First, for a subsidy to be 'illegal' it must also 'confer a benefit' on the recipient (Article 1.1(b)). Generally speaking, WTO dispute settlement panels have found that conferring a benefit entails a financial contribution by government on terms that are more advantageous than those which would have been available to the recipient on the open market.[44] Second, Article 1.2 of the SCM Agreement states that in order for a subsidy to be found illegal, it must also meet the definition of 'specific' contained in Article 2 of the SCM Agreement. The subsidy cannot be generally available – a complaining Member must show that the subsidies are *de jure* or *de facto* limited to a specific enterprise, industry, or group thereof. A subsidy is *de jure* specific when the granting government 'explicitly limits access to a subsidy to certain enterprises' (Article 2.1(a)). A subsidy that is *de jure* non-specific can still be *de facto* specific, if the subsidy is used only by a limited number of 'certain enterprises', if the subsidy is predominantly used by certain enterprises, if disproportionate amounts of the subsidy are granted to certain enterprises, or if the granting government favors certain enterprises in exercising its discretion (Article 2.1 (c)).[45] This broad definition demonstrates the intent of

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[42] A WTO Appellate Body report has stated that the Uruguay Round Agreement on Subsidies and GATT Articles VI and XVI complement each other, but in the event of a conflict the Agreement on Subsidies will prevail. See *Brazil – Measures Affecting Desiccated Coconut*, Report of the Appellate Body, WT/DS22/AB/R (1997), pp. 11–21.

[43] Note that agricultural subsidies are a separate issue, and are discussed in Part V of this chapter.

[44] See *Canada – Measures Affecting the Export of Civilian Aircraft,* Report of the Appellate Body, WT/DS70/AB/R (1999).

[45] Matsushita et al., *supra* note 17 at 271.

the SCM's negotiators to include a wide range of subsidies under the term 'specific'.[46] However, this distinction between 'specific' and 'general' subsidies may not be conceptually defensible. Almost every action a government takes will favor some sectors of the economy over others; for example investments in scientific education will assist primarily high technology industries. As well, the distinction between specific and general subsidies makes no distinction between competitively salient specific subsidies and those that are not. For example, a government subsidy to a firm to decommission a plant for environmental reasons or to assume some of the costs of job layoffs may have no effect on the firm's marginal costs of production and hence competitiveness in foreign markets, yet nevertheless is likely to fall into the objectionable specific subsidy category. Thus, it may be quite difficult for a panel to draw the line between specific and general subsidies on any principled basis. It should also be pointed out that the very basis of gains from liberal trade is differing productive conditions between trading states. To the extent that 'specific' subsidies contribute to differing productive conditions, they may in fact increase the potential gains from trade.

Another important feature of the SCM Agreement is its classification of subsidies into three categories: non-actionable, prohibited, and actionable. Non-actionable subsidies, as the name suggests, are immune from complaints under the SCM Agreement. Under Article 8.1, non-actionable subsidies include subsidies which are not specific within the meaning of Article 2, as well as subsidies which are specific but which fall within a class of exceptions provided for in Article 8.2.[47] However, the non-actionable subsidies category expired in 2000, pursuant to Article 31 of the SCM. As such, the only subsidies which should now be understood as non-actionable are those which are not specific.

Under Article 3, the following classes of subsidies are prohibited *per se*: subsidies contingent in law or in fact upon export performance, and subsidies contingent upon the use of domestic rather than imported inputs. The absolute prohibition with respect to these forms of subsidy means that there is no

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[46] *Ibid.*

[47] These exceptions include: assistance for research activities conducted by firms or universities, as long as the assistance does not cover more than certain specified percentages of research costs; assistance given to disadvantaged regions pursuant to a general framework of regional development, provided that the disadvantaged region meets certain requirements such as geographic continuity and lagging relative measures of GDP and unemployment; and assistance to promote adaptation of existing facilities to new environmental requirements provided that the assistance meets certain requirements such as being a one-off measure and covering less than 20% of the cost of the adaptations.

inquiry into whether the subsidy is causing injury, nullification or impairment, or serious prejudice to another Member, nor is there a requirement of specificity. If the measure in question is found to be a prohibited subsidy, a WTO Panel will recommend that the subsidizing Member withdraw the subsidy without delay (Article 4.7).

Subsidies that are neither prohibited nor non-actionable are placed in the actionable category. In order to be found illegal, actionable subsidies must first meet the criteria set out in Article 1 of the SCM Agreement, i.e. a financial contribution to a firm or industry that confers a benefit and is specific.[48] Furthermore, actionable subsidies must cause 'adverse effects to the interests of other Members'. Article 5 sets out three categories of 'adverse effects': material injury to the domestic industry of another Member;[49] nullification or impairment of benefits accruing directly or indirectly to other Members under the GATT; or 'serious prejudice' to the interests of another Member. Under Article 6.3, 'serious prejudice' may arise where the effect of the subsidy is to displace or impede the imports of like products into the market of the subsidizing country; where the effect of the subsidy is to displace or impede the export of a like product of another country from or to a third-country market; where the effect of the subsidy is a significant price-undercutting by the subsidized products as compared to like products from other countries in the same market; or where the effect of the subsidy is an increase in the world market share of the subsidizing country as compared to its world market share over the past three years. Under Article 6.1(a), 'serious prejudice' will be deemed to exist in the case of a subsidy which exceeds 5% of the value of the subsidized product, unless the subsidizing Member can prove otherwise. If the subsidy meets the requirements of Article 1, and is resulting in adverse effects on the interests of other Members, the subsidizing Member must withdraw the subsidy or face retaliatory action by the complaining Member (Articles 7.8–7.9).

4. Government procurement

Governments often use their significant purchasing power as a tool to accomplish various political, social, and economic objectives. Therefore, government

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[48] Under the Tokyo Round Subsidies Code, Article 11 contained a list of legitimate grounds for domestic subsidies, including for example: the elimination of industrial, economic and social disadvantages of specific regions, to facilitate the restructuring of certain sectors, and to sustain employment and encourage re-training. Such a list is not included in the SCM Agreement.

[49] The term 'injury' is defined as material injury to a domestic industry, threat of material injury to a domestic industry or material retardation of the establishment of such an injury.

procurement policies can distort trade if the objective of getting the best product or service at the lowest price is compromised by political motives, such as discriminating in favor of domestic over foreign producers. The most common areas for domestic preference in government procurement are: (1) to protect employment in declining industries; (2) to protect the supply of 'strategic' defense goods, and (3) to support emerging domestic hi-tech industries. Governments carry out domestic preferences through overtly discriminatory tactics as well as through less overt forms of discrimination. Some common overtly discriminatory tactics include: price differentials applied against foreign bids (whereby foreign bids may only be accepted if the foreign bid is a specified percentage lower than the best domestic bid); 'discounts' for the domestic content of a bid; selective sourcing policies where only domestic firms are invited to bid; and requiring foreign contractors to procure inputs from the local market as a condition of the award of the contract. Less overt forms of discrimination include: manipulating the time and method of notice of tender solicitations in order to favor domestic suppliers; giving short deadlines to submit bids which can only be met by domestic suppliers; and setting product or service standards in such a way that only domestic suppliers can meet the standards.

4.1. GATT disciplines dealing with government procurement

The GATT initially refrained from restricting government procurement policies. Paragraph 8(a) of Article III explicitly exempts government procurement from the GATT obligation of National Treatment.[50] This changed with the signing of the Tokyo Round Code on Government Procurement. The Code established the obligation of National Treatment with respect to government procurement. Another key aspect of the Code was the requirement of a transparent tendering procedure designed to provide adequate notice and information to prospective foreign bidders in order to ensure fair treatment. The tendering procedure included an 'open' tendering system under which a notice of prospective purchase (NPP), containing all the necessary information for the timely submission of both domestic and foreign bids, must be published. The Code further required that the contract be awarded to the lowest tender, or to the tender which is most advantageous according to the criteria set out in the NPP. Technical specifications, which were often manipulated in order to exclude foreign suppliers, were regulated by the Code. A system of enforcement and dispute resolution was also provided.

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[50] The principle of National Treatment is an important one and is discussed in greater detail in Part VI of this chapter. For the purposes of the present discussion, National Treatment is an obligation under the GATT to treat foreign firms and products the same as domestic firms and products, i.e. discrimination on the basis of nationality is prohibited.

However, the Code was limited in scope and coverage. It only applied to contracts for goods with a value of approximately US$170,000 or more, and did not cover contracts for services. It continued to allow governments to demand offset industrial benefits (i.e. local content requirements) from foreign firms as a condition of awarding contracts to them. As well, the Code was merely a plurilateral agreement with only about twenty signatories.

The Uruguay Round Government Procurement Agreement (GPA) represents a substantial revision of the Tokyo Round Code.[51] Like the Tokyo Round Code, the GPA contains national treatment and non-discrimination obligations with respect to government procurement practices (Article III).[52] Article VI regulates technical specifications, stipulating that they must not be prepared, adopted, or applied in order to create unnecessary obstacles to international trade (Article VI:1). Furthermore, technical specifications shall, where appropriate, be in terms of performance rather than design or descriptive characteristics, and shall be based on international standards where such standards exist (Article VI:2). The scope of the GPA is also much broader than under the Tokyo Round Code. Article I defines the scope and coverage of the GPA, which now includes construction contracts and contracts for services. The governmental entities covered by the GPA extend beyond central governments, and now include sub-national governments and public enterprises. Article XVI specifies that offset industrial benefits, permitted under the Tokyo Round Code, may no longer be demanded by governments. Finally, under Article XX, all parties to the GPA are required to establish domestic bid challenge procedures by which aggrieved foreign suppliers may challenge breaches of the GPA directly. However, like its Tokyo Round predecessor, the GPA is plurilateral, not multilateral, with only 28 signatories. This raises complex questions as to whether GPA members are entitled to discriminate against non-GPA members in the area of government procurement, given that the GPA does not include an exemption from the general MFN obligation in the GATT.

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[51] For a review of the Agreement, see Reich, Arie (1997), 'The New GATT Agreement on Government Procurement: The Pitfalls of Plurilateralism and Strict Reciprocity', *Journal of World Trade*, 31, at 125.

[52] Article III:1 states 'With respect to all laws, regulations, procedures and practices regarding government procurement covered by this Agreement, each Party shall provide immediately and unconditionally to the products, services and suppliers of other Parties offering products or services of the Parties, treatment no less favorable than that accorded to domestic products, services and suppliers; and that accorded to products, services and suppliers of any other Party.'

5. Trade in agriculture

Trade in agriculture has become one of the most prominent and acrimonious issues on the global trade agenda. Prior to the Uruguay Round, the GATT placed many fewer disciplines on agricultural trade than on any other sector. For example, although Article XI prohibits quantitative restrictions, many of the exceptions permitted under this article had to do with agricultural products. Article XVI instructs Members to seek to avoid subsidizing 'primary products' (which include agricultural products) for export, but ultimately permits such subsidies as long as they do not result in the subsidizing Member having more than an equitable share of world export trade in that product. In other instances, Members have completely ignored their agricultural commitments under GATT, and refused to comply with Panel decisions.[53]

The instruments of agricultural protection are varied. The European Union's Common Agricultural Policy has traditionally employed a combination of minimum prices for sales within the EU protected through variable import levies, guaranteed sales (i.e. government purchase of oversupply), and rebates on export sales below EU prices. This tends to result in overproduction and displacement of foreign producers in third-country markets. US agricultural protection has focused on price support measures coupled with production restrictions, and in recent years certain forms of export subsidies. Canada maintains marketing and production restrictions on poultry, eggs, and dairy products through the use of domestic and import quotas, and arguably confers various forms of subsidies on wheat and grain producers through the operation of state trading enterprises.[54] As well, Japan employs a wide range of instruments including price stabilization, supply management, import quotas, and extremely high tariffs. Agricultural protection imposes costs on consumers through higher food prices, on taxpayers who fund government subsidization programs, and on society through allocative efficiency losses as resources are misdirected toward agricultural production when no comparative advantage exists in this sector. It has been estimated that the yearly cost of agricultural protection to non-farm households in Europe, the United States, and Japan (taking into account both higher food prices and higher taxes) averages $1,400 per household per year.[55] The World Bank recently estimated the potential gain in global income from a new agricultural trade deal at between

53 See EEC – *Subsidies on Exports of Pasta Products*, SCM/43 (1983) (unadopted).

54 See *Canada – Measures Relating to Exports of Wheat and Treatment of Imported Grain*, Report of the Appellate Body, WT/DS276/AB/R (2004).

55 *The Economist*, 'Grotesque: A Survey of Agriculture', December 12, 1992, p. 7.

$290 billion and $520 billion per year, with over 60% of this gain benefiting developing countries.[56]

A number of rationales are often advanced for treating the agricultural sector differently from other sectors, including: exceptional price and income instability for agricultural producers, the importance to national security of agricultural self-sufficiency, and the social and cultural value of preserving rural lifestyles. With respect to the income instability rationale, it is arguable that this concern may no longer be compelling, since the majority of agricultural production is now accounted for by large commercial producers who are less sensitive to price volatility. With respect to the self-sufficiency rationale, self-sufficiency is not obviously more important in the case of agricultural products than many other essential products, and indeed sources of supply of agricultural products are often more diversified. With respect to the rural lifestyle preservation rationale, it is likely that alternative policy measures, such as regional development programs, may be preferable to extraordinarily costly and wasteful subsidies. Nevertheless, the influence of powerful farm lobbies and the disproportionate representation of rural areas in legislatures often make it politically difficult for certain governments to liberalize their agricultural sectors.

5.1. The Uruguay Round Agreement on Agriculture

The Uruguay Round Agreement on Agriculture represented the start of a fundamental shift toward the liberalization of trade in agriculture. The Agreement addresses three key sources of distortion in agricultural trade: domestic support measures (i.e. price supports, payments to farmers, supply management), export subsidies, and tariffs and non-tariff border measures. Articles 1(a), 6, and Annex 3 to the Agreement attempt to quantify domestic support measures in terms of a common metric, the Aggregate Measure of Support (AMS), and commit Members to 20% reductions in their level of domestic support. Articles 8–10 commit Members to the reduction of export subsidies over a six-year period, by 21% in terms of the volume of products that receive subsidies and 36% in terms of the cash value of such subsidies. Members also commit not to expand export subsidies beyond the levels reached after achievement of the six-year goal. It should be noted that this essentially overrides Article XVI of the GATT, which had theretofore largely permitted export subsidies on primary products. Article 4 requires Members to

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[56] The World Bank, *Global Economic Prospects 2004: Realizing the Development Promise of the Doha Agenda* (Washington: The World Bank, 2003). Online: http://www.worldbank.org/prospects/gep2004/full.pdf. Accessed February 13, 2005.

convert non-tariff border measures (such as import quotas) into tariffs, and to reduce overall agricultural tariffs (including non-tariff measures which have been converted) by at least 36% over a six-year period, with a minimum 15% reduction in each product category. Furthermore, new non-tariff measures of any kind are prohibited. Members also commit to reduce non-tariff border measures to an extent that allows foreign producers market access equivalent to 3% of total domestic production, rising to 5% by the end of the six-year phase-in period.

The Agreement also includes a system under which certain forms of subsidies are exempted from the reduction commitments. All forms of domestic support measures were classified into three categories: 'Yellow Box', 'Green Box', and 'Blue Box'. 'Yellow Box' support measures are those which definitely have market-distorting effects, such as price supports and other subsidies which encourage overproduction. These measures are subject to the reduction commitments. 'Green Box' subsidies are defined in Annex 2 to the Agreement, and include measures directed at research, infrastructure, domestic food aid, disaster assistance, training and advisory services. 'Green Box' subsidies are deemed to have no effect on trade or production and are exempt from the reduction commitments. 'Blue Box' subsidies are listed in Article 6, and involve direct payments to farmers made under 'production-limiting programs' and certain developing country subsidies designed to encourage agricultural production. 'Blue Box' subsidies are not subject to the reduction commitments, provided they adhere to certain requirements set out in Article 6.5(a). Article 13 of the Agreement, known as the 'peace clause', states that domestic support measures which are exempt from the reduction commitments (i.e. 'Green Box' measures) are non-actionable for the duration of the peace clause. Furthermore, 'due restraint' is to be exercised in initiating investigations into 'Blue Box' subsidies. The peace clause expired in January 2004.

Other important provisions in the Agreement include a safeguard clause (Article 5) which permits the imposition of additional duties where imports exceed a given trigger level or where import prices fall below a trigger price, and Article 15 which provides for special and differential treatment for developing countries. Generally, this treatment entails longer phase-in periods as well as exceptions from the Agreement's disciplines for certain forms of domestic subsidies.

5.2. Further reform

The Uruguay Round Agreement on Agriculture should be seen as only a modest beginning to agricultural liberalization. Post-Uruguay Round agricultural policies among OECD countries cause a $40 billion welfare loss to developing countries annually, while an additional 40% reduction in agricultural tariffs and subsidies would increase global real income by $60

billion.[57] To this end, Paragraph 13 of the Doha Declaration urges Members to build on the Uruguay Round Agreement and work toward the Agreement's ultimate objective of a fair and market-oriented agricultural trading system.

Despite these words, negotiations on further liberalization of trade in agriculture have floundered badly.[58] But a July 2004 'framework agreement' known as the Doha Work Programme provides some hope.[59] The main achievement of this agreement is a seven-page 'Framework for Establishing Modalities in Agriculture', representing a preliminary consensus among Members on the next stage of agricultural reform. The Framework reaffirms the Declaration's commitment to 'substantial' reductions in domestic support, specifying an immediate 20% cut in such subsidies upon the conclusion of the Doha Round. Higher levels of domestic support are to be targeted for the deepest cuts. Significantly, the Framework calls for the 'elimination' of export subsidies. This represents a substantial change in position from the Declaration, which aimed only at the 'reduction of, with a view to phasing out' export subsidies. Other forms of export support such as export credits and state trading enterprises are also targeted for elimination. The Framework also promises 'substantial overall tariff reductions', with the deepest cuts reserved for products with the highest tariffs. However, the Framework also makes allowances for certain products to be treated as 'sensitive' and presumably subjected to less drastic cuts. In addition, the Framework reaffirms that special and differential treatment for developing countries will be integral to negotiations, states that lesser commitments will be required of developing countries, and promises flexible treatment with regard to products designated as 'special' by developing countries.

6. National Treatment

6.1. National Treatment

The National Treatment principle is found in Article III of the GATT.[60] The

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[57] Hertel, T. and W. Martin (2000), 'Liberalizing Agriculture and Manufactures in a Millennium Round: Implications for Developing Countries', *The World Economy*, 23(4) at 456.

[58] See *The Economist*, 'The WTO Under Fire – The Doha Round', September 20, 2003, p. 30.

[59] WTO, *Doha Work Programme – Decision Adopted By General Council on 1 August 2004* (2004), WT/L/579 (General Council, August 2, 2004). Online: http://www.wto.org/english/tratop_e/dda_e/ddadraft_31jul04_e.pdf. Accessed February 13, 2005.

[60] Article III:4 states: 'The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of

National Treatment principle, along with the MFN principle, constitute the two strands of the non-discrimination principle that is widely seen as the foundation of the GATT/WTO regime.[61] A key distinction between the two is that MFN addresses favoritism among foreigners, while National Treatment addresses favoritism between domestic and foreign producers. National Treatment prohibits discrimination between domestic and foreign goods in the application of internal regulatory and taxation measures. The National Treatment principle prevents countries from engaging in 'regulatory protectionism', i.e. eroding the value of their tariff concessions by imposing discriminatory internal regulations and taxes. Therefore, any domestic tax or regulation which has a discriminatory effect on imports may be suspect under the National Treatment principle.

However, the application of the National Treatment principle must also be sensitive to regulatory diversity. If every attempt by governments to carry out domestic policy objectives were constrained by the need to facilitate imports, domestic regulatory autonomy would be severely impaired. As such, the National Treatment principle, and its interpretation by WTO panels, reflects an attempt to strike a balance (not always successfully) between permitting legitimate domestic regulation and constraining regulatory protectionism.

Mattoo and Subramanian argue that the key difficulty lies in distinguishing between two types of situations: (1) a non-protectionist government cannot prevent certain policies from incidentally discriminating against foreign competitors; and (2) a protectionist government uses a legitimate regulatory objective as an excuse to design domestic policies which inhibit foreign competition.[62] Frequently, the impugned domestic regulation is on its face non-discriminatory, 'but because of various circumstances of the marketplace or otherwise has the effect of tilting the scales against imported products'.[63] Some examples from WTO case law may be illustrative. In *Japan – Taxes on*

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all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use.' Article III:2, dealing with internal taxes, states: 'The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products.'

[61] Trebilcock, Michael J. and Shiva K. Giri (2003), 'The National Treatment Principle in International Trade Law', in E.K. Choi and James Hartigan, *Handbook of International Trade Volume II*, Oxford: Blackwell Publishers.

[62] See Mattoo, Aaditya and Arvind Subramanian (1998), 'Regulatory Autonomy and Multilateral Disciplines: The Dilemma and a Possible Resolution', *Journal of International Economic Law*, 1(2), 303–22.

[63] Jackson, John H. (1989), 'National Treatment Obligations and Non-tariff Barriers', *Michigan Journal of International Law*, 10(1), at 212.

Alcoholic Beverages,[64] Canada, the United States, and the European Community complained that Japan's Liquor Tax Law, which divided all liquors into sub-categories according to alcohol content per liter and imposed differential internal tax rates on these categories, was discriminatory. The Liquor Tax Law had the effect of imposing higher taxes on imported liquors, which tended to have higher alcohol content, than on Japanese liquors, which tended to have lower alcohol contents. The Appellate Body rendered a mixed decision, finding that some liquor imports were being treated unfairly and others were not. In *Asbestos*,[65] Canada challenged France's health-related ban on the use of asbestos in construction materials, arguing that under the National Treatment principle asbestos was entitled to treatment equal to that accorded substitute materials used in construction, and thus the ban on asbestos only was discriminatory. A WTO Panel decision upheld Canada's claim of a violation of the National Treatment principle, leaving the Panel open to criticism that it was insensitive to a sovereign state's prerogative to enact regulations to protect the health of its own citizens.[66] However, the Panel did ultimately find that the ban was justified under the health and safety exception of Article XX(g). Furthermore, the Panel's controversial decision on the application of the National Treatment principle was overturned by the Appellate Body, which acknowledged that significant differences in health effects between products (asbestos was a known carcinogen whereas the substitute materials were not) provided a sufficient basis for a country to implement differential regulations. As this brief overview demonstrates, application of the National Treatment principle can result in highly contentious forays into the domestic regulatory choices of sovereign states.

6.1.1. National Treatment – internal taxes Article III.1 of the GATT states that Members recognize that internal taxes, laws, regulations, and requirements affecting the internal sale, offering for sale, purchase, transportation,

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[64] *Japan – Taxes on Alcoholic Beverages*, Report of the Appellate Body, WT/DS8/AB/R (1996).

[65] *EC – Measures Affecting Asbestos and Asbestos-Containing Products*, Report of the Panel, WT/DS135/R (2000) and *EC – Measures Affecting Asbestos and Asbestos-Containing Products*, Report of the Appellate Body, WT/DS135/AB/R (2001).

[66] For analysis of various aspects of this case, see Yavitz, Laura (2002), 'The World Trade Organization Appellate Body Report, European Communities – Measures Affecting Asbestos and Asbestos-Containing Products', *Minnesota Journal of Global Trade*, 11(1), at 43; and Howse, Robert and Elizabeth Turek (2001), 'The WTO Impact on Internal Regulations – A Case Study of the Canada-EC Asbestos Dispute', in G. de Burca and J. Scott (2001) (eds), *The EU and the WTO: Legal and Constitutional Issues*, Oxford: Hart Publishing.

distribution or use of products should not be applied to imported or domestic products *so as to afford protection to domestic production*. Article III.2 (first sentence) states that imports from one Member into the territory of another Member shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind *in excess of* those applied to *like domestic products*. Moreover, Article III.2 (second sentence) states that no contracting party shall otherwise apply internal taxes or charges on imported or domestic products in a manner contrary to the principles set forth in Article III.1. An interpretive note to Article III.2 (second sentence) clarifies that a tax conforming to the requirements of Article III.2 (first sentence) would be considered to be inconsistent with the provisions of the second sentence only in cases where a taxed import and a domestic product are *directly competitive or substitutable* and the latter is *not similarly taxed*. Therefore, a complaining party can structure a claim regarding an internal taxation measure in two ways.[67] First, it could claim under Article III.2 (first sentence) that (a) the domestic and imported products are *like products*, and (b) the imported product is taxed *in excess of* the domestic product. Alternatively, it could claim under Article III.2 (second sentence), in conjunction with Article III.1, that (a) the two products are *directly competitive or substitutable*, (b) the two products are *not similarly taxed*, and (c) the dissimilar taxation operates *so as to afford protection* to domestic production.[68]

Clearly, the definition of ‘like product’ is important to cases which arise under Article III. Members may discriminate between products that are not like, but generally may not discriminate between imported and domestic products that are like. In the *Japan – Alcoholic Beverages* case, the Appellate Body adopted three criteria for the determination of ‘like product’ that were originally adopted in a 1970 Working Party Report on Border Tax Adjustments, the criteria being: (i) the product’s end-uses in a particular market, (ii) the prod-

[67] The following outline of claims under Article III.2 is taken from: Trebilcock, Michael and Robert Howse (2005), *The Regulation of International Trade*, 3rd edn, New York: Routledge, at 85–86.

[68] See *Japan – Taxes on Alcoholic Beverages*, *supra* note 64, at p. 24. The Appellate Body’s adoption of this two-step legal test signified its rejection of an earlier approach, known as the ‘aim-and-effect’ test, under which dispute settlement bodies attempted to discern whether the aims and effects of a domestic regulatory distinction showed intent to favor domestic over foreign producers. Such a test was rejected due to its inconsistency with the text of Article III, the inherent evidentiary and practical difficulties in proving legislative intent to discriminate, and the fact that most legislation has a multiplicity of aims and it is often difficult to determine which legislative aim should be viewed as paramount. For an example of the ‘aim-and-effect’ approach, see *US – Measures Affecting Alcoholic and Malt Beverages*, GATT BISD (39th Supp.) (1993).

uct's properties, nature, and quality, and (iii) consumer tastes and habits, which change from country to country.[69] The Appellate Body also noted the importance of tariff classifications. These criteria may be used to ascertain the 'likeness' of an imported product receiving less favorable treatment with the domestic product receiving more favorable treatment. Famously, the Appellate Body went on to describe the concept of 'likeness' as being similar to an accordion, in that depending upon how broadly or narrowly one construes a particular product market, two given products may or may not be viewed as like products.[70] The Appellate Body cautioned that although the Border Tax Adjustment criterion provides a degree of guidance, in every case there will be a certain amount of discretionary judgment to be exercised.[71]

Another important aspect of the Appellate Body's approach to Article III.2 claims is its interpretation of the phrase 'directly competitive or substitutable' (DCS). WTO Panels and the Appellate Body have settled on a 'mixed' approach which weighs both qualitative and quantitative evidence regarding the degree of competition and substitutability between the domestic and foreign product.[72] Under this approach, an analysis of cross-price elasticity of demand between the domestic and imported product is relevant to the determination of DCS, but must also be viewed in tandem with qualitative evidence such as comparisons of the products' end-uses, physical characteristics, distribution channels, and prices. Interestingly, a WTO Panel has also found that 'consumer theory', which focuses on the degree to which a good satisfies the particular wants or needs of consumers, may also be useful in the determination of DCS.[73] Some commentators have critiqued the approach of WTO dispute settlement bodies here, arguing that a more explicitly economic approach which borrows from antitrust law would be desirable.[74]

6.2.2. National Treatment – non-fiscal measures Article III.4 states that imported products shall be accorded treatment no less favorable than that accorded to like products of national origin in respect of all laws, regulations, and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution, or use. Therefore, a Member making an Article III.4 claim must show that (a) the impugned measure is a law, regulation, or

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69 *Japan – Taxes on Alcoholic Beverages, supra* note 64, at pp. 20–21.

70 *Japan – Taxes on Alcoholic Beverages, supra* note 64, at p. 24.

71 *Japan – Taxes on Alcoholic Beverages, supra* note 64, at p. 25.

72 See *Korea – Taxes on Alcoholic Beverages,* Report of the Appellate Body, WT/DS75/AB/R (1999), at paras 108–54, and *Chile – Taxes on Alcoholic Beverages*, Report of the Panel, WT/DS87/R (1999), paras 7.31–7.88.

73 See *Chile – Taxes on Alcoholic Beverages*, *supra* note 72, paras 7.81–7.87

74 See Trebilcock and Giri, *supra* note 61.

requirement affecting internal sale, offering for sale, purchase, transportation, distribution, or use; (b) that the imported and domestic products are 'like products'; and (c) the imported product is being accorded less favorable treatment than the domestic product.

The Appellate Body has held that 'like product' in Article III.4 may be interpreted more broadly than 'like product' in Article III.2 (first sentence), but not more broadly than Article III.2 (second sentence).[75] As well, the Appellate Body has interpreted the phrase 'no less favorable' in Article III.4 as being informed by the anti-protectionist principle of Article III.1.[76] According to the Appellate Body, a Member may draw distinctions between products that are like without necessarily imposing less favorable treatment. Less favorable treatment should be understood strictly as differential treatment *which results in protection of domestic production*. Other commentators favor the adoption of an antitrust-based test with regard to the determination of treatment 'no less favorable'. Such a test would condemn measures that raise the marginal costs of foreign firms relative to the marginal costs of domestic rivals so as to substantially lessen competition in the domestic market, by rendering it likely that domestic firms will be able profitably to raise prices significantly for a non-transitory period without attracting sufficient entry to make such a strategy unprofitable.[77]

An important branch of WTO law under Article III.4 deals with differences in production or processing methods (PPMs) between domestic and imported products. The key issue here is whether countries can use PPMs as a basis for drawing regulatory distinctions between domestic and imported products, as opposed to differences in the products themselves. The most famous examples of PPMs to date are the *Tuna-Dolphin* cases, which examined the conformity with Article III.4 of a US regulation which accorded less favorable treatment to tuna which had been caught using dolphin-unfriendly methods than tuna caught using dolphin-friendly methods.[78] A GATT Panel held that despite the difference in fishing methods, dolphin-friendly and dolphin-unfriendly tuna were still 'like products' and thus a regulatory distinction based on PPMs was discriminatory.[79] This view of PPMs has important implications for the abil-

[75] Matsushita et al., *supra* note 17, at 160.

[76] *Ibid.*

[77] See Treblicock and Giri, *supra* note 61.

[78] See *US – Restrictions on Imports of Tuna* GATT BISD (39th Supp.) (1992) ('Tuna-Dolphin I'). The ruling in Tuna-Dolphin I was never formally adopted by the GATT Council, by mutual agreement of the two parties to the dispute, Mexico and the United States. See also *US – Restrictions on Imports of Tuna: Report of the Panel*, DS29/R (1994) ('Tuna-Dolphin II').

[79] For analysis of these decisions, see Hudec, Robert E. (2000), 'The Product-

ity of countries to sanction certain labor or environmental practices, by discriminating on the basis of PPMs against products made in other countries under labor or environmental conditions which they find objectionable. Although many labor and environmental activists would applaud such discriminatory measures, other commentators have argued that to permit Panels to invent their own set of normative justifications for discrimination against imported products is likely to severely strain the political legitimacy of the WTO dispute settlement process.[80]

7. State trading enterprises

The term 'state trading enterprise' refers to entities such as state-owned enterprises or national monopolies, statutory marketing boards, export marketing boards, or boards or corporations resulting from nationalized industries. Such entities have the potential to distort trade flows by discriminating between different country markets, adopting artificial prices that substitute for tariffs, adopting quotas for imports and exports, and providing more favorable treatment for domestic products.[81] State trading enterprises are addressed in the GATT primarily in Article XVII, and by the Understanding on the Interpretation of Article XVII of the GATT, signed during the Uruguay Round. Article 1 of the Understanding defines state trading enterprises as: 'Governmental and non-governmental enterprises, including marketing boards, which have been granted exclusive or special rights or privileges, including statutory or constitutional powers, in the exercise of which they influence through their purchases or sales the level or direction of imports or exports'. Articles 2–4 of the Understanding commit Members to ensuring 'maximum transparency' with respect to the operation of their state trading enterprises, and require notification to the WTO of the practices and operations of state trading enterprises.

Article XVII of the GATT imposes several substantive obligations on the operation of state-owned enterprises. Under XVII:1(a), state trading enterprises must 'act in a manner consistent with the general principles of

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Process Doctrine in GATT/WTO Jurisprudence', in Marco Bronkers and Reinhard Quick (eds), *New Directions in International Economic Law: Essays in Honor of John H. Jackson*, New York: Kluwer Law International; Howse, Robert and Donald Regan (2000), 'The Product-Process Doctrine: An Illusory Basis for Disciplining Unilateralism in Trade Policy', *European Journal of International Law*, 11(2), 249–90; and Thaggert, Henry L. (1994), 'A Closer Look at the Tuna-Dolphin Case: Like Products and Extrajurisdictionality in the Trade and Environment Context', in James Cameron, Paul Demaret and Damien Geradin (eds), *Trade and the Environment: The Search for Balance*, London: Cameron May.

[80] See Trebilcock and Giri, *supra* note 61.

[81] Matsushita et al., *supra* note 17 at 129.

non-discriminatory treatment prescribed in this Agreement for governmental measures affecting imports or exports by private traders'. Article XVII:1(b) mandates that state trading enterprises act 'solely in accordance with commercial considerations' and that they 'shall afford the enterprises of the other contracting parties adequate opportunity, in accordance with customary business practice, to compete for participation in . . . purchases or sales'. Thus, the GATT/WTO system accepts the existence of state trading enterprises, but compels them to follow to some extent the same normative standards as private companies.[82]

Other provisions in the GATT also bear on state trading enterprises. Article II:4 states that a state-established import monopoly may not 'operate so as to afford protection on the average in excess of the amount of protection provided for' in the GATT. Most trade law scholars are of the view that the Most-Favored Nation and National Treatment obligations, set out in Articles I and III respectively, apply strictly and without qualification to the activities of state trading enterprises.[83]

The Appellate Body has most recently considered Article XVII in the Canada Wheat Board case.[84] The United States alleged that the Canadian Wheat Board was accorded certain privileges that enabled it to offer enhanced pricing and sales terms, that the structure of the Wheat Board gave it an incentive to engage in non-commercial transactions to the detriment of 'commercial' enterprises in Member States, and that the Canadian government exercised insufficient oversight to ensure that the Wheat Board was not in breach of its obligations under XVII:1. However, the Appellate Body upheld the finding of the Panel that there was no evidence that the Canadian Wheat Board acted inconsistently with Canada's obligations under Article XVII:1. In doing so, the Appellate Body upheld the Panel's interpretation of the term 'commercial considerations' in Article XVII:1(b) as meaning 'considerations pertaining to commerce and trade, or considerations which involve regarding purchases or sales as mere matters of business'.[85] The Appellate Body also upheld the Panel's finding that a state trading enterprise abiding by commercial considerations 'should seek to purchase or sell on terms which are economically advantageous for themselves and/or their owners, members, beneficiaries, etc.'.[86] The Appellate Body also added that the determination of

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[82] Matsushita et al., *supra* note 17 at 130.

[83] *Ibid*., at 131.

[84] *Canada – Measures Relating to Exports of Wheat and Treatment of Imported Grain, supra* note 54.

[85] *Canada – Measures Relating to Exports of Wheat and Treatment of Imported Grain, supra* note 54, at para. 140.

[86] *Ibid.*

whether a state trading enterprise is acting in accordance with 'commercial considerations' must be made on a case-by-case basis and only after a careful analysis of the relevant market.[87]

8. Trade policy and domestic health, safety, and technical regulation

Internal health, safety, and technical regulations governing areas such as food inspection, product labeling, or safety guidelines have the potential to raise the costs of foreign firms relative to domestic firms, thereby conferring an advantage on domestic firms. Sykes defines 'regulatory protectionism' as 'any cost disadvantage imposed on foreign firms by a regulatory policy that discriminates against them or that otherwise disadvantages them in a manner that is unnecessary to the attainment of some genuine, non-protectionist regulatory objective'.[88] Regulatory protectionism can result from the regulatory policies themselves, or from the procedures adopted by regulators to enforce the regulations (e.g. 'conformity assessment' procedures).[89] The protectionist effect may be deliberate, or it may simply result from the failure of regulators to appreciate the impact of their policies on foreign producers.[90] The economic impact of trade-restricting regulations is significant. The US Department of Commerce has estimated that in 1993 almost two-thirds of the $465 billion in US merchandise exports worldwide were affected by foreign technical requirements and standards.[91]

Consider the following illustrative example from a well-known WTO case involving allegations of regulatory protectionism, the *Beef Hormones* case.[92] This case concerned a European ban on the sale of beef from animals which had been treated with growth hormones, a practice which was widespread in the United States but not in Europe. Therefore, the ban had a significant effect on US beef producers, who either could not sell their beef in Europe or had to take expensive measures to ensure that it was hormone-free, while having little effect on European producers. The United States argued that the ban was disguised protectionism, whereas the European Union maintained that the ban was a legitimate public health measure designed to protect its citizens from

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[87] *Canada – Measures Relating to Exports of Wheat and Treatment of Imported Grain, supra* note 54, at para. 144.

[88] Sykes, Alan O. (1999), 'Regulatory Protectionism and the Law of International Trade', *University of Chicago Law Journal*, 66(1), at 3.

[89] *Ibid.*

[90] *Ibid.*

[91] National Research Council, International Standards, Conformity Assessment and US Trade Policy Project Committee (1995), *Standards, Conformity Assessment and Trade: Into the 21st Century*, Washington, DC: National Academy Press, at 111.

[92] *EC – Measures Concerning Meat and Meat Products (Beef Hormones)*, Report of the Appellate Body, WT/DS26/AB/R, WT/DS48/AB/R (1998).

possible health risks associated with the presence of hormones in beef. The Appellate Body upheld the US complaint, holding that the EU's regulatory measures were not based on a risk assessment consistent with their WTO obligations. This decision, which the EU has refused to implement, illustrates the difficulty of distinguishing between legitimate regulatory measures and regulatory protectionism.

Sykes argues that regulatory protectionism, when compared with other protectionist measures such as tariffs, quotas, and subsidies, is a particularly wasteful form of protectionism. In the case of these latter forms of protectionism, at least some economic surplus is captured by government (tariff revenues), quota-holders (economic rents from a quota), or consumers (subsidized prices). However, in the case of regulatory protectionism, the economic surplus may be completely destroyed because of the socially wasteful expenditures incurred by foreign firms in complying with discriminatory regulations, and by domestic governments in administering them.[93] According to Sykes, the inferiority of regulatory protectionism as a form of protectionism helps to explain why WTO Members have committed themselves, through a series of agreements discussed below, essentially to prohibit it. As Members find themselves increasingly constrained from engaging in their preferred forms of protectionism, it is in their interest to constrain themselves from moving toward an even more wasteful form of protectionism.[94] Furthermore, the degree of trade protection afforded by regulatory measures may be difficult to quantify. Thus, the transaction costs of future negotiations can be reduced if opaque forms of regulatory protectionism can be minimized.[95]

The original GATT as adopted in 1947 did not contain separate provisions disciplining domestic environmental, health, and safety standards. Articles XX(b) and XX(g) provided *exceptions* from the disciplines of the GATT for trade measures necessary to protect human, animal, or plant life or health, or relating to the conservation of natural resources. Domestic environmental, health, and safety regulation was subject only to the general MFN and National Treatment requirements. However, in response to a growing perception that the GATT was inadequate for dealing with trade barriers resulting from disparate national regulations, the *Agreement on Technical Barriers to Trade* ('Standards Code') was adopted during the Tokyo Round. Although the Standards Code was a useful first step toward addressing the trade barriers caused by divergent national standards, it did not create particularly strong

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[93] Sykes, *supra* note 88, at 7–12.
[94] *Ibid*., at 24–31.
[95] *Ibid*., at 6.

obligations and did not adequately distinguish between 'necessary' and 'unnecessary' restrictions on trade. Due to these deficiencies, an objective of the Uruguay Round was to develop and extend this legal framework. This was accomplished by the negotiation of two new agreements during the Uruguay Round: the *Agreement on Sanitary and Phytosanitary Measures* (SPS Agreement) and the *Technical Barriers to Trade Agreement* (TBT Agreement). Unlike the Standards Code, which was a plurilateral agreement binding on 39 Members, both the SPS and TBT Agreements are covered by the 'umbrella' provisions of the WTO, and all Members are bound by their terms.

8.1. SPS Agreement

The SPS Agreement addresses domestic regulatory measures and standards designed to protect human, animal, and plant life and health from pests, contaminants, toxins, disease-carrying organisms, and other hazards. It is important to note at the outset that GATT obligations, particularly Article III.4, run parallel to SPS obligations. For example, a given food safety measure could give rise to a complaint that it violates both Article III.4 and provisions of the SPS Agreement. In such a case, the procedure has normally been for a WTO dispute settlement body to consider the more specific rules (i.e. the SPS Agreement) before examining the measure against more general rules (i.e. Article III.4).

Article 3 of the SPS Agreement imposes a general obligation to base domestic SPS measures on international standards, subject to a right to deviate from international standards where a higher level of protection is desired and the requirements of Articles 2 and 5 (set out below) are met. Domestic SPS measures that do conform to international standards are presumed to be consistent with the SPS Agreement as a whole. Therefore, the remaining obligations imposed by the SPS Agreement that are discussed below relate only to measures that do not conform to international standards. The term 'international standards' is defined in an Annex to the SPS Agreement, and the standards of certain international standard-setting bodies are specified as being applicable.

A key issue with regard to the SPS Agreement is the appropriate standard of review WTO panels should adopt toward domestic regulatory decisions. In the *Beef Hormones* case, the Appellate Body discussed the standard of review issue. The Appellate Body referred to Article 2.2 of the SPS Agreement, which provides that SPS measures which diverge from international standards shall not be maintained without sufficient scientific evidence. In accordance with this Article, it was held that there are minimum 'substantive requirements' that domestic SPS regulations must adhere to, namely that the regulations must be based on science and that there must be 'sufficient' scientific

evidence to justify an SPS measure.[96] However, Members are entitled to rely on a divergent or minority scientific opinion if they choose, provided that the minority view comes from 'qualified and respected sources'.[97] The Appellate Body endorsed an approach of examining whether the scientific evidence is 'reasonably sufficient' to justify the SPS measure.[98] As well, the Appellate Body rejected the existence of any minimum procedural requirements for domestic risk assessment.[99] It is not necessary for a Member who enacts an SPS measure to conduct an investigation, engage in formal fact-finding, or publish a report justifying the SPS measure. Thus, in the *Beef Hormones* case the Appellate Body adopted a deferential approach to its review of domestic SPS regulations, provided Members can point to some sound scientific evidence to support the measures. However, in the *Japan – Apples* case the Appellate Body struck a less deferential posture, holding that an assessment of the 'rational connection' between scientific evidence and the impugned SPS measure did not require deference to the authorities of the regulating Member; rather it is appropriate for WTO dispute settlement bodies to engage in a *de novo* review of the scientific evidence and its relationship to the measure.[100] In light of this decision, it appears that the applicable standard of review under the SPS Agreement is still an open question.

Article 5.7 allows a Member to maintain a provisional SPS measure, notwithstanding the requirements of Article 2.2. The Appellate Body has set out four criteria that must be met for a provisional measure to be maintained under Article 5.7: (a) the relevant scientific information is insufficient; (b) the measure is adopted on the basis of pertinent available information; (c) the Member adopting the measure is seeking to obtain the additional information necessary for a more objective assessment of the risk; and (d) the Member adopting the measure will review it within a reasonable period of time.[101]

A recent Ruling by a WTO Panel in *EC–Biotech* appears to shed some additional light on Article 5.7.[102] In this dispute, the complainants (the United States, Canada, and Argentina) challenged the EC's regulatory scheme for the

[96] *Beef Hormones, supra* note 92, at para. 193.

[97] *Ibid*., at para. 194.

[98] *Ibid*., at para. 198.

[99] *Ibid*., at para. 189.

[100] *Japan – Measures Affecting the Importation of Apples*, Report of the Appellate Body, WT/DS245/AB/R (2003), paras. 160–167.

[101] *Japan – Measures Affecting Agricultural Products,* Report of the Appellate Body, WT/DS76/AB/R (1999), paras. 86–89.

[102] *EC – Measures Affecting the Approval and Marketing of Biotech Products*, Report of the Panel, WT/DS291,292,293/INTERIM. As of the date of writing, the decision had not been officially released. However, an advance copy of the decision has been leaked to the public.

approval of genetically modified organisms (GMO). Among other things,[103] the Panel found that specific EC country bans on certain GMO crops did not meet the requirements of Article 5.7 of the SPS. Although Article 5.7 does permit Members to adopt provisional measures where there is insufficient scientific evidence to assess the risk, the Panel found that studies carried out on the banned GMO crops by the EC scientific committee and by other competent national authorities, which concluded that the GMO crops were safe, constituted sufficient risk assessments under the SPS Agreement. Therefore, the first branch of the test set out for Article 5.7, that there be insufficient scientific information, was not met. Consequently, the Panel recommended that the ban on certain GMO crops be removed.

Article 5.1 requires that a Member's SPS measures, if not in conformity with international standards, must be based on an appropriate assessment of the risk. Article 5.2 specifies certain factors which Members must take into account when assessing risk, including available scientific evidence, relevant inspection and sampling methods, prevalence of specific diseases or pests, and quarantine or other treatment. The Appellate Body has held that in the presence of scientific controversy or disagreement, a Member may base an SPS measure upon minority, as opposed to mainstream, scientific opinion, provided that minority opinion comes from 'qualified and respected sources'.[104]

Other provisions in the SPS Agreement oblige Members to take into account the objective of minimizing negative trade effects when enacting SPS regulations, and to ensure they are no more trade restrictive than necessary in order to achieve the desired level of protection (Articles 5.4 and 5.6). The Appellate Body has set out an interpretive framework for this latter obligation. If there is an alternative SPS measure which is (a) reasonably available taking into account technical and economic feasibility; (b) achieves the Member's appropriate level of sanitary or phytosanitary protection; and (c) is significantly less restrictive of trade than the SPS measure being contested, then the contested measure is more restrictive of trade than necessary and is inconsistent with Article 5.6.[105] Finally, the provisions of Article 4 encourage the mutual recognition of domestic standards among Members.

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[103] The Panel also found that the EC, by applying a de facto moratorium on the approval of new GMO products and failing to consider specific GMOs for approval, had acted inconsistently with Annex C(1)(a) of the SPS Agreement, which requires Members to complete testing and approval procedures without undue delay.

[104] *Beef Hormones*, *supra* note 92, at para. 194.

[105] *Australia – Measures Affecting Importation of Salmon*, Report of the Appellate Body, WT/DS18/AB/R (1998), at para. 180.

8.2. TBT Agreement

The TBT Agreement covers all technical regulations and standards not covered by the SPS Agreement. Like the SPS Agreement, the TBT Agreement runs parallel to GATT and the same measure may be challenged under both GATT and the TBT Agreement. In such a case, the panel will generally first examine the measure under the TBT Agreement and then under GATT, moving from the more specialized regime to the more general regime (although in *EC – Asbestos* the order was reversed).

Article 2.2 places a obligation on Members to ensure that technical regulations are not more trade-restrictive than necessary to fulfill a legitimate objective. The burden of proof is on the complainant to show that a less trade-restricting alternative measure is available. Article 2.2 also states that this obligation not to make technical regulations more trade-restrictive than necessary must take into account the risks non-fulfillment of the regulatory goal would create. This implies that the length to which a Member should be expected to go in exhausting all regulatory alternatives to find the least trade-restricting one is connected to the kind of risk that is being regulated. The more serious the risk, the more a Member may be justified in utilizing a blunt yet obviously effective regulatory tool, as opposed to a more sophisticated yet speculative one.

Article 2.4 stipulates that, where they exist, Members shall use relevant international technical standards as the basis for their own technical regulations, except where such international standards would be an ineffective or inappropriate means for the fulfillment of the legitimate objectives pursued, due to factors such as climate, geography, or technological inability. How close a relationship between domestic standards and international standards is required for compliance with Article 2.4 is a question that largely remains to be answered. In the *Sardines* case, the Appellate Body merely stated that the domestic regulation may not contradict the international standard.[106] The Appellate Body has also introduced an element of retroactivity into Article 2.4, holding that the obligation to use international standards as a basis for domestic regulations applies to domestic regulations that were already in force when the international standard was adopted.[107] One difficulty in this regard is that, unlike the SPS Agreement, 'international standards' is not a defined term in the TBT Agreement and there is no list of international standard-setting bodies whose standards are recognized for the purposes of Article 2.4.

Other important provisions under the TBT Agreement include: Article 2.7,

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[106] *EC – Trade Description of Sardines*, Report of the Appellate Body, WT/DS231/AB/R (2002), at paras. 248–9.

[107] *Ibid.*, *supra* note 106, at para. 207.

which states that Members shall give consideration to accepting the technical regulations of other countries as equivalent to their own, provided that the foreign regulations accomplish the same objectives as their own regulations; Article 2.8, which instructs Members to design regulations based on product requirements in terms of performance rather than design or descriptive elements; and Articles 2.5, 2.9, and 2.11, which together impose notification and publication requirements on Members enacting new technical regulations, and also require publication in accessible format of existing technical regulations.

8.3. A comparison of the SPS and TBT Agreements

The substantive obligations in the SPS and TBT Agreements differ in important ways.[108] For example, Article 2.1 of the TBT Agreement contains a strict prohibition on discrimination, asserting that in respect of technical regulations, Members must accord imported products treatment no less favorable than domestic products. In contrast, Article 2.3 of the SPS Agreement acknowledges that discrimination between like products may occur, prohibiting only measures that arbitrarily or unjustifiably discriminate between Members where identical or similar conditions prevail.

However, the requirements for scientific evidence are much more stringent under the SPS Agreement. Article 2.2 of the TBT Agreement requires only that scientific information be 'considered' as part of the risk assessment process that leads to national technical standards. In contrast, the SPS Agreement is premised on the notion that requiring scientific justification for standards that deviate from international norms will make it more difficult for Members to engage in regulatory protectionism.[109] Accordingly, Article 2.2 of the SPS Agreement requires that any SPS measure not in conformity with international standards be 'based on scientific principles and . . . not maintained without sufficient scientific evidence', while Article 5.1 further requires Members, in their risk assessment process, to take into account 'available scientific evidence'.

Both the SPS and TBT Agreements accord Members a great deal of regulatory autonomy with respect to risk assessment. The preamble to the TBT Agreement states that 'no country should be prevented from taking measures necessary . . . for the protection of human, animal or plant life or health . . . at

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[108] The following borrows heavily from the comparison of the TBT and SPS Agreements in: Sykes, Alan O. (2002), 'Domestic Regulation, Sovereignty, and Scientific Evidence Requirements: A Pessimistic View', *Chicago Journal of International Law*, 3(2) at 356.

[109] Josling, Tim, Donna Roberts and David Orden (2004), *Food Regulation and Trade*, Washington, DC: Institute for International Economics, at 40.

the levels it considers appropriate'. Similarly, the SPS Agreement states that 'no Member should be prevented from adopting or enforcing measures necessary to protect human, animal or plant life or health'. Although these statements appear to reassure Members that the WTO will respect regulatory sovereignty regarding risk tolerance, Sykes argues that the scientific evidence requirements of the SPS Agreement, as interpreted by the WTO Appellate Body, have rendered this promise in no small part illusory.[110]

9. Exception clauses

9.1. GATT Article XX

Article XX permits Members to derogate from their GATT obligations in certain circumstances. Members often plead Article XX 'in the alternative' when structuring their legal submissions before WTO panels, arguing that a challenged trade measure is not in violation of the GATT, but in the event that it is, the violation is justified by one or more of the Article XX exceptions. However, any Member invoking Article XX bears the legal burden of proving such a claim.

Article XX consists of a 'chapeau' or preamble, followed by ten specific grounds for exemption from GATT obligations. The Appellate Body has set out a two-tiered approach in their analysis of Article XX.[111] First, the challenged measure must fall under one of the ten grounds for exemption. Second, the challenged measure must meet the strictures of the Article XX chapeau. The chapeau requires that the challenged trade measures not be applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade. The only provisions of Article XX which have been subjected to detailed legal analysis by WTO panels are XX(b) and XX(g). These provisions have been particularly important in the environmental context.[112] XX(b) and XX(g) will be discussed in turn, followed by a discussion of the Article XX chapeau, and a brief overview of the remaining provisions of Article XX.

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[110] Sykes, *supra* note 108, at 358.

[111] *US – Standards for Reformulated and Conventional Gasoline*, Report of the Appellate Body, WT/DS2/9/AB/R (1996), at p. 22.

[112] For GATT jurisprudence involving trade and environmental issues, see: *Tuna/Dolphin I and II, supra* note 78; *US – Import Prohibition of Certain Shrimp and Shrimp Products,* Report of the Appellate Body, WT/DS58/AB/R (1998)*; US – Taxes on Automobiles*, Report of the Panel, DS31/R (1994) (un-adopted); and *US – Standards for Reformulated and Conventional Gasoline*, *supra* note 111.

9.1.1. GATT Article XX(b) Article XX(b) authorizes measures *necessary* to protect human, animal, or plant life or health. In the *Asbestos* case, the Appellate Body approved a two-step test for the applicability of Article XX(b).[113] First, the challenged measure must be intended to protect human, animal, or plant life or health; second, it must be demonstrated that the challenged measure is 'necessary' to the achievement of the specified public policy goal of life or health protection. The Appellate Body's decision in *Asbestos* loosened this second branch of the test, determining that a measure need not be 'indispensable' or the only one available to a Member in order to accomplish a particular policy goal for it to be characterized as 'necessary'. Rather, the Appellate Body upheld the regulatory measure at issue in *Asbestos* on the grounds that there was no 'reasonably available alternative' regulatory measure that would have accomplished the stated public policy goal. Also of importance is the fact that the Appellate Body's decision was highly deferential to the *choice* of public policy goal. In the *Asbestos* case, France decided that its regulatory goal was to reduce the health risks associated with asbestos products to zero, and thus chose to ban the material. The Appellate Body made it clear that it was each Member's right to determine the level of health protection it wished to achieve, despite the possibility that a slightly less ambitious goal (i.e. a 90% risk reduction instead of 100%) might be significantly less trade-restrictive.[114] In general, the Appellate Body's current approach to the Article XX(b) analysis, as reflected in *Asbestos*, can be characterized as one of increased deference and sensitivity to the policy choices of domestic regulators.[115]

9.1.2. GATT Article XX(g) Article XX(g) authorizes Members to take measures relating to the conservation of exhaustible natural resources if such measures are made effective in conjunction with restrictions on domestic production or consumption.

The first issue that must be addressed under an Article XX(g) analysis is whether the challenged measure deals with an 'exhaustible natural resource'. WTO panels have interpreted this phrase broadly. According to the Appellate Body's reading of XX(g) in the *Shrimp/Turtle* case, a 'resource' may be living or non-living, and it need not be rare or endangered to be potentially 'exhaustible'.[116] Matsushita et al. note that under such an expansive

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[113] *EC – Measures Affecting Asbestos and Asbestos-Containing Products, supra* note 65, at para. 155.

[114] Trebilcock and Howse, *supra* note 67, at 532.

[115] Trebilcock and Howse, *supra* note 67, at 541.

[116] Matsushita et al., *supra* note 17, at 451.

interpretation, virtually any living or non-living resource, particularly those addressed by multilateral environmental agreements, would qualify.[117]

A second issue is how closely the challenged trade measure must be linked to the objective of resource conservation. GATT and WTO panels have compared the 'relating to' requirement in the text of XX(g) to the 'necessary' requirement of XX(b), and have stated that the legal standard in XX(g) is lower than in XX(b).[118] Rather, panels have interpreted 'relating to' to mean that the challenged measure must be 'primarily aimed at' conservation.[119] For example, in *Shrimp/Turtle* the Appellate Body found that an import ban on shrimp which were not harvested using turtle-friendly technology was reasonably related to the purpose of protecting sea turtles.[120] Academic commentators have questioned whether the 'primarily aimed at' interpretation is warranted given the text of the provision.[121]

A third issue is the requirement that measures taken pursuant to XX(g) be in conjunction with restrictions on domestic production or consumption. In the *Shrimp/Turtle* case, the Appellate Body ruled that the 'in conjunction with' requirement was satisfied because the above-mentioned measures relating to the harvesting of shrimp applied to both domestic and foreign trawlers.[122] However, the Appellate Body has also stated that this phrase does not necessarily require identity of treatment, stating in *Reformulated Gasoline*: 'We believe that the clause . . . is appropriately read as a requirement that the measures concerned impose restrictions, not just in respect of imported gasoline but also with respect to domestic gasoline'.[123] In other words, as long as environmental trade restrictions are coupled with some similar form of domestic regulation that addresses the same environmental issue, the measure will pass muster under this requirement of XX(g). It has been argued that this particular condition of XX(g) is effective in policing unilateralism, since it requires Members to have their own 'house in order', i.e. Members must implement a domestic regulatory regime before targeting the environmental policies of other countries through trade measures.[124]

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[117] Matsushita et al., *supra* note 17, at 451.

[118] *Canada – Measures Affecting Exports of Unprocessed Herring and Salmon*, GATT BISD (35th Supp.) (1988), para. 4.6; and *US – Reformulated Gasoline, supra* note 111, pp. 16–19.

[119] *US – Reformulated Gasoline, supra* note 111, pp. 18–19.

[120] *US – Import Prohibition of Certain Shrimp and Shrimp Products, supra* note 112, paras. 135–42.

[121] Matsushita et al., *supra* note 17, at 452.

[122] *US – Import Prohibition of Certain Shrimp and Shrimp Products, supra* note 112, paras. 143–5.

[123] US – *Reformulated Gasoline, supra* note 111, paras. 20–21.

[124] Trebilcock and Howse, *supra* note 67, at 524.

A final issue is extraterritoriality. The ability of Members to adopt trade measures aimed at sanctioning the environmental policies of other Members has been a contentious issue within the WTO. In the *Shrimp/Turtle* case, a WTO Panel opined that if Members were permitted to adopt measures conditioning access to its market for a given product upon the adoption by exporting Members of certain policies, including conservation policies, the integrity of the world trading order could be severely undermined by a series of unilateral measures.[125] In other words, measures aimed at other Members' environmental policies were *per se* illegal. However, the Appellate Body's ruling in *Shrimp/Turtle* overturned the Panel on this point of law, stating:

> It is not necessary to assume that requiring from exporting countries compliance with, or adoption of, certain policies . . . prescribed by the importing country, renders a measure *a priori* incapable of justification under Article XX.[126]

Therefore, the current state of the law is that unilateral measures conditioning market access on the environmental or conservation policies of the exporting country are not automatically illegal and may be justifiable under Article XX(g). Article XX(g) may be applied without distinction to exhaustible resources beyond areas of national jurisdiction as well as to domestic resources.[127]

This interpretation in favor of unilateralism may be defensible from a policy perspective. First, there may be instances where one country externalizes the environmental effects of economic activity onto another. The classic example would be pollution from a factory on one side of a border emitted into a water or air body on the other side of the border.[128] It is arguable that in such a case, unilateral measures may be appropriate in order to influence the policies of the polluting country. Second, unconstrained exploitation of the 'global commons', i.e. areas that lie outside the jurisdiction of any one nation such as the ocean and the ozone layer, may also necessitate unilateral measures.[129] The United States' ban on dolphin-unfriendly tuna, described earlier in this chapter, is one example of a measure designed to protect the world's oceans by discouraging dolphin-unfriendly fishing practices. Third, shared natural resources, such as undersea oil deposits or fish stocks that straddle jurisdictional boundaries, may

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[125] *US – Import Prohibition of Certain Shrimp and Shrimp Products, supra* note 112, paras. 7.44–7.45.

[126] *US – Import Prohibition of Certain Shrimp and Shrimp Products, supra* note 112, para. 121.

[127] Matsushita et al., *supra* note 17, at 453.

[128] Trebilcock and Howse, *supra* note 67, at 509.

[129] *Ibid.*

be the subject of unilateral measures if the policies of one country regarding these shared resources are contrary to the interests of another.

9.1.3. Article XX Chapeau All Article XX exemptions are qualified by the chapeau to Article XX. Three legal standards are set out in the chapeau: (1) arbitrary discrimination; (2) unjustifiable discrimination; and (3) a disguised restriction on international trade.[130] In particular, the prohibitions in the chapeau against arbitrary and unjustifiable discrimination speak to the fact that the chapeau imposes not only substantive but also procedural obligations. For example, consider the *Shrimp/Turtle* case, in which the United States enacted unilateral trade measures denying market access to countries which did not comply with turtle-friendly shrimp harvesting guidelines. The Appellate Body held that 'arbitrary discrimination' existed because the US regulations did not take into account the appropriateness of these guidelines for conditions in foreign countries, and also did not comply with basic standards of fairness and due process with regard to the certification process for shrimp imports.[131] The US regulations also constituted 'unjustifiable discrimination', in part because they applied different phase-in periods for countries which were similarly situated and similarly affected by the ban, and because the US had not made a serious effort at negotiating a multilateral agreement on the protection of sea turtles, which in the view of the Appellate Body was a reasonable alternative course of action available to the US.[132] In response to this decision, the US retained its general ban on shrimp from countries that do not protect sea turtles, but revised its regulations to allow imports of shrimp from harvesters which take specific measures to ensure that sea turtles are not harmed. The US also entered into negotiations with countries adversely affected by the ban and offered them technical assistance in complying with US regulations.[133] In a subsequent compliance decision under Article 21.5 of the Dispute Settlement Understanding (DSU), the Appellate Body held that the United States' revised regulatory scheme met the requirements of the Article XX chapeau.[134]

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[130] Matsushita et al., *supra* note 17, at 454.

[131] *Ibid.*, at 455; *US – Import Prohibition of Certain Shrimp and Shrimp Products, supra* note 112, paras. 177–84.

[132] Matsushita et al., *supra* note 17, at 455; *US – Import Prohibition of Certain Shrimp and Shrimp Products, supra* note 112, paras. 161–76.

[133] Matsushita et al., *supra* note 17, at 456.

[134] *US – Import Prohibition of Certain Shrimp and Shrimp Products, Recourse to Article 21.5 of the DSU by Malaysia*, Report of the Appellate Body, WT/DS58/AB/RW (2001).

9.1.4. Other provisions of Article XX Article XX(a) permits Members to derogate from their GATT obligations in order to adopt measures which are 'necessary to protect public morals'. Given the culturally specific and open-ended nature of the term 'public morals', frequent invocation of this clause could neutralize many GATT obligations. For example, Country A could ban products from Country B on the basis that these products are manufactured in a manner which uses child labor and causes environmental pollution, and are thus an affront to public morals in Country A.[135] The fact that the public morals exemption has not yet been invoked is evidence of wise self-restraint by Members.[136] However, a similar 'public morals' exemption contained in Article XIV(a) of the General Agreement on Trade in Services (GATS) has been litigated. Most recently, in *US – Gambling Services*[137] the US sought to rely on the public morals exemption in Article XIV(a) to justify its legislative ban on the supply of cross-border gambling services. The Appellate Body found that the US legislation imposing the ban addressed legitimate concerns over the social consequences of easily accessible electronic betting (such as underage and pathological gambling), held that these concerns fit within the scope of 'public morals' and/or 'public health', and held that the ban imposed by the US was 'necessary' to address these concerns. Nevertheless, the US was ultimately unable to rely on the public morals exemption for some measures. Certain aspects of the legislation exempted domestic firms, thus running afoul of the requirement contained in the chapeau to Article XIV(a) that the provision not be applied in a manner which constitutes arbitrary or unjustified discrimination between foreign and domestic service providers.

Article XX(d) permits measures 'necessary to secure compliance with laws or regulations which are not inconsistent with the provisions of this Agreement, including those relating to customs enforcement, the enforcement of monopolies . . . the protection of patents, trade marks and copyrights, and the prevention of deceptive practices'. In *Section 337 of the Tariff Act of 1930*, a GATT panel held that there was a three-part test to be satisfied for an otherwise GATT-inconsistent measure to be justified by Article XX(d): (1) the laws or regulations for which compliance is being secured must not themselves contravene GATT; (2) the measures adopted must be necessary to secure compliance; and (3) the conditions in the Article XX chapeau must also be met.[138] Importantly, the panel in the Section 337 case found that, with respect

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135 Bhala and Kennedy, *supra* note 16, at 147.

136 *Ibid.*

137 *US – Measures Affecting the Supply of Cross-Border Gambling and Betting Services,* Report of the Appellate Body, WT/DS285/AB/R (2005).

138 *US – Section 337 of the Tariff Act of 1930*, GATT BISD, (36th Supp) (1989) (*Section 337)*, cited in Bhala and Kennedy, *supra* note 16, at 150.

to the second branch of the test, if a contracting party could reasonably secure a desired level of enforcement in a manner not inconsistent or less inconsistent with other GATT provisions, it must do so.[139] This test has been further analyzed in subsequent cases.[140]

Other Article XX exceptions include: (c) measures relating to the importation or exportation of gold or silver; (e) measures relating to the products of prison labor; (f) measures imposed for the protection of national treasures; (h) measures undertaken in pursuance of international commodity agreements; (i) measures involving restrictions on exports of domestic materials necessary to a governmental stabilization plan; and (j) measures essential to the acquisition or distribution of products in general or local short supply. These provisions have not yet been litigated.

9.2. GATT Article XXI – national security

Article XXI lists various exemptions from GATT disciplines for national security reasons. It states that nothing in the GATT shall be construed to (a) require any contracting party to furnish any information the disclosure of which it considers contrary to its essential security interests; (b) prevent any contracting party from taking any action which it considers necessary for the protection of its essential security interests relating to fissionable materials, arms trafficking, or taken in time of war or other emergency in international relations; or (c) to prevent any contracting party from taking any action in pursuance of its obligations under the United Nations Charter for the maintenance of international peace and security. Although Article XXI has been invoked on a number of occasions, it has never been interpreted definitively.[141] A key issue in its interpretation is whether the subsections of Article XXI have objective content, or whether they are subjective in nature and can be invoked unilaterally. For example, can a Member unilaterally decide that, under XXI(b), a given trade restriction that it imposes relating to arms trafficking is 'necessary' to its national security interests? Furthermore, how closely linked must the trade restriction be to arms trafficking? Such questions could conceivably arise in the context of 'dual use' goods that have both military and civilian applications. Also potentially controversial is the XXI(c) exception, which authorizes trade restrictions in the event of an ambiguously

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139 *Ibid.*

140 *Japan – Restrictions on Imports of Certain Agricultural Products*, GATT BISD (35th Supp.) (1989); *EEC – Regulation on Imports of Parts and Components*, GATT BISD (37th Supp.) (1990). See more generally: Sykes, Alan O. (2003), 'The Least Restrictive Means Test', *University of Chicago Law Review*, 70(1) 403–20.

141 See Matsushita et al., *supra* note 17 at 221 for a listing of the occasions on which Article XXI has been invoked.

defined 'emergency in international relations'. If a Member were permitted to determine for itself when such an emergency exists, it would seem that the potential for abuse exists. It may be impossible to objectively define an 'emergency in international relations', and thus the case-by-case judgment of WTO dispute settlement panels must be relied upon to police any abuse.[142]

For these reasons, some commentators consider it fortunate that Article XXI has not evolved into the 'exception that swallowed GATT'.[143] In this age of increasing global security concerns, it is clear that a narrow interpretation of Article XXI is necessary in order to avoid abuse of the Article and maintain the integrity of the GATT.

10. Developing countries – special and differential treatment

Developing countries played a peripheral role in the formation of the GATT. However, they now dominate numerically the membership of the WTO. A key challenge facing the WTO is how to better integrate developing countries into the multilateral trading system.[144] During the period from 1980–99, developing countries' share of global was essentially unchanged – 27.4% in 1980 compared to 28.8% in 1999.[145]

Article XVIII of the GATT (in the form that emerged after a review of the Agreement in 1954–55) contained detailed provisions regarding developing country Members. In large part, these provisions granted developing country Members exemptions from their GATT commitments in order to 'grant the tariff protection required for the establishment of a particular industry', i.e. promote specific domestic industries through import substitution policies and to restrict imports in order to address balance of payment difficulties. In 1965, Part IV of the GATT, entitled 'Trade and Development' was added. Unlike Article XVIII, which focused on permitting developing country protectionism, Part IV focused on expanding developing country access to developed country export markets. The key principle of Part IV was 'special and differential treatment', under which developed countries were urged to make tariff concessions to developing countries, who were not expected to reciprocate. However, most of the commitments in Part IV were merely hortatory and non-binding on developed country Members.

The most substantive measures taken in the GATT to address the plight of developing countries were two waivers adopted in 1971. One waiver provided

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[142] *Ibid*., at 222–3 for an analysis of Art. XXI(b)(iii).

[143] Bhala and Kennedy, *supra* note 16, at 159.

[144] For a history of developing countries in the GATT system, see Hudec, Robert (1987), *Developing Countries in the GATT Legal System* (London: Gower).

[145] Michaelopoulos, Constantine (2001), *Developing Countries in the WTO*, New York: Palgrave, 2001, at 7–16, as cited in Matsushita et al., *supra* note 17 at 373.

an exception to the MFN obligation in order to allow developed countries to grant preferential tariff treatment to developing countries (known as the Generalized System of Preferences (GSP)). The second waiver to the MFN principle permitted developing countries to exchange such preferences amongst themselves. These waivers were formalized as a permanent part of the GATT in 1979 through an instrument known as the Enabling Clause.[146] Article 1 authorizes preferential tariff reductions toward developing countries, stating that notwithstanding the MFN obligation, 'contracting parties may accord differential and more favorable treatment to developing countries, without according such treatment to other contracting parties'. Under Article 5, such preferential treatment is non-reciprocal: 'The developed countries do not expect reciprocity for commitments made by them in trade negotiations to reduce or remove tariffs and other barriers to the trade of developing countries . . .'. Article 5 is also authority for 'special and differential treatment' for developing countries, stating that in the course of multilateral trade negotiations, developing countries shall not be required to make 'concessions that are inconsistent with [their] development, financial, and trade needs'. Article 7 is known as the 'graduation clause', which envisions that as developing countries' 'capacity to make contributions or negotiated concessions' increases along with their economic development, they are expected to 'participate more fully in the framework of rights and obligations under the [GATT]'.

Many developed countries have adopted GSP programs which extend preferential terms of trade to developing countries.[147] However, these GSP tariffs usually entail escape clause provisions in the event of import surges, and have not been extended to politically sensitive items such as textiles, clothing, and footwear, even though such items are of major export interest to many developing countries. Furthermore, as MFN tariff rates have continued to decline since the inception of GSP in the 1970s, the margin of preference between MFN rates and GSP rates has contracted.

Recently, in *EC – Tariff Preferences*,[148] the Appellate Body has ruled that tariff preferences extended under the GSP must be provided on a non-discriminatory basis. In other words, developed countries generally may not

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[146] GATT Contracting Parties Decision of November 28, 1979 on Differential and More Favorable Treatment, Reciprocity and Fuller Participation on Developing Countries (Enabling Clause).

[147] Some examples of US legislation include the Caribbean Basin Trade Partnership Act, the Africa Growth and Opportunity Act, the Andean Trade Preferences Act. The EU's Cotonou Agreement extends tariff preferences to a wide range of developing countries. See Matsushita et al., *supra* note 17, at 384.

[148] *European Communities – Conditions for the Granting of Preferences to Developing Countries*, Report of the Appellate Body, WT/DS246/AB/R (2004).

extend different levels of tariff preferences to different developing countries. The only circumstance in which a developed country can discriminate in its GSP program is if it demonstrates, among other things, that countries receiving different levels of preferences are not similarly situated (in the sense that countries receiving greater preferences have special development needs), and that all developing countries who are similarly situated in the sense of special development needs are receiving the enhanced level of tariff preferences.

Most GATT/WTO agreements contain some form of 'special and differential treatment', entailing less onerous obligations and longer phase-in periods for developing countries. The following is an overview of the provisions for special and differential treatment in some GATT/WTO agreements:

SCM AGREEMENT Under Article 27.1 of the SCM Agreement, Members recognize that subsidies may play an important role in the economic development programs of developing country Members. As such, Article 27 provides certain exemptions from the SCM Agreement for developing countries. Under Articles 27.2 and 27.3, the prohibitions in Article 3 on export subsidies and subsidies contingent on the use of domestic inputs do not apply to least developed countries, and other developing countries are given a grace period of five to eight years to comply with this prohibition. A further series of provisions appear to be designed to raise the legal standard that must be met in order to bring a successful subsidies complaint against developing countries, thus reducing the possibility of 'trade harassment'. The presumptive rules in Article 6.1(a), under which actionable subsidies may be automatically deemed to be causing 'serious prejudice', do not apply to developing countries, and any serious prejudice must be shown by positive evidence (Article 27.8). With respect to actionable subsidies, the dispute resolution process may not be invoked unless the subsidy entails nullification or impairment of GATT concessions or injury to the complaining party's domestic industry (Article 27.9). Countervailing duty actions may not proceed if a domestic agency determines that the overall level of a subsidy granted by a developing country is less than 2% of the per-unit value, or the subsidizing country has less than 4% market share with respect to the subsidized product in the complaining country (Article 27.10).[149]

Despite the special and differential treatment provided for in the SCM Agreement, developed countries are by far the most frequent initiators of countervailing duty claims, and developing countries are the most frequent targets. Out of the 168 countervailing duty initiations filed with the WTO from

[149] The comparable *de minimis* rule for developed countries is 1% of per-unit value. (SCM Article 11.9)

its inception in 1996 to December 31, 2003, 120 of those were filed by the European Community, United States, and Canada alone. Developing countries and economies in transition were the target of 110 of these initiations.[150]

GOVERNMENT PROCUREMENT AGREEMENT Article V of the GPA provides for special and differential treatment for developing countries. In particular, developing countries may negotiate exclusions from rules on national treatment under the GPA. Developed countries are under an obligation to facilitate increased imports from developing countries, provide government procurement-related technical assistance to developing countries, and respond to reasonable information requests from developing countries in the context of a tendering process.[151]

SPS AND TBT AGREEMENTS Both the TBT and SPS Agreement contain provisions regarding technical assistance and longer phase-in periods for developing countries. Article 9 of the SPS Agreement provides that technical assistance, for example assistance in developing national regulatory agencies, will be given to developing countries in order to allow them to achieve the appropriate level of sanitary or phytosanitary protection in their export markets. Article 10.2 of the SPS Agreement states that where developed countries introduce new SPS regulations and there is a phase-in period, longer compliance time-frames should be accorded to products of interest to developing countries. Developing country Members are also accorded the possibility of time-limited exceptions in whole or in part from obligations under this Agreement, taking into account their financial, trade, and development needs.

Article 11.8 of the TBT Agreement gives priority to the technical assistance needs of developing countries. Article 12.3 states that technical regulations, standards, and conformity assessment procedures of developed country Members should take account of the needs of developing country Members, with a view to ensuring that such technical regulations, standards, and conformity assessment procedures do not create unnecessary obstacles to exports from developing country Members.

DISPUTE SETTLEMENT UNDERSTANDING The DSU contains various procedural safeguards designed for the benefit of developing country Members. Among them are Article 12.10, which grants developing country Members additional

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[150] Data source: WTO – CV Initiations: By Reporting Member – 01/01/95 – 31/12/03. Online: http://www.wto.org/english/tratop_e/scm_e/scm_e.htm. Accessed February 12, 2005.

[151] Rege, Vinod (2001), 'Transparency in Government Procurement: Issues of Concern and Interest to Developing Countries', *Journal of World Trade*, 35(4), at 497.

time in answering a complaint brought against them, and Article 12.11, which requires panels, where one or more of the parties to a dispute is a developing country, to explicitly indicate the form in which account has been taken of relevant provisions on special and differential treatment for developing country Members which have been raised by the developing country Member in the course of the dispute settlement procedures. Article 8.10 states that in disputes involving a developing country Member and a developed country Member, if the developing country Member requests, at least one of the panelists must be from a developing country Member. Finally, Article 24 requires developed country Members to exercise 'due restraint' in initiating trade disputes and claims for compensation against least developed country Members, and provides for an enhanced mediation process for disputes involving a developing country Member before the dispute is referred to a panel.

11. Concluding postscript – outstanding issues

Despite the impressive and rapid evolution of the global trading regime since its inception, a number of important outstanding issues pose challenges. High tariff and non-tariff barriers persist in several product categories, such as agricultural products, textiles and clothing, leather, rubber, footwear and travel goods, fish and fish products, and transport equipment. Many of these product categories, including agricultural products, textiles, and footwear are areas where developing countries have significant export interests.

A particularly divisive current issue in world trade is the continued desire of some developed nations to link labor and environmental standards to trade agreements. Such a linkage is viewed by most developing nations as a form of disguised protectionism. In particular, President Clinton's statement at the Seattle Ministerial meeting of the WTO in December 1999 that trade sanctions should be available under the WTO multilateral system against countries violating international labor standards provoked an intensely hostile reaction from developing countries.[152] Despite these views, certain regional trade agreements such as NAFTA already link trade with labor standards and the environment. The North American Agreement on Labor Cooperation (NAALC) and the North American Agreement on Environmental Cooperation (NAAEC) bind NAFTA members to effectively enforce their own labor and environmental laws, and subject NAFTA members to dispute settlement proceedings and ultimately trade sanctions in the event of non-enforcement.

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[152] Treblilcock, Michael (2003), 'International Trade and International Labor Standards: Choosing Objectives, Instruments, and Institutions', in Stefan Griller (ed.), *International Economic Governance and Non-Economic Concerns*, New York/Vienna: Springer-Verlag.

At the WTO, the key issues are whether such linkages should be incorporated into the WTO, and if so what sort of institutional arrangements should be used to govern labor and environmental standards. Some commentators argue that the investigation and evaluation of Member countries' labor and environmental standards be delegated to specialist international agencies (such as the International Labor Organization in the case of labor standards), with the role of the WTO Dispute Settlement Body being to determine whether punitive trade sanctions as a result of any violations have been applied in a non-discriminatory and consistent fashion and meet some basic standard of proportionality.[153] However, developing countries as well as scholars such as Bhagwati continue to argue strenuously against the inclusion of any form of linkage in the WTO.[154]

Developing countries, led by India, China, and Brazil, have also tabled demands for continued special and differential treatment. Specifically, they have requested asymmetrical and non-reciprocal concessions from developed countries – i.e. rich countries should cut their tariffs and subsidies, while poor countries should cut theirs less dramatically or not at all. However, it is arguable that such a position is ultimately self-defeating. As explained in Section I of this chapter, unilateral trade liberalization is generally beneficial to a country, and thus developing countries seeking to avoid lowering their own trade barriers are merely hurting themselves. Furthermore, barriers to trade *between* developing countries currently constitute a serious impediment to their economic growth. For example, analysis conducted by the World Bank shows that 80% of the benefits to poor countries from agricultural liberalization would come from the reductions in barriers between poor countries themselves. Finally, Bhagwati notes that when poorer countries exempt themselves from tariff reductions, the wealthier countries remaining at the negotiating table tend to concentrate on products of interest to themselves – i.e. machinery, chemicals, and manufactures rather than textiles and agriculture.[155] Without some measure of reciprocity in trade negotiations, developing countries become largely dependant on the goodwill and generosity of developed countries (often in short supply). Although some degree of special and differential treatment for developing counties is defensible, such as longer phase-in

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[153] Trebilcock, *supra* note 152, at 293.

[154] See Bhagwati, Jagdish (2001), 'Free Trade and Labor'. Online: http://www.columbia.edu/~jb38/ft_lab.pdf. Accessed February 13, 2005; and Bhagwati, Jagdish, (1999), 'Third World Intellectuals and NGOs – Statement Against Linkage'. Online: http://www.columbia.edu/~jb38/TWIN_SAL.pdf. Accessed February 13, 2005.

[155] *The Economist*, 'The Poor's Best Hope – Trading for Development', June 22, 2002.

periods for tariff reductions or special provisions for technical assistance, the non-reciprocal and asymmetric trade liberalization currently advocated by developing countries may be an unproductive negotiating strategy.

The institutional structure of the WTO has come under heavy criticism, both from developing countries who feel underrepresented in the negotiating process and from developed countries who are concerned with a lack of transparency.[156] Indeed, the way in which the WTO does its business may be as much to blame for the failure of the Seattle and Doha Ministerial meetings as the substantive disagreements that emerged at these meetings. In particular, developing countries have become exasperated with a negotiating process where selected countries negotiate the outlines of a bargain and then others, who were not in the room, are expected to be takers.[157]

The WTO has been accused of lacking both internal and external transparency. The lack of internal transparency refers to the fact that WTO Members, especially smaller developing countries, are not always made aware of developments affecting them in a timely fashion. The lack of external transparency refers to the perception on the part of civil society groups and non-governmental organizations (NGOs) that information about WTO decisions and negotiations is not readily available and there is an element of secrecy to the WTO's workings. With respect to the external transparency issue, trade law scholars have noted that the trend at the WTO is generally a positive one, with negotiating proposals and other WTO documents increasingly being made public and easily accessible in electronic format.[158]

Another controversial institutional issue is the decision-making structure of the WTO. The Uruguay Round brought into being a structure known as the 'Single Undertaking'. Essentially, the Single Undertaking makes membership in the WTO an 'all-or-nothing' proposition – Members must sign on to all WTO treaty regimes, and as a general rule, no reservations or exceptions are permitted. Such a format may limit the flexibility of Members, particularly developing country Members, in shaping their trade policy agenda in order to pursue an optimal course of development. The Single Undertaking reflects a mindset that trade liberalization is an end in itself, rather than a means to continued economic development.[159] Debate on the wisdom of the Single Undertaking revolves around the trade-off between, on the one hand,

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[156] See Report of the Consultative Board for the Director-General of the WTO (2004), *The Future of the WTO: Addressing Institutional Challenges in the New Millennium*.

[157] Trebilcock and Howse, *supra* note 67, at 641–642.

[158] Trebilcock and Howse, *supra* note 67, at 644–645.

[159] Trebilcock and Howse, *supra* note 67, at 642–643.

preventing nations from free-riding on the concessions of others, and on the other hand, permitting Members to enjoy some degree of flexibility in trade policy.

The consensus method of decision-making in the WTO has also been criticized. As WTO membership continues to grow, it is becoming increasingly difficult to satisfy the diverse interests of all Members. However, to do away with the consensus method could imperil the legitimacy of WTO agreements, at least for any Members who dissented with respect to one or more agreements. Furthermore, from a practical point of view, the utility of any WTO agreement which did not have the support of one or more of the major Members, such as the US or EU, would be minimal.

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2. International trade: trade remedies

Alan O. Sykes

The term 'trade remedy laws' refers to three types of national laws that impose import restrictions under specified circumstances. 'Safeguard measures' are temporary trade restrictions, typically tariffs or quotas, which are imposed in response to import surges that cause or threaten 'serious injury' to a competing industry in an importing nation. 'Antidumping duties' are tariffs in addition to ordinary customs duties that are imposed to counteract certain 'unfair' pricing practices by private firms that cause or threaten to cause 'material injury' to a competing industry in an importing nation. 'Countervailing duties' are tariffs in addition to ordinary customs duties that are imposed to counteract certain subsidies bestowed on exporters by their governments, again when they cause or threaten to cause material injury to a competing industry.

Such measures under national law are permitted, but not required, by WTO law, subject to the limitations found in WTO treaty text, including GATT 1994 (hereafter GATT), the WTO Agreement on Safeguards (hereafter SA), the WTO Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade (the Antidumping Agreement, hereafter ADA), and the WTO Agreement on Subsidies and Countervailing Measures (hereafter SCMA). These WTO Agreements impose extensive substantive and procedural restrictions on the use of each type of measure.

This chapter provides an introduction to the law on each trade remedy measure, and to pertinent economic research and commentary. My emphasis will be on WTO obligations, to which national laws must conform (in the case of WTO member states). I make occasional reference to the national law of the United States to illustrate how WTO obligations have been implemented (or not), but will make no attempt at a cross-sectional survey of variation in national statutes.

1. Safeguard measures

The heart of the original GATT bargain in 1947 involved the reciprocal reduction of tariff rates, and negotiated ceilings or 'bindings' on tariffs governed by GATT Article II. The drafters of GATT anticipated that tariff concessions might become unexpectedly burdensome as a political matter, however, and provided two principal mechanisms for the adjustment of tariff commitments. GATT Article XXVIII provides for the renegotiation of tariff commitments

once every three years, as well as for 'out of season' renegotiation under special circumstances authorized by the membership. In addition, the drafters provided for 'emergency action on imports of particular products' in GATT Article XIX, a provision that addressed unexpected import surges. These 'emergency actions' came to be known as safeguard actions. Article XIX is also often termed the GATT 'escape clause', as it allows GATT members to 'escape' from their tariff commitments (and other obligations) under specified circumstances.

Perceived deficiencies in Article XIX and in GATT practice pursuant to it led to the negotiation of the SA during the Uruguay Round. The SA was targeted at extra-legal or 'gray area' substitutes for formal measures under Article XIX, but also introduced other procedural and substantive obligations.

The possibility of safeguard measures in services sectors has also been contemplated under WTO law. GATS (General Agreement on Trade in Services) Article X provides for multilateral negotiations on the subject. To date, however, the use of safeguards has not become an issue under GATS, and I will confine my attention here to the issues involving GATT and the SA, which govern trade in goods.

The key features of the treaty text in GATT and the SA are the subject of Sections A and B. Section C reviews the important disputes that have arisen over the use of safeguards to date in the WTO. Section D concludes with a review of the economic commentary on safeguard measures. The discussion here is of necessity quite abbreviated, and interested readers may wish to consult the much more complete book-length treatment in Sykes (2006). See also Lee (2005).

1.1. Safeguard measures under GATT[1]

Paragraph 1(a) of GATT Article XIX provides:

> If, as a result of unforeseen developments and of the effect of the obligations incurred by a contracting party under this Agreement, including tariff concessions, any product is being imported into the territory of that contracting party in such increased quantities and under such conditions as to cause or threaten serious injury to domestic producers in that territory of like or directly competitive products, the contracting party shall be free, in respect of such product, and to the extent and for such time as may be necessary to prevent or remedy such injury, to suspend the obligation in whole or in part or to withdraw or modify the concession.

The basic structure is a simple one. When an unanticipated import surge

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[1] Jackson (1969) remains the definitive reference on the treaty text of the original GATT and its interpretation.

results from some obligation under GATT and the import surge is a cause of serious injury or threat thereof to import-competing firms in the importing nation, the importing nation may deviate from its obligation temporarily and to the degree necessary to address the injury due to the import surge.

Article XIX further provides that such deviation from GATT obligations will come at a price. Paragraph 2 requires that a party invoking its right to suspend or modify concessions must notify adversely affected parties and 'consult' with them. Although it does not say so expressly, it was contemplated that such consultations might lead to an agreement to substitute alternative trade concessions for those withdrawn because of the import surge – trade 'compensation'. Paragraph 3 provides, however, that if negotiations over compensation are unsuccessful, the importing nation may deviate from its obligations nevertheless. In that event, adversely affected trading partners have a right to suspend 'substantially equivalent concessions'. Thus, absent a successful negotiation over compensation, affected trading partners could retaliate against safeguard measures, subject to the equivalence requirement. The equivalence requirement was subject to little policing, however, since collective action by the membership was necessary to disapprove the level of retaliation, and any such action under the original GATT required unanimity.

Over the years, the system devised by Article XIX malfunctioned in two ways. The first problem arose because the textual requirements of paragraph 1(a) became increasingly difficult to apply with the passage of time. The text requires that safeguard measures respond to the consequences of an 'unforeseen development'. Unforeseen by whom, at what point in time? These questions had a natural answer in 1947 – an 'unforeseen development' was something unforeseen by the original GATT negotiators in 1947 when the original tariff bindings were negotiated. But ten, twenty, or forty years later, this anchor for the unforeseen developments requirement seemed inapt, as few things occurring that many years later could have been foreseen in 1947. And if the anticipations of the original negotiators were no longer the relevant benchmark, what should substitute for them?

Much the same issue arose with the requirement that the import surge be traceable to a GATT obligation. Again, the obvious interpretation in 1947 was that the surge had to result from the 1947 tariff binding. But what of a surge twenty years later? Could any import surge at that time be fairly said to 'result' from a twenty-year old binding? What if additional bindings had been negotiated in the interim (or not)? Of course, it could always be argued that but for a tariff binding, the importing nation would have raised its tariff to prevent the surge. But on that reading, the requirement of linkage to a GATT obligation would be trivially satisfied for any product covered by a tariff binding.

The eventual response to these textual conundrums was to ignore the text that led to them. When domestic authority for safeguard measures was

included in the US Trade Act of 1974, for example, the statute made no mention of any requirement to link increased imports to any unforeseen development, or to any particular GATT obligation, and indeed US law still omits any reference to these issues.[2] Prior to the entry into force of the treaty establishing the WTO, no nation complained about this state of affairs to my knowledge.

The demise of these textual prerequisites for safeguard measures created another problem, however, which I will address in detail below. For now, I simply note that the requisite inquiry into the 'cause' of serious injury or threatened injury under Article XIX becomes conceptually problematic when there is no longer any 'unforeseen development' to serve as an exogenous shock, and thereby to establish a baseline for the volume of imports and to define the counterfactual for ascertaining whether the import surge is causally responsible for injury.

The second problem with the system arose because GATT members resorted increasingly to extra-legal substitutes for safeguard measures, generally negotiated on a bilateral basis. These arrangements were often termed 'orderly marketing' arrangements or 'voluntary export restraints' (VERs). One of the most dramatic examples of the extra-legal nature of these measures arose after a safeguards case brought by the US automotive industry, in which the domestic authority charged with administering the law (the US International Trade Commission (ITC)) concluded that the domestic industry had not met the statutory requirements for safeguard relief. President Carter nevertheless proceeded to negotiate an export restraint agreement with the Japanese government that remained in place for a number years.

The economic appeal of these negotiated 'gray area' measures was readily apparent. As noted, nations wishing to use safeguard measures were subject to a requirement under Article XIX to provide trade compensation lest they suffer retaliation. VERs afforded compensation in the form of 'quota rents' – covered exporters reduced the *quantity* of their exports, but because of the quantity restriction they were able to charge a higher *price* (the quota rent). Thus, VERs were the rough equivalent of cartel agreements, in which foreign and domestic industries agreed to restrict overall output in a national market in order to enjoy the benefits of higher prices.

Although these arrangements proliferated during the later years of GATT, they were subjected to extensive criticism by economic commentators. See, for example, Lawrence and Litan (1986). The commentators observed that gray area measures may be used when the Article XIX preconditions for safeguard measures had not been met, and that the magnitude and duration of gray

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[2] See US Trade Act of 1974 §§201 et seq., codified as 19 USC §§2251–54.

area measures was entirely undisciplined. The political tide turned against these measures during the Uruguay Round, probably because they were often quite discriminatory in their impact on trading partners, and a substantial effort was undertaken to put an end to them, culminating in the SA. [3]

1.2. The Agreement on Safeguards

The SA introduces a number of innovations. Most prominently, it seeks to end the use of gray area measures through two devices. The first is a simple prohibition on them – Article 11(1)(b) provides that 'a Member shall not seek, take or maintain any voluntary export restraints, orderly marketing arrangements or any other similar measures on the export or the import side'. Second, to diminish the perceived incentives to resort to gray area substitutes, the SA alters the rules regarding compensation and retaliation. All members using safeguards 'shall endeavor to maintain a substantially equivalent level of concessions',[4] i.e., to negotiate trade compensation. But if negotiations over compensation are unsuccessful, no right of retaliation exists during the first three years of a safeguard measure that conforms to the legal requirements of the Agreement and that follows an absolute increase in the level of imports (Article 8(3)). Thus, the 'threat point' is plainly altered in the compensation negotiations, and nations adversely affected by safeguards actions must settle for less in compensation lest they walk away with nothing for three years.

Relatedly, because various measures to protect injured industries dragged on for years under GATT, the SA introduces some bright-line time limits. Safeguards measures can last only four years, although they may be extended for another four years if a formal determination is made to justify it. Further, after safeguard measures are once used in an industry, they cannot be reapplied in that industry for a length of time equal to the time that they had been in effect. Finally, any safeguard measure lasting over one year is to be liberalized at 'regular intervals'.[5]

Several other elements of the SA warrant brief mention here. GATT Article XIX contained no procedural requirements for the imposition of safeguard measures under national law, and GATT members sometimes used procedures that were not transparent. Article 3 of the SA now requires an investigation by 'competent authorities', including notice to all interested parties and 'public hearings or other appropriate means' to allow parties to present evidence and

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[3] Bown (2002) provides additional background on the effort to eliminate extralegal measures in the Safeguards Agreement, as well as the puzzle as to why WTO negotiators sought to eliminate such measures.

[4] Art. 8(1).

[5] Id. Art. 7.

views. The findings of the competent authorities must be published setting forth 'reasoned conclusions' on all matters of law and fact.

Articles 2 and 5 pertain to the so-called issue of 'selectivity', or discrimination in the use of safeguard measures. Article 2 requires that a measure apply to any imported product 'irrespective of its source'. Article 5 contains rules regarding the use of quotas, including rules for the allocation of quota shares among supplier countries. Such shares must be negotiated among all concerned, or else based on market shares during a 'previous representative period,' subject to an exception for disproportionate import surges from particular sources.

Unlike Article XIX, the SA makes no reference to 'unforeseen developments' as a predicate for safeguard measures, or to the requirement that import surges be linked to any particular GATT obligation. On the basic preconditions for safeguard measures, the Agreement simply states that a 'Member may apply a safeguard measure to a product only if that Member has determined . . . that such product is being imported into its territory in such increased quantities, absolute or relative to domestic production, and under such conditions as to cause or threaten serious injury to the domestic industry that produces like or directly competitive products'.[6]

The only guidance as to the meaning of 'serious injury' under this standard, and on the proper approach to the analysis of causation, is provided by Article 4 of the Agreement, which states in pertinent part:

> 1. For purposes of this Agreement:
> (a) 'serious injury' shall be understood to mean significant overall impairment in the position of a domestic industry;
> (b) 'threat of serious injury' shall be understood to mean serious injury that is clearly imminent . . .
> 2. (a) In the investigation to determine whether increased imports have caused or are threatening to cause serious injury to a domestic industry . . . the competent authorities shall evaluate all relevant factors of an objective and quantifiable nature having a bearing on the situation of that industry, in particular, the rate and amount of the increase in imports of the product concerned in absolute and relative terms, the share of the domestic market taken by increased imports, changes in the level of sales, production, productivity, capacity utilization, profits and losses, and employment.
> (b) The determination referred to in subparagraph (a) shall not be made unless this investigation demonstrates, on the basis of objective evidence, the existence of the causal link between increased imports of the product concerned and serious injury or threat thereof. When factors other than increased imports are causing injury to the domestic industry at the same time, such injury shall not be attributed to increased imports.

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[6] Id. Art. 2(1).

The next section will address some of the issues that this text leaves open.

1.3. Issues in dispute resolution – WTO safeguards cases to date

The brief exposition of the law above masks a number of difficult issues that have now surfaced in WTO dispute proceedings. As has been argued elsewhere, WTO case law in the safeguards area has done little to resolve these issues, and has instead produced confusion and incoherence. See Horn and Mavroidis (2003), Grossman and Mavroidis (2004), Grossman and Sykes (2004), Pauwelyn (2004), Sykes (2003), Sykes (2004), Sykes (2006). This section briefly reviews the major issues, and notes their (often unsatisfactory) resolution to date.

UNFORESEEN DEVELOPMENTS AND THE EFFECT OF THE OBLIGATIONS INCURRED

As noted, GATT practice came to ignore the requirement in Article XIX(1)(a) that any import surge be linked to unforeseen developments and to particular GATT obligations as a prerequisite for GATT members to employ safeguard measures. Likewise, the SA made no mention of these requirements, and it might have been assumed that they would remain dormant under WTO law. But in its first important ruling in a safeguards dispute – *Korea – Dairy*[7] – the WTO Appellate Body held that Article XIX and the Safeguards Agreement are to be read cumulatively, and that all of the original requirements of Article XIX remain binding: '[I]t seems to us that the ordinary meaning of the phrase "as a result of unforeseen developments" requires that the developments which led to a product being imported in such increased quantities and under such conditions as to cause or threaten to cause serious injury to domestic producers must have been "unexpected". With respect to the phrase "of the effect of the obligations incurred by a Member under this Agreement, including tariff concessions", we believe that this phrase simply means that it must be demonstrated, as a matter of fact, that the importing Member has incurred obligations under the GATT 1994, including tariff concessions'.[8] The Appellate Body went on to endorse the reasoning of the working party report in the old GATT Hatter's Fur case, which stated: ' "unforeseen developments" should be interpreted to mean developments occurring after the negotiation of the relevant tariff concession which it would not be reasonable to expect that the negotiators of the country making the concession could and should have foreseen at the time when the concession was negotiated'.[9] *United States – Lamb*[10] further held that

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[7] *Korea – Definitive Safeguard Measure on Imports of Certain Dairy Products*, WT/DS98/AB/R (1999).

[8] Id. ¶84.

[9] Id. ¶89.

[10] *United States – Safeguard Measures on Imports of Fresh, Chilled or Frozen Lamb Meat from New Zealand and Australia*, WT/DS178/AB/R (2001).

WTO members must demonstrate their compliance with these elements of Article XIX prior to the time that a safeguards measure is undertaken. The US ITC's failure to consider the matter in its lamb investigation was 'not surprising' given the absence of any reference to it in the governing US statute, but that was no defense for the United States under WTO law.[11] Much the same problem arose for the United States in the recent steel decision.[12]

Given the uniform practice of ignoring these issues in the latter years of GATT, it is questionable whether the drafters of the SA had any intention of reviving them. Having done so, however, the Appellate Body has done little to resolve the conundrums that led these parts of the treaty text to be ignored in the first instance. At what point in time must the events in question have been unforeseen – the time of the last tariff concession? What if the last concession on the product in question was decades ago – could anything today have been foreseen? What if the product has been the subject of numerous tariff concessions over time – are expectations associated with the last concession the only relevant ones? Why or why not? At present, these questions are less pressing, because the cases tend to suggest that the relevant expectations are the reasonable expectations of trade negotiators at the end of the Uruguay Round. But as time passes and additional negotiating rounds accumulate, they will likely resurface.

Another issue of considerable practical importance concerns the task of demonstrating the *effects* of an unforeseen development. How do the competent authorities determine the degree to which imports have surged as a consequence of it? In the recent steel dispute, the United States asserted before the WTO dispute panel that the collapse of the former Soviet Union and the Asian financial crisis were both 'unforeseen developments' that had resulted in an import surge. But there was little more than bare assertion that these events had caused significant import shocks in each of the many steel product lines or 'industries' under investigation. Sykes (2004) reviews the efforts of the dispute panel in the steel case to come to grips with some of these issues, but the fundamental problems remain unresolved.

With regard to the 'effect of the obligations incurred', by contrast, the Appellate Body apparently offers a reading that enables the requirement to be trivially satisfied in every case – a member simply needs to show that it has incurred some obligations with respect to the product in question. It is hard to imagine how a dispute could arise without such an obligation, since a member with an unbound tariff could always raise it unilaterally without any need to rely on a safeguard measure.

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[11] Id. ¶73.

[12] *United States – Definitive Safeguard Measures on Imports of Certain Steel Products*, WT/DS248–49, 251–54, 258–59/AB/R (November 2003).

INCREASED QUANTITIES Article XIX allows safeguard measures when a 'product is being imported . . . in such increased quantities and under such conditions as to cause or threaten serious injury'. To ascertain whether imports have increased, of course, some baseline must be used. The original baseline for Article XIX was the volume of trade in 1947. But with the passage of time, that baseline became increasingly absurd, since global trade in most products had since increased dramatically. The other obvious baseline might have been the volume of trade on the date of the 'unforeseen development' that produced the import surge, but since that prerequisite for safeguards measures had long been ignored under GATT, it did not supply a baseline in practice either.

In *Argentina – Footwear,*[13] the Appellate Body considered a case in which Argentina had adopted the approach embraced some years earlier by the US ITC – a five-year 'rule of thumb' for establishing the import baseline. The Appellate Body concluded that the phrase 'is being imported' requires 'the competent authorities to examine recent imports, and not simply trends in imports during the past five years – or, for that matter, during any other period of several years'.[14] '[N]ot just *any* increased quantities of imports will suffice. There must be "*such* increased quantities" as to cause or threaten to cause serious injury to the domestic industry in order to fulfill this requirement for applying a safeguard measure. . . . [T]he increase in imports must have been recent enough, sudden enough, sharp enough, and significant enough, both quantitatively and qualitatively, to cause or threaten to cause "serious injury" '.[15]

Thus, the Appellate Body insists that imports must have increased 'recently'. But how recently, and in what amount? The phrase 'recent enough, sudden enough, sharp enough, and significant enough, both quantitatively and qualitatively, to cause or threaten to cause "serious injury"' provides little useful guidance. The insistence on 'not just any increase' but 'such increased quantities' as to cause injury is equally unhelpful. Indeed, as I will detail in a moment, it is not even clear what it means to say that increased imports are a 'cause' of injury.

SERIOUS INJURY Like Article XIX and the SA, the Appellate Body has not attempted to define 'serious injury' with any precision. Its focus has been primarily on the text of Article 4.2, which simply provides: 'the competent authorities shall evaluate all relevant factors of an objective and quantifiable nature having a bearing on the situation of that industry, in particular, the rate

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13 *Argentina – Safeguard Measures on Imports of Footwear*, WT/DS121/AB/R (1999).

14 Id. ¶130.

15 Id. ¶131.

and amount of the increase in imports of the product concerned in absolute and relative terms, the share of the domestic market taken by increased imports, changes in the level of sales, production, productivity, capacity utilization, profits and losses, and employment'. According to the Appellate Body, the text requires that all of the listed factors be 'evaluated' in every case, and it has found safeguard measures wanting under WTO law whenever a member has failed to discuss one or more of these factors in its official report on safeguard action.[16] The Appellate Body has further held that the obligation to evaluate 'all relevant factors' may extend to factors not raised by any of the parties to the safeguards investigation.[17]

Otherwise, the Appellate Body has simply insisted that serious injury represents 'significant overall impairment' as stated in Article 4.1 of the Safeguards Agreement. It characterizes this standard as 'high' and 'exacting'.[18] It is not necessary that every 'relevant factor' reflect industrial decline, however, for serious injury to be present – 'a certain factor may not be declining, but the overall picture may nevertheless demonstrate "significant overall impairment" '.[19] Beyond a requirement that all factors listed in the Safeguards Agreement be 'evaluated' in each case, however, it remains unclear what conditions will support a finding of serious injury or threat, and what degree of deference on the matter will be afforded to national authorities.

CAUSATION As originally drafted, Article XIX contemplated that the conjunction of an 'unforeseen development' with new GATT constraints on national trade policy might lead to an import surge that caused or threatened serious injury. The causal variable in this chain, or the exogenous shock in economic parlance, was the 'unforeseen development' coupled with the trade concession. The economic logic of this test is clear, although to be sure it begs the question of what counts as an unforeseen development, and how its impact is to be demonstrated.

Because GATT practice came to ignore the unforeseen developments requirement, however, member states wishing to use safeguard measures had to employ a different conceptual framework to assess the causal impact of imports. United States law took the lead, and in the Trade Act of 1974 it

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[16] See *Argentina – Safeguard Measures on Imports of Footwear*, WT/DS121/AB/R (1999), ¶121.

[17] See *United States – Definitive Safeguard Measures on Imports of Wheat Gluten from the European Communities*, WT/DS166/AB/R (2001), ¶55.

[18] *United States – Safeguard Measures on Imports of Fresh, Chilled or Frozen Lamb Meat from New Zealand and Australia* WT/DS178/AB/R (2001), ¶124.

[19] *Argentina – Safeguard Measures on Imports of Footwear*, WT/DS121/AB/R (1999), ¶139.

simply asks whether increased quantities of imports cause or threaten serious injury.[20] The difficulty with this inquiry from the standpoint of economic logic is that import quantities are not a causal or exogenous variable – they are endogenous and *result* from other forces.

For example, if imports and domestic products are perfect substitutes, then the quantity of imports will simply equal the difference between domestic demand and domestic supply at the equilibrium price. Within this framework, the exogenous factors are the determinants of domestic supply, domestic demand, and the import supply curve. Domestic demand is affected by such things as consumer tastes and incomes; domestic supply by the costs of inputs into production and the state of available production technology; and import supply by factors affecting supply and demand in other countries. The quantity of imports is then a *result* of the interaction of these forces; it is not a causal variable at all. Likewise, changes in the quantity of imports will be the *result* of changes in the determinants of domestic supply, demand and import supply. Increased quantities of imports may result, for example, from a shift in import supply due to falling input costs abroad, to improved production technology abroad, or to weakening demand abroad. Increased quantities of imports can also result from an increase in domestic demand attributable, for example, to rising consumer incomes. Finally, increased quantities of imports can result from increasing costs of domestic production reflected in a leftward shift of the domestic supply schedule.

Against this backdrop, the question 'did increased quantities of imports cause serious injury to a domestic industry?' is largely incoherent. Suppose, as an illustration, that the domestic industry suffers a decline due to rising costs. As domestic production falls at the world price, imports will increase to fill the rising gap between domestic demand and supply. Are 'increased quantities' of imports the 'cause' of this 'injury'? Certainly not in any intelligible sense of the term 'cause'. By hypothesis, what changed are the costs of domestic firms, and that change *resulted* in reduced domestic production and increased imports.

The decision by the Appellate Body to resurrect the unforeseen developments requirement can offer at least a conceptual solution to this problem, by reframing the question as one of whether the imports that *resulted* from the exogenous 'unforeseen development' are the cause of actual or threatened injury. The practical challenges of making such a showing might be considerable and it would remain to determine what should 'count' as an unforeseen

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[20] See 19 USC §2251(a). US law actually asks whether increased quantities are a 'substantial cause,' defined as a cause no less important than any other. For more detail on this test and its operation under US law, see Sykes (2003), (2004).

development, but at least the issue would be framed coherently. Puzzlingly, however, this is not the approach that the Appellate Body has taken to date.

Argentina – Footwear briefly addresses the proper method for determining whether imports are the 'cause' of injury. The dispute panel in the case concluded that 'if causation is present, an increase in imports normally should coincide with a decline in the relevant injury factors'.[21] The Appellate Body agreed with the panel that 'in an analysis of causation, "it is the *relationship* between the *movements* in imports (volume and market share) and the *movements* in injury factors that must be central to a causation analysis and determination". Furthermore, with respect to a "coincidence" between an increase in imports and a decline in the relevant injury factors, we note that the Panel simply said that this should "normally" occur if causation is present'.[22]

Hence, in its first important statement on the subject, the Appellate Body holds that the principal way to determine whether increased imports are the cause of injury is simply to look for a correlation between rising import volumes and indicators of decline in the domestic import-competing industry. It tips its hat to the familiar statistical distinction between correlation and causation, but sweeps it under the rug. One has no sense that the Appellate Body is aware of (or at least troubled by) the profound conceptual difficulty in confounding the two in a setting where the ostensible 'causal' variable is in fact endogenous.

The other Appellate Body opinions on causal analysis focus principally on the so-called 'non-attribution requirement' of Article 4.2 of the SA, which provides that safeguard measures may not be employed unless the 'investigation demonstrates, on the basis of objective evidence, the existence of the causal link between increased imports of the product concerned and serious injury or threat thereof. When factors other than increased imports are causing injury to the domestic industry at the same time, such injury shall not be attributed to increased imports.' One question raised by this language during the course of various disputes has been whether the harm 'caused' by increased imports (again suspending the issue of what it means to treat increased imports as causal) must by itself amount to serious injury, or must simply contribute to serious injury, perhaps along with other factors. To this ill-posed question, the Appellate Body has responded that 'the SA does not require that increased imports be "sufficient" to cause, or threaten to cause, serious injury. Nor does that Agreement require that increased

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[21] *Argentina – Safeguard Measures on Imports of Footwear*, WT/DS121/AB/R (1999), ¶141.

[22] Id. ¶144.

imports "alone" be capable of causing, or threatening to cause, serious injury'.[23]

Although increased imports need not account for all of the serious injury, the Appellate Body nevertheless underscores the importance of ensuring that injury caused by 'factors other than increased imports' 'not be attributed to increased imports'. The Appellate Body has found fault with members' 'non-attribution analysis' on multiple occasions, generally because the reasoning was deemed inadequately clear.[24]

Among the difficult issues posed by the non-attribution requirement of the SA is the identification of what constitutes a 'factor other than increased imports'. In line with the earlier illustration, suppose that an increase in the costs of domestic firms leads to an increase in imports. Is the cost increase a 'factor other than increased imports'? Is that view coherent when the 'other factor' was actually the cause of the increased imports, as posited? At this writing, the Appellate Body has given no indication that it even understands the complex issues of economic causality raised by the SA. Sykes (2003, 2004 and 2006) provides further discussion of the conceptual difficulties with causation analysis under the SA and the unsatisfactory state of Appellate Body opinions on the matter to date.

Several economic commentators have proposed ways to make the causation analysis in safeguards proceedings more coherent. The predominant suggestion is that national authorities should inquire whether shifts in the import supply curve have caused serious injury or threat, as opposed to shifts in domestic demand and supply conditions. See Grossman (1986); Kelly (1988); and Irwin (2003). Pindyck and Rotemberg (1987) offer another suggestion based on counterfactual quotas that freeze import quantities at some baseline level, and analogous counterfactual assumptions to assess the quantitative impact of 'other factors'. To date, however, national authorities have shown little inclination to embrace either approach, and the receptiveness of the Appellate Body to either approach remains untested.

A final important issue that as yet has received little attention from the

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[23] *United States – Safeguard Measures on Imports of Fresh, Chilled or Frozen Lamb Meat from New Zealand and Australia* WT/DS178/AB/R (2001), ¶170. See also *United States – Definitive Safeguard Measures on Imports of Wheat Gluten from the European Communities* WT/DS166/AB/R (2001), ¶70.

[24] See *United States – Definitive Safeguard Measures on Imports of Wheat Gluten from the European Communities* WT/DS166/AB/R (2001); *United States – Safeguard Measures on Imports of Fresh, Chilled or Frozen Lamb Meat from New Zealand and Australia* WT/DS178/AB/R (2001); *United States – Definitive Safeguard Measures on Imports of Circular Welded Carbon Quality Line Pipe from Korea,* WT/DS202/AB/R (2001).

Appellate Body concerns the task of determining which domestic firms are relevant for purposes of injury analysis. SA Article 2 follows GATT Article XIX in stating that the serious injury or threat thereof must be suffered by the domestic industry that produces 'like or directly competitive products'. The question of how to 'define the industry' under this standard often receives much attention from the competent authorities during their investigation – in the recent steel safeguard investigation in the United States, for example, the US ITC ultimately determined that 27 separate steel product 'industries' were involved, and conducted a separate analysis of each. Although some of the WTO safeguard disputes have included challenges to the definition of 'industry' by competent authorities, most have been resolved largely on other grounds.

1.4. An economic perspective on safeguard measures

Sykes (1991) reviews the possible justifications for safeguard measures, and rejects most of them. By their nature, safeguard measures afford protection to industries that have difficulty meeting foreign competition. They delay the contraction of those industries, and impede the transfer of resources from declining industries to others where comparative advantage may lie. At first blush, therefore, safeguard measures seem quite problematic from the standpoint of economic efficiency.

Industrial proponents of safeguards most often argue that they are needed for troubled industries to restore their competitiveness – a temporary period of protection will provide firms with profits to finance new investments, the argument runs, so that they can again compete in global markets. A difficulty with this argument is that it is often impossible for declining industries to restore their competitiveness through new investment, which would simply entail throwing good money after bad. In addition, there is little reason to think that national governments have the ability to identify industries that can become competitive 'again' very reliably. And if governments can do it, why do the capital markets not do it as well and lend firms the money to finance worthwhile investments without the need for temporary protection?

From the standpoint of economic efficiency, therefore, safeguard measures appear highly questionable, at least at first blush. If this observation is correct, however, a puzzle arises from a positive economic standpoint – why does the WTO system provide for safeguard measures nevertheless? Commentators have suggested several answers to this puzzle.

SAFEGUARDS AS 'COMPENSATION' The distributional consequences of trade liberalization are uneven. Some groups will benefit, and others will lose, even if the aggregate effect on economic welfare is positive. It is sometimes

suggested that safeguard measures may serve as a mechanism for compensating some of the groups disadvantaged by trade.[25]

One difficulty with this claim is that trade protection is an extremely costly and clumsy device for compensating the 'losers' from trade liberalization. To a great extent, it may simply benefit diversified shareholders in protected industries, doing little for individuals whose jobs have been sacrificed for the broader public good. Targeted unemployment and retraining programs seem a much more tailored response. Second, and relatedly, it is not clear that safeguard measures will 'compensate' for trade-related dislocation in any meaningful sense. Depending on how they are implemented, they may simply postpone the burden of dislocation. Finally, it seems clear from the text of Article XIX that safeguards were not conceived as a general compensation mechanism. They were to be employed only when 'unforeseen developments' led to import-related dislocation. In perhaps most cases, however, the dislocation associated with trade liberalization is quite foreseeable, and indeed it is the anticipated competitive advantage from trade concessions that leads exporters to encourage their political officials to secure better access to foreign markets. If distributional equity were the goal of safeguards, it is perhaps a puzzle as to why measures to achieve it would have been limited to the situations in which dislocation was unforeseen.

ADJUSTMENT COSTS AND ORDERLY CONTRACTION Proponents of safeguard measures sometimes argue that temporary protection is needed to facilitate 'orderly contraction'. Implicitly, the claim is that without protection the industry will collapse precipitously, leading to unnecessary unemployment and dislocation. This argument has received some credence from economic commentators. See Horn and Mavroidis (2003), Sykes (1990). Horn and Mavroidis focus on the costs of unemployed factors of production (most notably labor), and suggest that measures to slow the pace of industry contraction may, under certain conditions, reduce these costs. They begin by acknowledging that nothing is gained by a safeguards measure that simply postpones the costs of adjustment without reducing them, incurring the economic costs of protectionism in the process. But it is possible to imagine that protection can reduce adjustment costs and not merely postpone them. As an example, they posit a declining industry in which 12,000 workers will lose their jobs each month. They further imagine that suitable positions for those workers will open up in another industry, but only at the rate of 6,000 per month. By slowing the rate of layoffs in the declining industry to 6,000 per

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[25] For a related argument predicated on Max Corden's notion of the conservative social welfare function, see Deardorff (1987).

month in this scenario, safeguard measures can avoid the unemployment that results when 12,000 laid-off workers a month have only 6,000 new jobs open to them.

Horn and Mavroidis concede that such problems will only arise under limited conditions. In particular, why do workers in the declining industry suffer unemployment if they have no alternative job opportunity, rather than taking whatever wage cuts are necessary for them to retain their positions? And if the supply of unemployed workers to other industries is greater than the demand at current wages, why do wages in other industries not fall to accommodate more hires? In a well-functioning labor market with wage flexibility, unemployment should reflect an efficient period of job search rather than an inefficient idling of resources. But there are reasons why wage adjustments may not clear the labor market efficiently. Horn and Mavroidis note the possibility that labor unions may resist wage cuts. Another possibility is that government safety net programs provide income subsidies that discourage workers from seeking new jobs as quickly as they might. One can perhaps imagine other reasons, and thus it is certainly possible in theory that industries may contract 'too quickly' and that measures to slow the rate of contraction may be useful, other things being equal.

It would not necessarily follow that safeguard measures are the best policy response, however, as Horn and Mavroidis also acknowledge. Various other policy instruments might be employed to address the problem, such as subsidies to encourage the hiring of the unemployed. But all instruments are imperfect, and it is perhaps conceivable that measures to protect a declining industry that slows its rate of contraction may at times be the best option.

Does this possibility afford a convincing justification for safeguards under WTO law? The difficulty with this account is that nothing in the structure of WTO law (or in the national laws) limits safeguard measures to circumstances in which they might usefully slow the process of contraction. Sykes (1990) makes the point that US law permits safeguards in a far broader set of circumstances, and it is clear that WTO law does as well. Neither body of law requires any showing that an industry is exhibiting inefficiently high levels of unemployment of labor or any other factor of production, much less evidence that temporary protection can do more than merely postpone the problem.

THE POLITICAL ECONOMY RATIONALE FOR SAFEGUARD MEASURES In my judgment, the most convincing explanation for the presence of safeguards in the WTO system lies in the realm of political economy. Treaties are contracts of a sort, and the direct parties of interest are political officials. The officials who negotiate and ratify treaties may be expected to design provisions that serve their joint political interests, which may or may not coincide with economic welfare, conventionally defined. Because treaties are negotiated under conditions of

uncertainty, it is in the interest of political officials to include provisions that allow them to adjust the bargain when its obligations become politically onerous, much as private contracting parties permit deviation from contractual commitments under circumstances where their performance has become economically onerous (as through clauses excusing nonperformance due to acts of war or *force majeure*). Several commentators have advanced theories of safeguard measures that locate them squarely within this framework.

Bagwell and Staiger (1990, 2002) suggest that safeguard measures are allowed because the temptation to cheat on tariff commitments can become acute in response to short-term import surges. In their model, the temptation arises because following an import surge, a tariff increase affords a larger terms of trade gain to the importing nation. If a tariff increase under these circumstances were defined as a breach of agreement, other nations would retaliate, cooperation might unravel and the long-term benefits of the trade agreement might be lost. The parties to trade agreements recognize this problem and allow each other to 'cheat' in these short-term situations to preserve long-term cooperation.

Sykes (1991) offers a slightly different argument, which rests on the observation that the political pressure to protect industries in severe decline is often acute. One explanation is that in declining industries, both firms and workers have made sunk investments on which the rates of return have fallen below competitive levels. If they are able to obtain protection that raises prices, they will retain the benefits for themselves – no competitive entry will occur unless returns exceed the competitive level. Accordingly, they will lobby harder for protection than other industries in which the benefits of protection would be competed away. Likewise, if protection for a declining industry harms foreign exporters who are highly profitable and growing, they will tend to raise less political objection to it because their prosperity would often be competed away in any event. It may then be in the mutual political interest of parties to trade agreements to allow each other to reimpose protection to help an industry that is in severe decline due to some shock that also leaves its foreign competitors prosperous and expanding – arguably, the circumstances contemplated by Article XIX. This line of analysis also provides an explanation as to why Article XIX should be designed to provide temporary rather than permanent protection for declining industries. Such industries will tend to become a less potent lobby for protection over time as existing physical and human capital depreciates, and the returns to sunk investments that are lost due to foreign competition diminish.

Bagwell and Staiger (2005) extend their prior work to consider a related situation in which governments face uncertainty about future political pressures for protection, and where the degree of domestic pressure that they face cannot be observed by other governments (private information). Here again, it

may be in the mutual interest of the parties to trade agreements to allow each other to deviate from commitments when the domestic pressure to do so is high in an importing nation, but they must also worry that trading partners may deviate opportunistically because domestic political pressure is unobservable by others. A partial solution to this problem is to limit the number of times that nations may deviate from commitments in a given industry – governments will be less tempted to cheat by deviating when political pressure to do so is low, for fear of losing their right to deviate in the future when pressure is high. This observation suggests an explanation for one feature of the SA noted earlier – safeguard measures cannot be used in an industry that has used them in the past, for a length of time equal to the time that they were in place.

These analyses also have interesting normative implications. The Bagwell and Staiger framework suggests that without a safeguards mechanism, cheating on trade agreements might become acute and cooperation might unravel, denying trading nations the long-term benefits of trade liberalization. Sykes further emphasizes how the opportunity to deviate from commitments when the pressure to do so is high may make trade negotiators more comfortable about making trade concessions in the first instance, a point also noted in Dam (1970). The economic welfare effects of the safeguards mechanism then depend on the balance between the economic welfare gains associated with more trade concessions *ex ante*, and the economic costs associated with renewed protection under the safeguards mechanism *ex post*. The *ex post* welfare consequences of the safeguards mechanism also depend importantly on the extent to which nations negotiate trade compensation when they employ safeguards measures, or instead trigger trade retaliation.

2. Antidumping duties

Antidumping duties are by far the most frequently used measure in the trade remedy arsenal. The WTO website reports the initiation of over 2,500 investigations since 1995. Exporters in the People's Republic of China have been the most frequent targets of antidumping complaints. Other frequent targets include exporters in Korea, Taiwan, and the United States.

'Dumping' entails a decision by an exporter, usually a private firm, to sell abroad at an 'unfairly' *low* price. The benchmark for what constitutes a 'fair' price, generally termed the 'normal value', and the task of ascertaining the magnitude of dumping, is a principal subject of this section. Before antidumping duties may be employed as a countermeasure against dumping, however, WTO law also requires that dumped imports be a cause of actual or threatened injury to competing firms in the importing nation. This 'injury test' will also be a focus of attention. Section 2.1 provides a brief pre-GATT history of antidumping law. Section 2.2 concerns the existence and magnitude of dumping under modern WTO law and practice, while Section 2.3 addresses the

injury test. Section 2.4 concludes with a review of economic commentary regarding the logic and wisdom of antidumping law. In contrast to the safeguards area, WTO Appellate Body decisions to date in antidumping disputes largely concern narrow technical or procedural points, and I will not devote a section to them although I will mention a few rulings in passing.

2.1. The genesis of antidumping law

The first antidumping law was enacted by Canada in 1904. As amended in 1907, it provided that any imported article, of a class or kind also manufactured in Canada, would be assessed an additional duty (subject to a cap) whenever the price charged for the article in Canada, less the costs of shipment to Canada, was less than the price of the article in the exporter's home market.[26]

The Canadian legislation was proposed in a budget speech by the Minister of Finance, who offered the following justification for it:

> We find today that the high tariff countries have adopted that method of trade which has now come to be known as . . . dumping; that is to say, that the trust or combine, having obtained command and control of its own market and finding that it will have a surplus of goods, sets out to obtain command of a neighboring market, and for the purpose of obtaining control of a neighboring market will put aside all reasonable considerations with regard to the cost or fair price of the goods; the only principle recognized is that the goods must be sold and the market obtained . . . They send the goods here with the hope and expectation that they will crush out the native Canadian industries. And with the Canadian industries crushed out, what would happen? The end of cheapness would come, and the beginning of dearness would be at hand.[27]

The passage reflects a concern for what we might today term predatory pricing, or monopolization, under national antitrust laws.

After Canada enacted its antidumping law, antidumping policy quickly spread. Australia included antidumping measures as part of its unfair business practices law in 1906 (although with a more antitrust-like procedure for setting cases in motion and deciding them), and the Union of South Africa followed with an antidumping law substantially the same as Canada's in 1914.

In the United States, the Antidumping Act of 1916, recently repealed,[28] made it 'unlawful for any person . . . to import, sell or cause to be imported

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[26] See US Tariff Commission (1919).

[27] Quoted in Id., p. 22.

[28] The 1916 Act was ruled a violation of the ADA on the basis of a finding that that GATT Article VI(2) limits the remedy for dumping to antidumping duties imposed in conformity with the ADA – the criminal penalties and treble damages under the 1916 Act were additional measures against dumping that were deemed impermissible. See United States – Antidumping Act of 1916, WT/DS136, 162/AB/R (2000).

. . . articles within the United States at a price substantially less than the actual market value or wholesale price of such articles, at the time of exportation to the United States, in the principal markets of their country of production, or of other countries to which they are commonly exported . . . [if] such act or acts be done with the intent of destroying or injuring an industry in the Untied States'.[29] That Act was construed to require much the same showing as a predatory pricing case under the US antitrust laws, and was little used throughout its history. The US Antidumping Act of 1921, by contrast, now subsumed in the Tariff Act of 1930, embraced antidumping duties as a countermeasure against dumping, thus moving American law in the direction of Canada's statute. And unlike the 1916 Act, it requires no showing of predatory design, simply a showing that dumped imports cause or threaten 'material injury'. Much of the substance and procedure of the antidumping provisions of the Tariff Act of 1930 have been imported wholesale into WTO antidumping law.

2.2. GATT and the ADA – identifying and quantifying dumping

In the course of negotiations over the creation of an International Trade Organization during the 1940s, the United States proposed to include a provision in the ITO charter to regulate antidumping measures. A modified version of the US proposal was incorporated into the General Agreement on Tariffs and Trade (GATT) as Article VI. As far as one can tell from historical accounts, the drafters of the GATT did not discuss the policy behind antidumping measures at length. Rather, it was accepted at the time that national antidumping legislation was permissible, and the goal was to constrain its use to avoid a proliferation of antidumping measures that would frustrate the market access expectations created by the reciprocal tariff concessions of GATT.[30] Additional discipline over antidumping measures was introduced in the 1960s with the conclusion of the first GATT Antidumping Code. The Code was revised during the Tokyo Round, and after further changes became the ADA during the Uruguay Round.[31]

Note that GATT members are under no obligation to prevent their exporters from engaging in dumping, and of course WTO/GATT law does not bind private exporters. GATT Article VI(1) simply provides that 'dumping, by which products of one country are introduced into another country at less than the normal value of the products, is to be condemned if it causes or threatens material injury to an established industry . . . or materially retards the establishment

[29] 15 USC § 72.
[30] See generally Jackson (1969).
[31] See generally Jackson (1997).

of a domestic industry'. The remedy for dumping, however, lies entirely with the importing country, in the form of antidumping duties, 'not greater in amount than the margin of dumping'. (GATT Art. VI(2)). In this section, I address the task of determining whether dumping exists, and of measuring its magnitude (the 'margin of dumping'). Injury will be considered in the next section.

Antidumping investigations proceed in several stages. The first stage, 'initiation', generally involves a petition from a domestic industry alleging that dumping and injury (or threat) are present and setting forth evidence in support of that claim.[32] If the investigating authorities find the evidence presented to be both accurate and adequate, a formal investigation will begin. They will then gather further information from both exporters and domestic petitioners regarding the existence of dumping and injury, and will commonly make preliminary determinations on these issues. If the preliminary determinations are 'affirmative' on both issues, provisional duties may be imposed.[33] After affirmative preliminary determinations, there may also be an opportunity for a settlement of sorts in the form of a price undertaking from exporters. Absent a settlement, the investigating authorities will next proceed to audit the information provided to them by exporters for accuracy, and to entertain further arguments from all interested parties regarding the magnitude of dumping and the injury issue. Ultimately, they must make final determinations on the dumping and injury questions, and if both determinations are affirmative, the investigating authorities will impose definitive antidumping duties. Note that the ADA contains a *de minimis* rule, and forbids duties when the margin of dumping is less than 2% of the export price.[34]

On the existence and magnitude of dumping, Article VI(1) states that an exported product is sold below 'normal value' when its price (a) 'is less than the comparable price, in the ordinary course of trade, for the like product when destined for consumption in the exporting country, or, (b) in the absence of such domestic price, is less than either (i) the highest comparable price for the like product for export to any third country in the ordinary course of trade, or (ii) the cost of production of the product in the country of origin plus a reasonable allowance for selling cost and profit'. Thus, an export price may be judged a dumping price with reference to three benchmarks: the 'comparable' price of the like product sold by the exporter in its home market in the 'ordinary course of trade'; the 'comparable' price of the like product sold by the

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[32] See ADA Art. 5. In exceptional circumstances, investigating authorities can self-initiate investigations. ADA Art. 5.6.

[33] See ADA Art. 7.

[34] ADA Art. 5.8.

exporter to a third country in the 'ordinary course of trade'; and what is generally termed the 'constructed value' of the good, which is equal to its 'cost of production' plus a reasonable allowance for general, selling and administrative expenses and profit. In turn, the 'margin of dumping' will equal the difference between the price of the exported good, adjusted as necessary to make it 'comparable', and one of these three benchmarks. This same basic approach, now considerably elaborated, is now contained in Article 2 of the ADA.

Several remarks are in order about the use of these benchmarks in practice and under the ADA. *First*, importing nations are not free to pick and choose among the benchmarks. The *preferred* benchmark is the 'comparable' price of the 'like product' sold by the exporter in its home market. Importing nations may use another benchmark only when home market sales do not establish a reliable benchmark. Why might this problem arise? The obvious possibility is that the exporter in question does not sell the 'like product' in its home market. ADA 2.6 defines 'like product' as 'a product which is identical, i.e. alike in all respects to the product under consideration, or in the absence of such a product, another product which, although not alike in all respects, has characteristics closely resembling those of the product under consideration'. If the exporter does not sell an identical product in the home market, therefore, it is permissible to use the price of a similar product to establish the benchmark. Adjustments to the price must then be made to account for differences between the products – if the product sold at home is more expensive to produce, for example, one might expect it to sell for a higher price, and it would be inappropriate to conclude that dumping is present simply because the product sold in the home market has a higher cost of production. These adjustments can become complex, and may rest on shaky assumptions about cost differences. At some point, the dissimilarities between products may become so great that confident adjustments are impossible. And in some cases, an exporter simply does not sell any plausibly 'similar' products at home. The importing nation must then turn to one of the other benchmarks.

A related problem may arise when the exporter has some home market sales of a 'like product', but they are very small in number.[35] A possible concern in such cases is that the exporter may be manipulating home-market sale prices downward simply to avoid a finding of dumping, so that the home-market benchmark becomes unreliable. That concern also arises when home-market sales are made to a related company and may not reflect arm's-length pricing.[36] Prices charged between related parties may be manipulated with an eye on the antidumping laws, and need not be used as the basis for

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35 See ADA 2.2.
36 Id.

comparisons.[37] Sometimes this problem can be solved by looking further down the chain of distribution to subsequent arm's-length sales, but such transactions may not always be available.

Lastly, it is permissible to disregard home market sales as being outside the 'ordinary course of trade' if they are made 'below per unit (fixed and variable) costs of production plus administrative, selling and general costs', if they are also made over an 'extended period of time' and in 'substantial quantities'.[38] After such sales are disregarded, there may be no sales left in the home market, or too few of them to establish a reliable benchmark.

If the home market benchmark cannot be used, the ADA makes clear that the next preferred alternative is the 'comparable price' on the 'like product' sold to a third country.[39] The importing nation will select the third country to use for this benchmark when more than one are plausible candidates. ADA 2.2 directs that the third country be 'appropriate' and that the comparison price be 'representative', but in practice importing nations can often choose the third country that yields the highest benchmark (and thus the highest margin of dumping). The third-country benchmark may prove unusable, however, for essentially the same reasons as the home-market benchmark – there may be no sales of like products to third countries, they may be very few in number or made to related parties, or they may be below cost. In that event, the importing nation must turn to the third benchmark, constructed value.

Second, in the price-to-price cases (home-market or third-country benchmark), it is essential to compare prices at the same 'level of trade' – a comparison of 'apples to apples'. The ADA deems it inappropriate to compare the retail price in one country, for example, with the wholesale price in another. ADA 2.4 requires a price comparison 'normally at the ex-factory level, and in respect of sales made at as nearly as possible the same time'. This requirement necessitates an additional set of price adjustments beyond those for any physical differences between the 'like product' and the imported product noted earlier. Typically, for example, an importing nation may have information on the delivered prices of imported goods. It must then deduct built-in costs like freight and insurance to work back to the ex-factory prices, and may be required to make the same adjustments to home-market or third country prices. These adjustments become even more extensive when sales to related parties are present, and the investigating authorities must look farther down the chain of distribution to find an arm's-length price with which to begin the analysis.

The desire to compare apples to apples in the price-to-price cases can

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[37] ADA 2.3.
[38] ADA 2.2.1.
[39] ADA 2.2.

necessitate a range of other adjustments as well. For example, suppose that sales in one market are to large customers who negotiate quantity discounts in the ordinary course, while sales in another market are to small customers who do not receive discounts. Or suppose that goods are marketed in different ways in different markets, with considerable differences in selling expenses. Many other factors might be imagined that affect the prices of the goods in question,[40] and that must be made the subject of an adjustment lest dumping be found (or not) even though, from the seller's perspective, the same net price is being charged to comparable buyers.

Third, certain additional adjustments are required by GATT law to avoid impermissible findings of dumping. Article VI(5) provides that if a product benefits from an export subsidy, so that the export price is below the home-market price by the amount of the subsidy, and if that product is subject to a countervailing duty as a result, it cannot also be subjected to an antidumping duty to counteract the price differential as dumping (and vice versa). In an antidumping case, therefore, the amount of a countervailing duty imposed on the same good to counteract an export subsidy will be added into the price of the exported good to reduce the margin of dumping and prevent a 'doubling up' of the duties. Likewise, Article VI(4) prohibits antidumping duties where the price differential results from a rebate on exportation, or an exemption for exports, for certain qualifying taxes. Visitors to Europe, for example, may recall the opportunity to obtain a refund of the VAT on goods that they purchase in Europe and take home with them. The same rebate is available to firms who export from Europe. The VAT is built in to the price of goods in Europe, and so if the price for exports were calculated net of the VAT refund, it would be lower than the home-market price by that amount and dumping would appear to be present. To avoid such a result, VAT refunds and certain other qualifying rebates or exemptions will be added to the price of the exported good to reduce the margin of dumping. It bears emphasis that not all taxes qualify for rebate or exemption, which has sparked a longstanding debate over whether particular tax systems (such as a VAT) create an advantage for exporters in international trade.[41]

Fourth, the computation of dumping margins requires some method for comparing and averaging data. Dumping investigations may involve vast numbers of transactions, both in the importing nation and the home country or third country market, and the ADA provides three possible ways for the information from the pertinent transactions to be aggregated to produce a dumping margin. The first is to compute a weighted average of the export prices, to be

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[40] See ADA 2.4.

[41] For further information, see the chapter by Julie Roin in this volume.

compared with a weighted average of the home-market or third-country transactions. The second is to compare export prices and home-market prices on a transaction-to-transaction basis, and then to create an average of these individual comparisons to establish the dumping margin. Under limited circumstances, dumping margins may also be based on a comparison of individual export transaction prices with a weighted average of home-market or third-country prices.[42] As of yet, the Appellate Body has said little about when these different comparison methods can or should be used, and the ADA itself provides only modest guidance.[43]

An issue relating to the comparison that has surfaced repeatedly in dispute proceedings concerns the practice of 'zeroing'. As a simple illustration, imagine that an importing nation is using the transaction-to-transaction method, and imagine a total of four sales of identical products, two in the home market and two in the importing nation. In month one, a home-market sale occurs at $4 and an export sale at $5. In month two, a home-market sale occurs at $5 and an export sale at $4. The average of the two sales in each market is $4.50. With 'zeroing', however, the investigating authorities conclude that there is no dumping in month one, and the margin of dumping for that month is set at zero. They conclude that a dumping margin of $1 is present in month two. The margin of dumping is then computed to be ($0 + $1)/2 = $.50, even though a comparison of the average home-market price with the average export price would yield a zero margin of dumping. The same issue can easily arise when the importing nation compares weighted-average normal value prices to individual export transaction prices. Less transparently, it can also arise in weighted-average to weighted-average comparisons because in many cases, investigating authorities will break down the products under investigation into subcategories for purposes of comparability, and the practice of zeroing across the subcategories will have a similar effect when the data from the subcategories are re-aggregated to produce a 'weighted average of the weighted averages'. In the cases decided thus far, the Appellate Body has ruled against the practice of zeroing, although it has not yet confronted all conceivable scenarios in which it might be used.[44]

Fifth, although dumping is a practice in which individual firms engage, firms involved in dumping cases may or may not be aggregated for the

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[42] ADA 2.4.2.

[43] For the current approach of the US Commerce Department, see 19 C.F.R. §351.412.

[44] See *European Communities – Anti-Dumping Duties on Imports of Cotton-Type Bed Linen from India*, WT/DS141/AB/R (2001); *United States – Final Dumping Determination on Softwood Lumber from Canada*, WT/DS264/AB/R (2004). The Bed Linen case is discussed in Janow and Staiger (2003).

purpose of computing a dumping margin. Antidumping cases generally encompass all of the exports of covered products from a given country, not just those of selected exporters. The ADA states that, 'as a rule', investigating authorities should determine individual dumping margins for each exporter.[45] But where that becomes impracticable because large numbers of exporters are involved, the investigating authorities may instead employ statistically valid samples, or may investigate the exporters supplying the largest percentage of the volume of exports that it is reasonably practicable to investigate. Exporters who desire to be investigated individually but who are excluded from the sample chosen by the investigating authorities may submit individual information to the authorities nonetheless, who must then determine an individual margin if the information is sufficient and the task is not unduly burdensome or time consuming. Exporters who are not individually investigated will be subject to antidumping duties based on averages for the exporters who are investigated.[46]

Sixth, any examination of dumping is necessarily based on information about past transactions or costs, but antidumping duties are applied going forward after dumping is found (if injury is also found as discussed below), and WTO law requires that such duties 'not exceed the margin of dumping'. What ensures that duties applied to future transactions will not exceed the margin of dumping, when that margin is calculated on the basis of historical information? The ADA provides for two approaches to the assessment of duties, 'retrospective' and 'prospective'.[47] Both approaches must be designed to ensure that exporters have an opportunity to receive refunds for any duty paid in excess of the actual margin of dumping. In the US system, for example, the Commerce Department will conduct an administrative review periodically to examine the transactions to which an antidumping duty has been applied. Excess duties are refunded, and if the margin of dumping has increased the importer of record will be responsible for the difference.

It may occur to the reader to ask why an exporter would ever continue dumping once subject to an antidumping duty – why not cease dumping, and then collect a full refund of antidumping duties paid down the road (or allow one's customers to collect the refund)? One answer is that to obtain a full refund, the exporter must raise its price to offset the margin of dumping, while its customers pay *in addition* the full antidumping duty for a period of time until the issue of a refund is adjudicated. Customers may simply turn elsewhere. In

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[45] ADA 6.10. A dispute over this obligation arose in *Argentina – Definitive Anti-Dumping Duties on Imports of Ceramic Floor Tiles from Italy*, WT/DS189/R (2001).

[46] See ADA 6.10, 9.4.

[47] ADA 9.3.

addition, as noted below, a full refund may be far from a certainty, because many factors make it difficult for exporters to know by how much they will be found to be dumping.

Seventh, an exporter can only dump in an importing nation if it is aware that its goods are being sold to that nation. For example, suppose that an exporter sells its goods to a trading company without knowledge as to where the trading company will resell them, and the goods are later resold by the trading company at different prices in different national markets. In this chain of distribution, only the trading company can engage in dumping, not the original exporter. Likewise, when goods are sold by a company in country A to another company in country B without knowledge as to their ultimate destination, and the second company then re-exports them to country C, only the company in country B can engage in dumping, and its resale price in country B would provide the relevant home-market benchmark.[48]

Eighth, even though dumping in principle involves a deliberate decision by a firm to sell to the importing nation at a price below the pertinent benchmark, firms often 'dump' by accident. As should now be clear, the computation of a dumping margin is a complicated undertaking. Complex price adjustments are required, which may be based on controversial assumptions about costs and cost allocation. Averaging methods may be used that can inflate apparent dumping, and the time period for price comparisons can be chosen strategically to maximize the evidence of dumping as well. If the constructed value benchmark is used, investigating authorities may assess the cost of production and the additional expenses that may be added to constructed value using data that a firm may not ordinarily gather itself, and using assumptions about cost allocation that are unpredictable or with which the firm may disagree. Investigating authorities are not required to accept everything submitted to them at face value, and will generally insist on verifying its accuracy, rejecting information that is unverifiable. In that event, investigating authorities may turn to other sources of information to complete their analysis, information termed 'facts available', which in practice may involve reliance on allegations submitted by the domestic industry seeking antidumping duties.[49] Exporters are also to some extent at the mercy of currency fluctuations, which may convert their prices into dumping prices unexpectedly.[50] As a result, it is exceedingly easy for exporters to find themselves 'dumping' notwithstanding their best efforts to avoid it.

Ninth, once an exporter is found to be dumping and becomes subject to

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[48] See ADA 2.5.
[49] See ADA 6.8, Annex II.
[50] See ADA 2.4.1.

antidumping duties, it may be exceedingly difficult for that exporter to escape them later. To be sure, the ADA does require investigating authorities to entertain requests by exporters for reinvestigation if they allege that circumstances justifying the antidumping duty have changed, and further requires a 'sunset review' of antidumping duties every five years to ascertain whether the removal of the duty would likely lead to continuation or recurrence of dumping and injury.[51] On what basis may such a determination be made? In US practice, for example, the fact that dumping continues after an antidumping duty is in place is treated by the investigating authorities as evidence strongly supporting the continued need for the duty. Likewise, even if dumping ceases after a duty is in place, the fact that import volumes decline or fall to zero after the cessation of dumping is taken to be evidence of the continued need for the duty. Thus, whether the exporter ceases exports to the United States, raises price to avoid dumping and then suffers a large but not complete loss of business, or continues dumping to avoid losing market share, the investigating authorities will likely conclude during the sunset review that the duty should be maintained. The only case where the authorities will likely conclude that the duties are unnecessary is where dumping has ceased, and imports of the goods covered by the duty were steady or rising after the duty was imposed – a scenario unlikely to materialize very often. The Appellate Body has suggested that this policy is not on its face inconsistent with the ADA as long as the investigating authorities are willing to give proper weight to other considerations that may rebut the inference that dumping and injury are likely to recur.[52]

Tenth, antidumping cases may be 'settled'. After preliminary findings of dumping and injury by investigating authorities, exporters may enter 'price undertakings' to revise their prices upward to a level that either eliminates the dumping fully or avoids its injurious effects.[53] From the exporter's perspective, such agreements will often be preferable to the imposition of antidumping duties for the obvious reason that the exporter will retain the price increase, rather than see an antidumping duty paid by its customers to the importing nation. A fair number of cases are settled in this fashion, but many are not. Several reasons may be offered. In many instances, exporters accused of dumping face stiff competition from firms in the importing or a third nation, which do not face any prospect of antidumping duties. A price undertaking may force such an exporter out of the market, and its only hope of remaining

[51] See ADA 11.3.

[52] See *United States – Sunset Review of Anti-Dumping Duties on Corrosion-Resistant Carbon Steel Flat Products from Japan*, WT/DS244/AB/R (2003).

[53] See ADA Art. 8.

competitive may be to proceed to the conclusion of the investigation in the hope of prevailing on the dumping or injury issues. Relatedly, although the ADA prohibits price undertakings before the investigating authorities determine preliminarily that dumping and injury are present, in practice the authorities are unlikely to be interested in pursuing a price undertaking after final determinations on those issues have been made – the threat of the final determination exists as a sort of leverage to extract the price undertaking. When the outcome of the final determination appears uncertain, exporters may not be willing to offer a price undertaking with which the investigating authorities are satisfied, and may then prefer to take their chances by pursuing the case to conclusion.[54] In addition, investigating authorities need not accept price undertakings if their negotiation and administration is deemed impractical, as when a case involves a very large number of exporters – it is easily possible to imagine that exporters might 'cheat' on their price undertakings, and investigating authorities will tend to reject them unless they are satisfied with their ability to verify compliance. Further, the investigating authorities will not accept price undertakings unless a group of exporters accounting for substantially all of the imports from the country under investigation agree to them, and some of the exporters may balk (such as those that expect ultimately to demonstrate the absence of dumping on their part through an individual investigation). Lastly, investigating authorities might be expected to exhibit some bias against price undertakings, for the same reason that exporters might prefer them – a price undertaking represents a loss of revenue from the national treasury to the exporter, relative to an antidumping duty.

The remarks above are by no means a complete guide to the ADA. I have emphasized the substantive aspects of the investigation into the existence and magnitude of dumping, for example, over the procedural aspects. The ADA contains numerous other provisions regarding access to proceedings by interested parties, notice and publication of proceedings and findings, the presentation of evidence and the protection of confidential information, the requirements for the initiation of investigations, the standing of parties to seek antidumping duties, and other details regarding the conduct of proceedings and reviews. The major category of substantive obligations not yet discussed pertains to the analysis of injury in antidumping cases, the subject of the next section.

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[54] This problem is an example of the 'optimism' model in the economics of litigation – if plaintiffs are more optimistic about their chances of winning or the size of their victory than defendants, then there may be no bargaining range within which settlement can occur.

Before proceeding, however, note one unique feature of the ADA that must be borne in mind whenever any controversies arise as to its interpretation. Article 17.6 of the ADA provides a special standard of review to be applied in WTO antidumping disputes. In particular, '[w]here the panel finds that a relevant provision of the Agreement admits of more than one permissible interpretation, the panel shall find the authorities' measure to be in conformity with the Agreement if it rests upon one of those permissible interpretations'.

2.3. The injury test under the ADA (and the SCMA)

The so-called 'injury test' under WTO law operates more or less identically in antidumping and countervailing duty proceedings. Accordingly, I will address it only once in this chapter with particular reference to the ADA – the reader should recognize that nearly identical provisions exist in the SCMA. [55]

GATT Article VI(6)(a) provides that no party shall employ antidumping or countervailing duties 'unless it determines that the effect of the dumping or subsidization, as the case may be, is such as to cause or threaten material injury to an established domestic industry, or is such as to retard materially the establishment of a domestic industry'. The last clause, sometimes termed the 'material retardation' test, is of little importance in practice and I shall not dwell on it.[56] Virtually all dumping investigations in practice are focused instead on the question of whether dumped imports are a cause of current or threatened material injury to an established industry.

To answer this question, investigating authorities must begin by determining the set of domestic producers who compete with the imports under investigation. This yields the 'definition of domestic industry' in the parlance of ADA Article 4, and is an exercise somewhat akin to (though imperfectly) the task of defining the relevant market in antitrust cases. In general, the domestic industry is to be defined as the 'domestic producers as a whole of the like products'. The concept of the 'like product' thus appears in the injury context too (recall that the price-to-price comparisons for computing a dumping margin are to the properly adjusted prices of home-market or third-country 'like products'), and the definition of the term noted earlier applies equally here. It is permissible to exclude from the domestic industry any companies that are 'related' to the exporters under investigation.[57] In exceptional cases where competition is highly regionalized within the territory of the importing nation, such that producers in one region sell little or none of their production

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[55] Compare ADA Arts. 3 and 4 with SCMA Arts. 15 and 16.

[56] It is easy to see why the material retardation test is unimportant. Dumping cases are generally initiated at the behest of a competing domestic industry – if no such industry yet exists, there is rarely any constituency for antidumping action.

[57] Note 11 to Art. 4.1 defines the concept of relatedness.

in other regions, it is also permissible to define two or more regional industries and to impose limited antidumping duties if only one of them satisfies the injury test.[58] Finally, the members of a customs union or free trade area may define a single industry encompassing all of their territories.[59]

Article 4.1 makes some allowance for the possibility that the number of domestic producers may be vast, making it difficult to survey them all in assessing injury – thus, it is enough to include 'those of them whose collective output of the products constitutes a major proportion of the total domestic production'. Article 3.6 makes a related allowance for data issues that may arise in the assessment of injury. If it is not possible to obtain reliable data limited to the domestic production of the like product, the injury analysis may be based on an 'examination of the production of the narrowest group or range of products, which includes the like product, for which the necessary information can be provided'.

Once the industry is defined, investigating authorities must then determine whether 'the effect of the dumping . . . is such as to cause or threaten material injury' to that industry (GATT Art. VI(6)). ADA Article 3.1 elaborates by stating that a determination of injury must rest on 'an objective examination of both *(a)* the volume of the dumped imports and the effect of the dumped imports on prices in the domestic market for like products, and *(b)* the consequent impact of these imports on domestic producers of such products'. The differences in language relate partly to a longstanding debate under US law as to whether a causal link must be drawn between material injury and *dumping*, or only between material injury and *dumped imports*. The difference between the two may not be obvious, but consider the following illustration: Suppose that exporters under investigation have a 20% market share in the importing nation, and that all of their imports are dumped at a margin of only 2%, just above the *de minimis* threshold. If one focuses on the large market share, it may be easy to conclude that the effect of the *dumped imports* on domestic producers is material. If one focuses instead on the small dumping margin, however, one might in some cases conclude that the effect of *dumping* is not material, in the sense that a 2% change in the price of the imports might have little impact. ADA Article 3 seems deliberately designed to perpetuate the debate over the proper standard. Articles 3.2–3.5 refer repeatedly to effects caused by 'dumped imports'. And with regard to the size of the dumping margin, Article 3.4 simply lists it as one of the 'relevant economic factors and indices' that must be part of the 'evaluation' by the investigating authorities. But Article 3.5 then provides: 'It must be demonstrated that the dumped

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[58] See ADA Art. 4.1(ii), 4.2.
[59] ADA 4.3.

imports are, through the effects of dumping, as set forth in paragraphs 2 and 4, causing injury within the meaning of this Agreement'. The second clause seems to require a causal link to dumping, while the third undercuts that interpretation by referring back to paragraphs 2 and 4, which refer only to the effects of 'dumped imports'. At this writing, the Appellate Body has yet to weigh in on the issue.

Otherwise, the central approach of ADA Article 3 is to require that certain factors be taken into account by investigating authorities in their analysis of injury, without saying how much weight they should be given, or how as a methodological matter their 'consideration' is to proceed. Paragraphs 2, 4 and 5 are the key provisions:

> 3.2 With regard to the volume of the dumped imports, the investigating authorities shall consider whether there has been a significant increase in dumped imports, either in absolute terms or relative to production or consumption in the importing Member. With regard to the effect of the dumped imports on prices, the investigating authorities shall consider whether there has been a significant price undercutting by the dumped imports as compared with the price of a like product of the importing Member, or whether the effect of such imports is otherwise to depress prices to a significant degree or prevent price increases, which otherwise would have occurred, to a significant degree. No one or several of these factors can necessarily give decisive guidance.

> 3.4 The examination of the impact of the dumped imports on the domestic industry concerned shall include an evaluation of all relevant economic factors and indices having a bearing on the state of the industry, including actual and potential decline in sales, profits, output, market share, productivity, return on investments, or utilization of capacity; factors affecting domestic prices; the magnitude of the margin of dumping; actual and potential negative effects on cash flow, inventories, employment, wages, growth, ability to raise capital or investments. This list is not exhaustive, nor can one or several of these factors necessarily give decisive guidance.

> 3.5 It must be demonstrated that the dumped imports are, through the effects of dumping, as set forth in paragraphs 2 and 4, causing injury within the meaning of this Agreement. The demonstration of a causal relationship between the dumped imports and the injury to the domestic industry shall be based on an examination of all relevant evidence before the authorities. The authorities shall also examine any known factors other than the dumped imports which at the same time are injuring the domestic industry, and the injuries caused by these other factors must not be attributed to the dumped imports. Factors which may be relevant in this respect include, *inter alia*, the volume and prices of imports not sold at dumping prices, contraction in demand or changes in the patterns of consumption, trade restrictive practices of and competition between the foreign and domestic producers, developments in technology and the export performance and productivity of the domestic industry.

Article 3.2 lists factors that will be quite familiar to US antidumping lawyers, as they have been central to decisions by the US ITC for many years. An increasing volume or market share for the dumped imports weighs in favor of a finding of injury, particularly if the increases are correlated with declining prosperity for the domestic industry. Such analysis is subject, of course, to the objection that correlation does not prove causation, doubly so if a causal link is required to *dumping*. The search for price undercutting by dumped imports is also a commonplace, even though such price differentials may simply reflect the fact that the dumped imports are lower quality products that must sell for less in equilibrium. The question whether dumped imports have suppressed domestic prices is a more logical question to ask from an economic standpoint, although nothing is said in Article 3.2 about how that question should be answered. In practice, investigating authorities may rely heavily again on a simple correlation between import quantities or prices on the one hand, and domestic prices on the other.

Article 3.4 merely lists a number of factors that must be evaluated by the investigating authorities in deciding whether injury is present, again without saying how or indicating how much weight each should receive. WTO antidumping disputes to date make clear, however, that investigating authorities would be wise to ensure that they expressly 'consider' every factor, along with any others brought to their attention by parties to the investigation.[60]

In addition to the confusing phrasing regarding the requisite causal link discussed above, Article 3.5 contains the 'non-attribution' requirement of the ADA. Again without saying how the investigating authorities are to perform the task, the investigating authorities must 'examine' all of the 'known factors' that are causing injury to the domestic industry, and ensure that such injury is not attributed to dumped imports.[61] Investigating authorities may indeed run foul of this provision if a known factor is before them and they do not provide adequate evidence that it has been 'considered', or that its effects have somehow been separated from the effects of dumped imports.[62]

I note in passing that nothing in Article 3 clearly speaks to an issue that has divided ITC Commissioners under US law – the choice between 'bifurcated'

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[60] See *Thailand – Anti-dumping Duties on Angles, Shapes and Sections of Iron or Non-Alloy Steel and H-Beams from Poland*, WT/DS122/AB/R (2001); Egypt – Definitive Anti-Dumping Measures on Steel Rebar from Turkey, WT/DS211/R (2002).

[61] In *European Communities – Anti-Dumping Duties on Malleable Cast Iron Tube or Pipe Fittings from Brazil*, WT/DS219/AB/R (2003), the Appellate Body held that the other known factors may be considered individually and need not be assessed collectively.

[62] See *United States – Anti-Dumping Measures on Certain Hot-Rolled Steel Products from Japan*, WT/DS184/AB/R (2001).

and 'unitary' injury analysis. 'Bifurcated' analysis first asks whether the domestic industry is suffering 'material injury', i.e., some degree of distress, in an absolute sense. Only if the answer to that question is yes does the analysis proceed to the second stage and inquire into the cause of the material injury. 'Unitary' analysis does not search for indicia of distress relative to normal times, but instead simply asks whether the domestic industry would be materially better off without the dumping (or dumped imports). Hence, unitary analysis might find injury to an industry that is 'healthy' in an absolute sense. My reading of the ADA suggests that both approaches are permissible, although the issue has not been raised in WTO dispute proceedings at this writing.

Two other provisions in ADA Article 3 warrant a mention. Article 3.3 allows for what is generally termed 'cumulation'. When a dumping investigation involves imports from only one country, it is understood that all exporters from the country may be aggregated for purposes of examining, for example, the volume of dumped imports, even if the exporters will later receive individual margins and duties. Article 3.3 authorizes a similar practice for purposes of injury analysis when the investigation covers exporters from more than one country. Their exports may be 'cumulated' if the exporters from each nation have a non-*de minimis* dumping margin, the quantity of imports from each nation is not 'negligible', and a 'cumulative assessment of the effects of the imports is appropriate in light of the conditions of competition'. The effect of cumulation, of course, is that exporters from countries with small volumes of exports may be swept into an investigation, and ultimately subjected to duties, even though the investigating authorities might not consider them to have a material impact on the domestic industry if viewed in isolation. Likewise, cumulation may result in the imposition of duties on exporters whose exports have been declining, and might not be viewed as sufficiently correlated with decline in the domestic industry if analyzed in isolation.

Finally, Articles 3.7–3.8 add some special provisions regarding affirmative determinations of injury based on threatened injury alone. Such cases are to be decided with 'special care', the threatened injury must be 'clearly foreseen and imminent', and the investigating authorities must address four additional factors as part of their analysis. WTO decisions to date do indicate that dispute panels may take a particularly hard look at the investigating authorities' reasoning when an affirmative injury finding rests solely on threat.[63]

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[63] See *United States – Investigation of the International Trade Commission in Softwood Lumber from Canada*, WT/DS277/R (2004) (affirmative threat determination based on 'finding of a likely imminent substantial increase in imports is not one which could have been reached by an objective and unbiased investigating authority in light of the totality of the factors considered').

The reader may well have noted that the ADA leaves much open, including the basic methodological approach to injury analysis in dumping cases. National authorities often proceed quite loosely, relying as noted on simple correlations and other economically questionable methods for drawing a causal link between dumping and injury. A number of economic commentators have suggested ways to give the analysis of injury more structure and coherence. See Boltuck (1991); Kaplan (1991); Knoll (1989); Murray and Rousslang (1989). Although these proposals differ in some particulars, the thrust of each is to suggest that investigating authorities use some form of econometric or simulation modeling to estimate the impact of dumping quantitatively. Given econometric estimates or otherwise plausible assumptions about the magnitude of dumping, the quantity of dumped imports in the market, the elasticity of domestic supply and demand, the elasticity of the supply of non-dumped imports, and the degree of substitutability between imports and domestic products, computer models can generate estimates about the impact of dumping on domestic production and prices, and can be expanded to yield results about other relevant variables in the domestic industry as well (for example, employment). The Office of Economics at the US ITC has produced simulation results based on such modeling exercises quite regularly, although few Commissioners have relied heavily on them in their analysis.

Widespread adoption and reliance on such methods would, if done carefully, bring much more economic coherence to the assessment of injury by national authorities.[64] It is not obvious, however, that economic coherence in injury analysis is of any particular utility – for reasons that the next section will elaborate, antidumping policy itself is of dubious economic value, and one may doubt whether a more coherent implementation of only one aspect of that policy will improve it. In particular, recall that the injury test requires nothing more than 'material injury', which is understood to impose a fairly low threshold for an affirmative finding (contrast 'serious injury' in the safeguards area). It will be an extremely rare instance in which a simulation exer-

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[64] The models used in practice do not explicitly identify the effects of other 'known factors,' and it is not entirely clear whether they might be perceived as running afoul of the 'non-attribution' requirement as described in the cases. See *United States – Anti-Dumping Measures on Certain Hot-Rolled Steel Products from Japan*, WT/DS184/AB/R (2001). Logically, they simulate the partial equilibrium effect of a change in dumping alone, and so would not attribute to dumping injury caused by other factors. Whether the Appellate Body would accept this point as satisfactory 'non-attribution' reasoning is unclear. If the investigating authorities must also quantify in systematic fashion the effects of all other 'known factors', the costs of proceeding in an economically careful fashion rise dramatically.

cise does not show *some* adverse impact of dumping on domestic prices and production. Might investigating authorities that are otherwise inclined to decide in favor of the domestic industry not simply label the effect as 'material' and declare victory? Would the Appellate Body second guess a determination that injury is 'material' if investigating authorities otherwise jump through all the hoops? For those who believe that antidumping policy ought be curtailed, it is not clear whether economically rigorous injury analysis would help or hinder. Sykes (1996) develops this theme at length.

This last observation raises another general issue. Because the injury test is so loosely framed under WTO law, and the findings by investigating authorities rest on analysis that is quite malleable, one might wonder whether the whole exercise in the end turns on political considerations rather than on any economic 'merits'. Finger, Hall and Nelson (1982) hint at an affirmative answer to this question. Anderson (1993) responds in the negative.

2.4. Economic commentary on antidumping policy

Antidumping law found an early friend in the respected economist Jacob Viner. Viner (1923) introduced a distinction that survived for some time in the literature between 'sporadic' dumping, 'short-run' dumping, and 'permanent' dumping. 'Sporadic' dumping was extremely short-lived, as for the purpose of disposing of a temporary overstock, and Viner viewed it as benign even if an irritant to competitors. 'Permanent' dumping is continuous over a period of many years, as perhaps when the home market is protected from competition but export markets are competitive, and Viner believed here that the gains to consumers from such dumping would outweigh the losses for domestic firms. But where dumping is 'short run' – of significant but not indefinite duration – Viner believed that the injury to the domestic industry might be severe, and might outweigh the gains to consumers. That danger was most acute when the domestic industry would be driven out of business and exporters would later enjoy a monopoly, but Viner did not believe that outcome necessary for short-run dumping to be harmful. He argued that even if prices do not rise above their previous levels after dumping ceases, a net loss is likely to arise because short-run dumping leads domestic workers and firms to sit around idle while waiting for it to stop.

Viner further believed that much dumping was of the short-run variety. He noted correctly that prices below long-run average costs of production are by definition unsustainable (although the short run can last many years). He evidently believed that price discrimination dumping (prices below home-market or third-country prices) is also likely to be temporary, although a clear explanation for that belief is lacking. Modern economics suggests that price discrimination dumping (when it is deliberate rather than accidental) will tend to occur mainly because exporters face different demand elasticities in different

markets – firms with market power will sell at higher prices in markets where demand is less elastic. The home-market price can be higher, for example, for no other reason than the fact that it has a higher protective tariff, allowing firms to charge more in their home markets. There is no reason to think that this situation is necessarily short run. Nevertheless, on the basis of his twin premises – that short-run dumping was injurious to the importing nation, and that most dumping was short run – Viner argued that dumping in general should be condemned.

Viner wrote in the early days of modern microeconomics, and made no attempt to formalize his argument or to identify carefully the assumptions necessary for it to be true. Modern economists find the analysis questionable. If factor markets clear at competitive prices and if expectations regarding the duration of dumping are rational, one would expect resources to remain idle in response to short-run dumping only if that is their best expected use under the circumstances. The loss to the owners of those resources should be smaller than the gain to consumers for much the same reasons that yield efficiency in any competitive equilibrium. Viner's argument requires some market imperfection or error in expectations that prevents efficient adjustment to temporarily cheap imports, and he gives us no reason to expect that such problems will arise routinely. Likewise, and even more importantly, if the government is to have the capacity to take corrective measures sensibly, it must be able to identify industries suffering from these market failures. Certainly, nothing in the antidumping law itself requires a search for indicia of these market imperfections. The modern economic literature on choice of policy instruments also casts doubt on the soundness of Viner's position. If the difficulty lies with some imperfection in the labor market that leads to inefficiently long periods of unemployment, for example, the modern literature would suggest that the proper policy instrument is direct intervention in the labor market, as perhaps with a wage subsidy.

Since the work of Viner, the positive and normative economics of dumping and antidumping measures have received a great deal of further study. On the positive side, new reasons for the existence of dumping have been identified, such as various kinds of uncertainty across markets. See, for example, Ethier (1982). Dumping within industries that fit the 'strategic trade' models has also been exhaustively analyzed. See, for example, Gruenspecht (1988), Dick (1991).

On the normative side, the weight of modern commentary has been highly critical of antidumping policy. It is generally argued that the only plausibly useful function of the antidumping laws from an efficiency standpoint is the avoidance of predatory pricing and monopolization by foreign firms. Many commentators note that this objective can be accomplished through the antitrust laws without the need for a separate antidumping law.

More importantly, antidumping law is not simply redundant of antitrust policy. Price discrimination dumping (when deliberate) likely occurs in most instances because of differences in demand elasticities, as noted, and not because of predation. Sales below 'constructed value' are commonplace in many markets as well, particularly when demand is weak or new competitors have entered. Hence, investigating authorities will find dumping in circumstances where firms are in no way embarked on a campaign of monopolization. Likewise, if the underlying concern were for monopolization, antidumping measures would be restricted to concentrated markets exhibiting entry and re-entry barriers so that a monopolistic outcome is plausible. Nothing in the modern definition of dumping or the injury test imposes such a restriction. See, for example, Barcelo (1972); Deardorff (1993); Hindley and Messerlin (1996): Ordover, Sykes and Willig (1983).

If modern antidumping law is badly tailored to addressing any *bona-fide* problem, it is nevertheless worth noting that antidumping duties may, in some instances, yield economic benefits by coincidence. At least three scenarios may be identified in which such benefits may arise.

First, taking a global welfare perspective, antidumping duties will to some degree discourage international price discrimination. Much as the domestic welfare effects of imperfect price discrimination are indeterminate, so are its effects across global markets, and it is *possible* that global welfare will increase because antidumping policy reduces the degree of output constriction by firms with market power. Of course, the opposite outcome is also possible. Second, from a national welfare perspective, antidumping duties may benefit large nations that are not already charging their 'optimal tariff'. The logic here is that large nations have a degree of monopsony power, and can exploit it through tariffs that extract rents from foreign exporters by inducing them to lower their prices. Antidumping duties might by chance yield a welfare gain to a large importing nation (but not the world as a whole) for this reason, although again the opposite outcome is certainly possible. Third, in industries fitting the strategic trade paradigm – an industry that exhibits increasing returns to scale that can eventually earn monopoly rents at the expense of foreign consumers, or that generates positive externalities that do not cross national borders – it is well known that protection can enhance national economic welfare. See Gruenspecht (1988), Dick (1991). There is no reason to think that a duty equal to the margin of dumping calculated under existing law is the best duty for this purpose, of course, and the law applies antidumping measures to all industries, most of which do not plausibly fit the strategic trade paradigm. But one cannot exclude the possibility that in some cases, antidumping duties generate these types of benefits by chance. Sykes (1998) and Willig (1998) offer a more detailed treatment of these issues.

Some commentators have offered what might be termed 'political'

defenses of antidumping policy. One possibility is that whenever trade is perceived to be 'unfair', governments will be induced to restrict it, and that it is better to do so through measures that eliminate only the perceived unfairness than through measures that go even farther. This is the essence of Jagdish Bhagwati's argument for countermeasures against subsidized imports, as I understand him, an argument that might be extended to dumped imports if they too are genuinely perceived as 'unfair' (Bhagwati 1988). A difficulty with such an argument is that it is not clear why dumping should be perceived as unfair, given that it is really quite a normal business practice for many foreign and domestic firms.

A related, though seemingly distinct, argument for antidumping measures is the suggestion that they redirect pressures for protection away from the legislature and into a more benign administrative process. Boltuck and Litan (1991) observe: '[T]he imperfect success with which domestic interests have pursued unfair trade remedies suggests perhaps the only principled reasons for the statutes: as a legal "safety valve" for channeling the strongest claimants for protection away from overtly supporting more transparent forms of protection'. The administrative process that doles out antidumping remedies, the argument runs, will ultimately give less protection than would arise if the interest groups seeking protection were to turn to the legislature for more conventional protectionist intervention. A difficulty with this argument is that it is hard to see why the interest groups who, by hypothesis, could secure a greater degree of protection from the legislature in the absence of the administrative remedy, would be forced to settle for the lesser degree of protection that the administrative remedy provides. An alternative hypothesis is that groups with the power to secure high levels of protection from the legislature will do so notwithstanding the administrative alternative, and that groups without such power will avail themselves of the administrative route, thereby increasing the total amount of protection in the end. Put differently, it seems problematic to argue that if an additional avenue for interest groups to secure protection is opened while previous avenues also remain open, the net result will be a reduction in protection. Of course, if antidumping measures were somehow restricted or abolished, it is surely right to say that the resources devoted to the pursuit of antidumping duties would be redirected elsewhere and that unintended consequences might result.

If the bulk of the modern normative commentary is correct in suggesting that antidumping policy is economically unsound, however, a positive puzzle arises: Why do trading nations not agree to eliminate the use of antidumping duties, much as they have negotiated to reduce their tariffs generally? Occasional proposals within the WTO system to eliminate antidumping policy and subsume it within a sensible competition policy have had little traction. What explains the persistent popularity and surviv-

ability of antidumping policy? Sykes (1998) offers the suggestion that the political constituency for antidumping policy is not (and never has been) an anti-monopoly constituency, but is instead much the same as the political constituency for safeguard measures – declining industries. Because of the injury test, the principal beneficiaries of antidumping duties are industries that have difficulty competing in open markets. These industries present an effective lobby for protection for reasons noted earlier, and as yet the exporters targeted by antidumping measures have proven ineffective in political opposition.

Part of the reason why may lie in the fact that at least some exporters may not be harmed by antidumping actions against them. If they are able to settle the case through a price undertaking, they will have raised price and restricted output much like a cartel. Prusa (1992) and Staiger and Wolak (1989) argue that antidumping policy can indeed provide a government-sponsored route to cartelization that would otherwise violate the antitrust laws. This outcome is not observed in all cases by any means, since many cases are not settled. But the fact that it occurs some of the time no doubt has a bearing on the ongoing political equilibrium.

Finally, it is interesting to note that antidumping policy may disappear as trading economies become more integrated. The US federal system has some restrictions on domestic price discrimination in the Robinson-Patman Act, but they have always been much more closely linked to antitrust concerns and are not nearly as intrusive on pricing policies as international antidumping rules. Indeed, the Robinson-Patman Act is hardly ever enforced. Similarly, the formation of the European Union eventually led to the abolition of antidumping law internally. By contrast, the North American Free Trade Agreement (NAFTA) assiduously preserves the right of members to take antidumping measures against other members, as did the predecessor US–Canada Free Trade Agreement. An understanding of the political reasons for this heterogeneity in regional arrangements may also illuminate the reasons for the current state of the law in the WTO.

3. Countervailing duties

The WTO system takes a two-track approach to the discipline of subsidies. First, subsidies may directly violate WTO law, which now contains elaborate rules limiting the ability of governments to engage in certain subsidy practices. For non-agricultural products, these rules are contained in the SCMA; for agricultural products, they are contained in the Agreement on Agriculture. These direct limitations on subsidy practices are discussed in the chapter by Trebilcock and Fishbein elsewhere in this volume. Readers seeking a more elaborate discussion may wish to consult Sykes (2005).

Second, WTO/GATT law has always permitted members to take

countermeasures against imported goods[65] that benefit from 'subsidies', and that cause or threaten material injury to import-competing firms. These 'countervailing duties' are part of the trade remedy arsenal, and will be the final subject of this chapter.

Note that the injury requirement for the use of countervailing duties is virtually identical to that for the use of antidumping duties, both substantively and procedurally. I thus refer the reader to the discussion of injury analysis in the last section and will not address it further here. Likewise, the procedural requirements for national countervailing duty investigations, and for the collection and periodic review of countervailing duties, are nearly identical to those for antidumping investigations, and I will not dwell on them. The focus of this section is on what constitutes a countervailable subsidy, how the subsidy is measured, and whether countervailing duties make economic sense.

3.1. Countervailable subsidies under WTO law

Countervailing duty law dates back to the first US legislation in 1897. The US Tariff Act of 1930 strengthened the law, authorizing the Department of the Treasury to impose duties to offset any 'bounty or grant' bestowed on imported merchandise. Article VI of the original GATT was drafted in 1947 to permit the continuing use of countervailing duties, providing in paragraph two that '[n]o countervailing duty shall be levied on any product . . . in excess of an amount equal to the estimated bounty or subsidy determined to have been granted, directly or indirectly, on the manufacture, production or export of such product', and adding an injury requirement in paragraph six.

US law did not attempt to define the term 'bounty or grant', and GATT likewise left open the definition of 'bounty or subsidy'. Early US cases generally involved what are now termed 'export subsidies', which entail government payments or other incentives contingent on exportation (for example, a government program providing that producers will receive one shilling for each widget that they export). Later cases imposed duties to offset what are now termed 'domestic subsidies', which entail government payments or other benefits to domestic producers that are not contingent on exportation (for example, a government program providing that producers will receive one shilling for each widget that they produce). WTO law now recognizes that both types of programs may produce countervailable subsidies.

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[65] The GATS commits members to negotiate regarding subsidies in Article XV, but as of yet little has been accomplished, and I will focus here entirely on the rules governing goods markets.

3.1.1. The concept of 'subsidy' in the SCMA The Uruguay Round SCMA undertook for the first time to provide a definition of 'subsidy' under WTO law, drawing heavily on the evolution of the concept under US law. Article 1 defines 'subsidy' as a 'financial contribution' by a government or any other public body within the territory of a member. The contribution can arise from a direct transfer of funds, from revenue otherwise due that is foregone, from government provision of goods or services 'other than general infrastructure', from government purchases, from government support for a funding mechanism that makes any such contributions, or from certain income or price support schemes. The government contribution must also confer a 'benefit' – government purchases of goods or services at fair market value, for example, would not result in any benefit.

Not all 'subsidies' within this definition may be the subject of countervailing duties. In addition to the injury requirement, the subsidy must also be 'specific'. The 'specificity test' has its origins in US law, and has long been a source of controversy. Very roughly, the function of the specificity test is to distinguish familiar activities of governments that are considered acceptable and in no way 'unfair', from other activities that somehow confer an unfair advantage on the beneficiary. The essential premise of the test is that narrowly targeted programs (and export-contingent or import-substitution programs) are more troublesome than those that are more broadly available in the economy. Accordingly, pursuant to Article 2.3, all subsidies contingent in law or in fact on export performance are automatically 'specific', as are subsidies that are contingent on the use of domestic over imported goods. For other programs that fit the definition of 'subsidy' in Article 1, 'specificity' is present when the beneficiaries of the subsidy are limited to 'an enterprise or industry or group of enterprises or industries'. This situation can arise when the granting authority or the legislation that it administers expressly limits the beneficiaries to 'certain enterprises', or can occur when the subsidy is *de facto* specific. A finding of *de facto* specificity may result from the 'use of a subsidy programme by a limited number of certain enterprises, predominant use by certain enterprises, [or] the granting of disproportionately large amounts of subsidy to certain enterprises'. In addition, a subsidy that is 'limited to certain enterprises located within a designated geographical region within the jurisdiction of the granting authority shall be specific'.

The definition of specificity under WTO law leaves open a most fundamental issue – how narrowly targeted must a subsidy be to be deemed limited to a 'group of enterprises or industries?' This text on its face is quite useless at delimiting the scope of the relevant 'group', and to date WTO dispute cases provide little guidance on the subject.

3.1.2. Measurement issues Once a subsidy is found to be specific, its value must be computed in relation to the value of the subsidized merchandise in

order to compute an appropriate countervailing duty. Sometimes this exercise is fairly straightforward. For example, if widget producers in an exporting nation receive a one shilling grant for each exported widget and the value of an exported widget is ten shillings, then a 10% duty is appropriate to 'countervail' the export subsidy. Likewise, if widget producers receive a two shilling grant for every widget produced, and each widget is worth ten shillings, then the proper duty is 20% to countervail the domestic subsidy. Producers receiving both subsidies would properly be subject to a countervailing duty of 30%.

Often, however, valuation of the subsidy is more complicated. Suppose the subsidy takes the form of a loan or loan guarantee, an equity infusion, a special tax provision, or the sale of goods by the government – how is the subsidy to be measured in such cases? The SCMA begins with the premise that the relevant 'benefit' is the benefit to the recipient (see Art. 14), as distinguished from the cost to the government. Thus, a loan to a firm at a below market rate would confer a 'benefit', even if the government could borrow funds itself at an even lower rate, and thus argue that it earns a 'profit' on the loan.

When feasible, the benefit to the recipient will be measured by a market benchmark. Thus, for a loan by the government, the benefit must ordinarily be assessed with reference to the interest rate that the recipient would pay on a comparable commercial loan in the private market. For a loan guarantee, the question is whether the guarantee results in interest savings to the recipient in excess of the price paid to the government for the loan guarantee. When the government sells goods and services, the question is whether the government has sold them for less than the private market would charge in the same country. When the government infuses equity into domestic firms, the question becomes whether it has behaved in a manner inconsistent with what private investors would do under similar circumstances.[66]

Market benchmarks, however, are not always available. The tax issue presents an obvious example – when a firm benefits from a special provision in a tax law, it makes no sense to ask how much tax the firm would instead pay in a 'private market'. Rather, the standard benchmark looks to the taxes that the firm would otherwise pay. Although such an approach sounds sensible, it leads to some arguably peculiar results. Imagine a widget industry in a country that has no corporate income tax at all. Such an industry receives no tax 'benefit'. By contrast, consider a widget industry that is exempted from corporate income tax in a country that applies a corporate income tax to other industries. That industry would receive a 'benefit' in the amount of the foregone

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[66] See generally SCMA Art. 14.

taxes on its income, even though it pays exactly the same tax (zero) as the other hypothetical widget industry that receives no tax 'benefit'.

Market benchmarks may also prove unavailable in countries that do not have private markets. The United States, for example, has long taken the position that the countervailing duty laws cannot be coherently applied to non-market economies. (It has more than made up for its 'generosity' on this front, however, through aggressive application of antidumping law to non-market economies.)

Finally, market benchmarks may prove problematic if the government subsidy program is so extensive that it can be said to have 'distorted' the private market. In the long-running dispute between the United States and Canada over alleged subsidization of lumber exports by Canada, the United States has claimed that subsidized prices for standing timber on crown lands have depressed prices for all timber in Canada.[67] Thus, argues the United States, the price of private timber is not the proper benchmark for measuring the amount of the government timber subsidy. In a subsequent WTO proceeding, the Appellate Body accepted the notion that, in principle, private market prices in the subsidizing may be distorted by subsidy programs and an alternative benchmark may become necessary.[68]

Several other recurrent issues warrant a mention. First, the valuation of subsidies can involve complicated allocation issues, across products and over time. Suppose that a one-time below-market loan is used to build a multi-product factory. If only one of the products of the factory is subject to a countervailing duty investigation, say, it will be necessary to determine what portion of the subsidy 'benefits' the production of that particular product. Likewise, if the factory has a useful life of a number of years, it will be necessary to decide how much of the subsidy 'benefits' the production of the product in any window of time. Such questions are typically answered with complex allocation rules that may rest on somewhat arbitrary assumptions.[69]

Second, difficult issues may arise when a subsidy is bestowed at one stage of processing, while the exported good is produced by a later stage of processing. One must then ask whether the 'upstream' subsidy 'passes through' to the later stage of processing. When both stages of processing are integrated into a single company, the tendency is to assume that the subsidy passes through in

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[67] Canada has forcefully disputed this proposition, to be sure, arguing that a below market price for standing timber on government lands will not affect the size of the harvest, and thus the price of competing timber on private land.

[68] See *United States – Final Countervailing Duty Determination with Respect to Certain Softwood Lumber from Canada*, WT/DS257/AB/R (2004).

[69] For further discussion of such issues and the way that they are handled under US law, see 19 CFR §§351.504 et seq.

full. But what if the recipient of the subsidy sells its goods at arm's-length to another company that processes them further and then exports the finished product? Again drawing on the softwood lumber dispute for illustration, the Appellate Body has faulted the United States for failing to conduct a proper analysis of whether timber subsidies given to loggers pass through to unaffiliated sawmills that purchase the logs and manufacture them into lumber.[70]

Third, privatization transactions can raise difficult questions regarding alleged subsidies to the owners of privatized assets. Suppose that a government builds an uneconomical steel mill, for example, seeking to prop up local employment. Subsequently, the government auctions the mill for as much as the market will bear. Can the new owner be deemed 'subsidized', or is he immune from such a finding on the grounds that he paid fair market value for the assets and thereby received no 'benefit'? In two recent decisions, the Appellate Body leans strongly toward the latter view.[71] Grossman and Mavroidis (2003) question the logic of that approach, which implies that a government can build uneconomic productive capacity in an industry and then 'cleanse' the assets of any subsidy by selling them at arm's length, even though the uneconomic plants will thereafter continue to operate and cause the same harm to foreign competitors.

Finally, because countervailing duties offset subsidies that are commonly granted to an entire industry, it has been commonplace for national authorities to compute a single rate of duty for all exporters in a given exporting nation. Article 19.3 of the SCMA affords an opportunity for individual exporters to seek an individual rate, however, noting the possibility that some exporters may renounce subsidies, while others may enter price undertakings to avoid the application of countervailing duties, akin to the undertakings available in antidumping cases. Differential rates of duty may also arise when the granting authority is a subsidiary government – in the softwood lumber case, for example, the United States has computed different duties for each Canadian province because most of the alleged subsidy programs are administered at the provincial level.

3.2. Economic commentary on countervailing duties

In contrast to the generally hostile view of antidumping measures taken by most modern economists, commentary on countervailing duties is more

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[70] See *United States – Final Countervailing Duty Determination with Respect to Certain Softwood Lumber from Canada*, WT/DS257/AB/R (2004).

[71] See *United States – Imposition of Countervailing Duties on Certain Hot-Rolled Lead and Bismuth Carbon Steel Products Originating in the United Kingdom*, WT/DS138/AB/R (2000); *United States – Countervailing Measures Concerning Certain Products from the European Communities*, WT/DS212/AB/R (2002).

mixed. Critics such as Sykes (1989) begin with the observation that subsidized (and thus cheaper) imports are generally beneficial to an importing nation – regardless of the reason why imports are cheap, an improvement in the terms of trade will yield an aggregate gain in national economic welfare, other things being equal. Likewise, the welfare effect of countervailing duties will often be adverse, much like the welfare effect of any other tariff. This view counsels openness to subsidized imports, and indeed suggests that perhaps the proper policy response is to 'send a thank-you note to the embassy' as Paul Krugman once quipped.

To be sure, special circumstances may arise in which countervailing duties yield a benefit to the importing nation. Two possibilities, noted earlier in the discussion of antidumping duties, are that countervailing duties allow the extraction of monopsony rents by a large nation with market power over the price of its imports, or that they afford useful protection to an industry that fits the 'strategic trade' paradigm. But nothing in WTO law (or national law) limits countervailing duties to the cases where such benefits plausibly arise. Further, the gains to an importing nation from exploiting its monopsony power or from protecting its strategic industries come at the expense of its trading partners, and global welfare can decline if all nations pursue such policies.

Defenders of countervailing duty law, by contrast, such as Jackson (1997), urge that countervailing duties may serve as a useful deterrent to wasteful subsidy practices. It is well known that government subsidies can distort market outcomes and divert resources away from higher-valued uses. The problem can become all the more acute when political pressure exists for governments to match the subsidies granted by others – many governments may find themselves subsidizing the same sectors, collectively wasting resources while accomplishing little to provide net benefits to the subsidy recipients. See Hufbauer and Erb (1984). A threat of countervailing duties, the argument runs, will discourage such wasteful practices. The benefits of countervailing duty law thus arise not in the cases where duties are actually employed, but in the cases where subsidies are never bestowed in the first instance. Likewise, even if the actual use of a countervailing duty by an importing nation lowers its welfare when viewed narrowly, the broader systemic benefits from the discouragement of wasteful subsidies by a prospect of countervailing duties may make all nations better off on balance.

This more optimistic view may be correct, but there are several reasons to question it. First, and rather trivially, a tradeoff exists between the welfare costs that can arise in cases where duties are actually used, and any welfare gains that arise in other cases from the discouragement of wasteful subsidy practices. It is not obvious *a priori* how the balance is struck in practice.

Second, and relatedly, there are reasons to doubt the efficacy of countervailing duties as a deterrent to wasteful subsidy practices. Countervailing

duties are unilateral policies undertaken by importing nations without coordination. When the United States imposes a countervailing duty on a product from another country, for example, it will often be the only country in the trading system to impose a countervailing duty on that product. The subsidized goods may simply be diverted to another market, and in any case the damage to the beneficiary of the subsidy may be quite modest in relation to the value of the subsidy. The use of countervailing duties is also limited by the injury test. One can question whether the prospect of uncoordinated countermeasures, limited to situations of demonstrable injury, will do much to discourage subsidization.

Third, the ability of countervailing duties to discourage wasteful subsidies turns importantly on the ability of the law to distinguish the subsidies that are 'wasteful'. The specificity test may be a questionable basis for sorting cases in this respect. Broad subsidies to agricultural producers, for example, may be 'non-specific' because they benefit more than a 'group' of industries, even though the agricultural sector is widely considered to be distorted by subsidies in many countries. More generally, nations may be able to exploit the specificity test by designing subsidy programs to be broad enough to avoid running afoul of it. It is also possible that a 'specific' subsidy may not be wasteful. For example, a subsidy to research and development in an industry where intellectual property rights are difficult to enforce may have sound economic justification, yet appear quite 'specific'.[72] Schwartz and Harper (1972) take this type of criticism a step further. If a democratic society chooses to divert resources into a particular industry – such as family farming – who is to say that the program is wasteful? Perhaps the program results from a failure of the political process, or perhaps it reflects the genuine preferences of the society for preserving certain activities despite the cost. The general point is that a simple and administrable criterion to distinguish 'waste' from the legitimate activities of governments may be quite difficult to fashion, and one can certainly wonder whether the specificity criterion is satisfactory.

Fourth, as Bagwell and Staiger (2002) note, any notion that a subsidy is 'wasteful' must be mindful of the theory of the second best. In a global economy still pervaded by various trade barriers – tariffs, quotas and the like – the existing volume of trade in many products is inefficiently small. Subsidies can increase the volume of trade toward its 'free-trade' ideal, and enhance global welfare, other things being equal.

Fifth, and again relatedly, countervailing duty laws invariably examine subsidy programs in isolation. Firms are subject to a wide array of tax, regu-

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[72] Note that the limited 'safe harbor' for R&D subsidies under Part IV of the SCMA has now expired.

latory and possibly subsidy policies. All of these have the potential to distort the behavior of the firm relative to some ideal, 'free-market' benchmark, and many of the distortions may be offsetting. Ideally, a subsidy program should be deemed 'wasteful' only if it induces a *net* diversion of resources into the subsidized activity relative to a proper benchmark. But the task of determining the net impact of government on the position of a firm or industry relative to a proper benchmark would be Herculean, and so countervailing duty law generally ignores most government burdens that might offset the benefits of a subsidy. For this reason as well, the notion that countervailing duties as computed in practice will appropriately target 'wasteful' subsidies and leave constructive government activities alone seems quite dubious.

One last strand of literature warrants a quick note. WTO law does not clearly require an importing nation to demonstrate that a subsidy program has caused injury to its producers before imposing a countervailing duty. It is arguably enough that the subsidy has conferred a 'benefit', is specific, and that the 'subsidized imports' have caused injury.[73] Some commentators have suggested that this situation leads to an inappropriate use of countervailing duties in cases where the subsidy has no cross-border impact. For example, a government might give an unconditional grant to a firm, and the firm might simply distribute it to shareholders without changing output or prices. Or perhaps the government might pay a firm to reduce its output (as in certain agricultural schemes), which raises prices and actually benefits its foreign competitors. To avoid duties in such cases, Goetz, Granet and Schwartz (1986) and Diamond (1990) advocate legal reforms that would limit countervailing duties to amounts that offset the adverse cross-border impact of subsidy programs, roughly, by undertaking to measure the extent to which subsidy programs lower marginal costs. Critics question the administrative feasibility of such reforms, among other things, although it is noteworthy that the WTO Agreement on Agriculture does take some steps toward distinguishing trade-distorting subsidies from those that arguably do not distort trade. See Sykes (2005).

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[73] The requisite linkage between injury and subsidization is confounded as in the antidumping area by the argument that a link to the 'subsidized imports' is enough. See the discussion of this issue earlier in this chapter in the antidumping section.

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3. International trade: trade in services*

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One of the major results of the Uruguay Round was the creation of a General Agreement on Trade in Services (GATS). By establishing rules and disciplines on policies affecting access to service markets, the GATS greatly extended the coverage of the multilateral trading system. This chapter discusses the rules and disciplines of the GATS. It does not deal with regional integration initiatives, of which the pre-eminent example to date is the European Union. The focus is on the GATS because it is the only multilateral set of binding disciplines on trade in services.

As an integral part of the World Trade Organization (WTO), the GATS entered into force on January 1, 1995. A major innovation for the global trading system, which until 1995 covered only trade in goods, the GATS was the result of a 15-year discussion that commenced in the early 1980s. Services were put on the multilateral trade agenda at the initiative of the US. A first attempt to put services on the GATT (General Agreement on Tariffs and Trade) agenda was made during the 1982 GATT Ministerial meeting. This met with resistance on the part of many GATT contracting parties. While no consensus on launching negotiations in this area proved possible – indeed, the 1982 Ministerial broke down – the meeting did result in a subsequent GATT work program under which the major players agreed to undertake national studies of their services sectors to determine what their interests were in this area (see Feketekuty, 1988 for a contemporary discussion of the 'pre-history' of the GATS).

The reason why the original GATT 1947 did not cover services is straightforward: at the time the GATT was negotiated services were mostly nontradable. It is only relatively recently that technological change and regulatory reforms allowed an increasing number of services to be traded internationally through telecommunications networks. Another reason for the emergence of services as a potential topic for multilateral trade negotiations was the realization by the United States in the 1980s that it had a large surplus on the current

* The views expressed in this chapter are personal and should not be attributed to the World Bank. We are grateful to Alan Sykes for helpful comments on an earlier draft.

account in the area of services. Given that the US had a deficit in manufactures trade at the time, and that prospects for significant liberalization of agricultural policies were limited, negotiating on services trade and investment liberalization offered an area where the US government could offer industries potential gains from better access to foreign markets.

There were also good economic reasons to focus on services liberalization. An efficient and well-regulated financial sector will improve the transformation of savings to investment by ensuring that resources are deployed where they have the highest returns. Improved efficiency in telecommunications generates economy-wide benefits, as this service is a vital intermediate input and also crucial to the dissemination and diffusion of knowledge. Similarly, transport services contribute to the efficient distribution of goods within a country, and are particularly important in determining the ability of firms to contest international markets. Business services such as accounting and legal services are important in reducing transaction costs associated with the operation of financial markets and the enforcement of contracts. Retail and wholesale services are a vital link between producers and consumers, and the margins that apply in the provision of such services influence competitiveness. Education and health services are determinants of the ability of citizens to benefit from trade opportunities.

Trade agreements can provide a valuable focal point and instrument for policy reforms to increase competition in service industries. A comprehensive 'behind-the-border' policy reform agenda focusing on enhancing competition in services industries can help boost growth prospects and enhance welfare. Mattoo, Rathindran and Subramanian (2006) analyze the effects of trade and investment openness in the financial and telecommunications sector on growth in a cross-sectional analysis. Controlling for other determinants of growth, they find that countries that fully liberalized the financial services sector grew, on average, about 1 percentage point faster than other countries. Fully liberalizing both the telecommunications and the financial services sectors was associated with an average growth rate 1.5 percentage points above that of other countries. Focusing on a sample of transition economies, Eschenbach and Hoekman (2005) explore the impact of financial and infrastructure services policy reforms on per-capita income growth of transition economies using time-series data covering the 1990–2004 period. Controlling for other potential explanatory variables, they find that improvements in services policies – infrastructure and finance – have an important, statistically significant positive impact on per-capita growth.

One reason for this is that many services are inputs into production and thus their cost and quality may have a substantial impact on the ability of all firms in an economy to compete internationally. Increasing competition in service markets will reduce what Konan and Maskus (2005) call the cartel effect – the markup of price over marginal cost that incumbents are able to charge due to

restricted entry; and an attenuation of what they call the cost-inefficiency effect – the fact that in an environment with limited competition marginal costs of incumbents are likely to be higher than if entry were allowed. The latter is most important as inefficiency imposes a cost on all sectors and households that consume the services involved. Simulation studies for Egypt and Tunisia that analyze the likely impact of services liberalization conclude that removing policies that increase costs can have much greater positive effects on national welfare than the removal of trade barriers – by up to a factor of seven or eight (see, for example, Hoekman and Konan, 2001; Konan and Maskus, 2006). Instead of the 'standard' 0.5 to 1 percent increase in welfare from goods liberalization, introducing greater competition in services markets that removes cost inefficiencies raises the gains to 6–8 percent. These large effects of services liberalization reflect both the importance of services in the economy and the extent to which they tend to be protected.

What follows first describes in Sections 1–3 the scope, main disciplines and sectoral annexes of the GATS. Section 4 looks ahead at what needs to be done to improve the clarity of the structure, the depth of the rules, and generate meaningful commitments. Section 5 concludes.

1. The scope of the GATS

Services have unique characteristics that affect their tradability (Bhagwati, 1984; Sampson and Snape, 1985). Typical characteristics include: (i) intangibility – so that international transactions in services are often difficult to monitor, measure and tax; (ii) nonstorability – so that production and consumption must often occur at the same place and time; (iii) differentiation – services are often tailored to the needs of customers; and (iv) joint production, with customers participating in the production process.

The GATS covers all measures affecting *trade* in *services*. Instead of worrying about a precise definition of what a service is, GATS negotiators proceeded to list the entire range of services covered:

1. Business services
2. Communication services
3. Construction services
4. Distribution services
5. Educational services
6. Environmental services
7. Financial services
8. Health-related and social services
9. Tourism and travel-related services
10. Recreational, cultural and sporting services
11. Transport services
12. Other services not elsewhere included

As the conventional definition of trade – where a product crosses the frontier – would miss out on a whole range of international transactions, the GATS takes an unusually wide view of trade, which is defined (in Article I) to include four modes of supply:

- *Mode 1 – cross-border*: services supplied from the territory of one Member into the territory of another. An example is software services supplied by a supplier in one country through mail or electronic means to consumers in another country.
- *Mode 2 – consumption abroad*: services supplied in the territory of one Member to the consumers of another. Examples are where the consumer moves, for example, to consume tourism or education services in another country. Also covered are activities such as ship repair abroad, where only the property of the consumer moves.
- *Mode 3 – commercial presence*: services supplied through any type of business or professional establishment of one Member in the territory of another. An example is an insurance company owned by citizens of one country establishing a branch in another country.
- *Mode 4 – presence of natural persons*: services supplied by nationals of one Member in the territory of another. This mode includes both independent service suppliers, and employees of the services supplier of another Member. Examples are a doctor of one country supplying through his physical presence services in another country, or the foreign employees of a foreign bank.[1]

Thus, any measure affecting the supply of services through any of these modes is covered by the GATS. The inclusion of commercial presence as a mode extends the reach of the Agreement to measures affecting foreign direct investment, and the inclusion of presence of natural persons to measures affecting the entry of foreign nationals, both of which have traditionally been a tightly controlled province of national government.

2. The rules of the GATS

The wide scope of the GATS contrasts with the gentleness of its rules. The major provisions of the GATS are summarized in Table 3.1.

There are annexes allowing for one-time MFN exemptions, addressing the movement of natural persons, excluding air transport services, defining commitments on financial and telecommunications services, and clarifying the potential coverage of maritime transport commitments.

It is convenient to think of GATS rules as operating at two levels. First, there is a set of general rules that apply across the board to measures affecting trade in services, of which the most important are *transparency* and the *most-*

[1] The GATS does not apply either to measures affecting natural persons seeking access to the employment market of a Member, or to measures regarding citizenship, residence or employment on a permanent basis.

Table 3.1 Major provisions of the GATS (Article and main disciplines implied)

I	Definition. Trade in services covers all four modes of supply.
II	MFN obligation. Option to invoke exemptions on a one-time basis.
III	Notification and publication. Obligation to create an enquiry point.
IV	Increasing participation of developing countries. High income countries to take measures to facilitate trade of developing nations.
V	Economic integration. Allows for free trade and similar agreements.
VI	Rules for domestic regulation. Requirements concerning the design and implementation of service sector regulation, including in particular qualification and licensing requirements.
VII	Rules on recognition of qualifications, standards and certification of suppliers.
VIII	Monopolies and exclusive suppliers. Requires that such entities abide by MFN and specific commitments (Articles XVI and XVII) and do not abuse their dominant position.
IX	Business practices. Recognition that business practices may restrict trade. Call for consultations between Members on request.
XIV	General exceptions. Allows measures to achieve noneconomic objectives.
XVI	Market access. Defines a set of policies that may only be used to restrict market access for a scheduled sector if they are listed in a Member's specific commitments.
XVII	National treatment. Applies in a sector if a commitment to that effect is made and no limitations or exceptions are listed in a Member's schedule.
XVIII	Additional commitments. Allows for any other specific commitment to be made on a sector-by-sector basis. To date these have been limited primarily to telecommunications, through the so-called Reference Paper (discussed below).
XIX	Calls for successive negotiations to expand coverage of specific commitments (Articles XVI and XVII).
XXIX	States that annexes are an integral part of the GATS.

favored-nation (MFN) principle. Then there are the sector-specific commitments made by Members on *market access* and *national treatment* which are the core of the GATS, and determine the liberalizing impact of the Agreement.

2.1. *Key general rules: The MFN principle and transparency*

Article II of the GATS constitutes a general obligation which is, in principle,

applicable across the board by all Members to all services sectors. Article II:1 of GATS states:

> With respect to any measure covered by this Agreement, each Member shall accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favorable than that it accords to like services and service suppliers of any other country.

The GATS and its MFN obligation came into effect before WTO Members were willing to completely eliminate discriminatory measures in services trade. Specific sectoral sensitivities that emerged in the Uruguay Round raised the specter of wholesale sectoral exclusions from GATS as a means of avoiding the MFN rule. In order to prevent this, it was agreed to permit limited exemptions to MFN under GATS. Such exemptions, however, had to be taken at the time the negotiations were concluded and *in principle* were not to last longer than ten years (i.e., not beyond 2004). They are discussed in more detail in Annex 1 of this chapter.

Apart from services specified in individual MFN exemption lists, the only permitted departure from most-favored-nation treatment under the GATS covers preferential treatment among countries that are members of regional trading arrangements. The GATS rules on 'Economic Integration', in Article V, are modeled on those in Article XXIV of the GATT. Article V:1 permits any WTO member to enter into an agreement to further liberalize trade in services with the other countries that are parties to the agreement, provided the agreement has 'substantial sectoral coverage', eliminates measures that discriminate against service suppliers of other countries in the group, and prohibits new or more discriminatory measures. An approved agreement must be designed to help trade among its members, and must not result in an increase in the overall barriers faced by non-members in trading with the group within the respective sectors or sub-sectors (Article V:4). If the establishment of the agreement, or its subsequent enlargement, leads to the withdrawal of commitments made to non-members, there must be negotiations to provide appropriate compensation (Article V:5).[2]

A related exception from the MFN rule, for the movement of natural persons, is permitted by Article V *bis* of the GATS. This allows countries to take part in agreements which establish full integration of labor markets. The

[2] Agreements that have been notified so far include NAFTA, the European Communities, agreements between the EU and the Slovak Republic, Hungary, Poland, the Czech Republic, Romania, Norway, Iceland, Liechtenstein and Bulgaria (many of which became redundant upon accession of the countries concerned to the EU), and agreements between Canada and Chile and between Australia and New Zealand.

only such agreement notified so far is the one involving Denmark, Finland, Iceland, Norway and Sweden.

The challenge to multilateral disciplines posed by the explicit departures from the MFN obligation, such as the exceptions for regional integration agreements and the MFN exemptions listed by Members, are widely recognized. However, the difficulties arising from less visible, implicit discrimination have not been adequately appreciated. For example, an issue that has not been widely recognized concerns how quotas can/should be allocated in ways that ensure consistency with MFN. This has not been a major issue so far because commitments reflected the status quo. Any quotas, particularly with regard to service suppliers, were descriptions of the existing market structure – thus when Bangladesh scheduled 'four licenses issued' for cellular telephony, the ambiguity in the choice of tense was not an accident: the licenses in question had already been issued. In the future, as genuine liberalizing commitments are made, the non-discriminatory allocation of quotas is bound to be an important issue.

GATT precedent offers limited guidance on this matter. GATT Article XIII, on the 'non-discriminatory administration of quantitative restrictions', requires that quotas be distributed on the basis of trade shares which countries might be expected to have in the absence of such restrictions or according to what was supplied during a previous representative period. In the services context, a requirement to replicate historical shares may have no relevance if there was no previous foreign presence, or perpetuate historical discrimination if quotas were allocated to favored suppliers.[3] Furthermore, neither of the obvious candidates for a non-discriminatory rule, first-come, first-served or a system of auctions to the highest bidder, would necessarily lead to distributions 'which . . . might be expected to obtain in the absence of such restrictions'. A first-come, first-served scheme favors the proximate, while auctions would give relatively efficient producers larger shares than they would have obtained in the absence of quotas (when quotas are set at below unrestricted trade levels). Thus, rules for ensuring non-discriminatory allocation of quotas under GATS need to look beyond the GATT precedent. It is possible that a less elaborate variant of the disciplines in the Agreement on Government Procurement, designed to ensure competitive tendering on a non-discriminatory basis, will need to be considered.

Another arises in the light of the recent rulings of a WTO Panel and the

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[3] In the *Bananas* case, the European Union's method of allocating import licenses for bananas from certain sources was found to be inconsistent with Article II because it reallocated quotas and quota rents away from the importers who traditionally imported from these sources (see paras 7.350–7.353 of the Panel Report). In a sense, the Panel's reasoning followed the logic of GATT Article XIII.

Appellate Body on the dispute concerning the European Communities' regime for the importation, sale and distribution of bananas (henceforth, *Bananas* Case).[4] First, while the MFN obligation under GATT 1994 is concerned with measures affecting products *per se*, the domain of this obligation in the GATS includes also measures affecting service *suppliers*.

Second, the *Bananas* Case confirmed a broad interpretation of the term 'affecting', i.e. measures concerned need not affect trade in services as such but could also be measures taken in other areas with repercussions on services – such as measures in respect of the purchase of goods.[5] Third, the Appellate Body in the Bananas Dispute upheld the Panel's conclusion that the MFN provision, like the national treatment provision, prohibits both *de jure*, or formal, and *de facto* discrimination.

Transparency

Article III (Transparency) requires that all measures of general application affecting trade in services be published by a Member, and that other Members be informed of significant changes in trade policy. Furthermore, all members must establish enquiry points to provide, on request, specific information concerning any laws, regulations and administrative practices affecting services covered by the Agreement. This rule was not controversial though its implementation has not been verified.

2.2. *Specific commitments on market access and national treatment*

The specific commitments on market access and national treatment are the core of the GATS, and the impact of the Agreement depends to a large extent on the commitments made by Members.[6] Both types of commitments are made for each of the four modes of delivery of service transactions.

Article XVI stipulates that measures restrictive of *market access* which a WTO Member cannot maintain or adopt, unless specified in its schedule, include limitations on:

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[4] See *European Communities: Regime for the Importation, Sale and Distribution of Bananas*, Report of the Panel, WT/DS27/R/USA, 22 May 1997, and European Communities: Regime for the Importation, Sale and Distribution of Bananas, Report of the Appellate Body, WT/DS27/AB/R, 9 September 1997.

[5] See paras 7.277–7.286 of the Panel Report and paras 217–222 of the Report of the Appellate Body. It was also confirmed that GATT 1994 and GATS may overlap in application to a particular measure.

[6] Both the market access and national treatment provided for in the schedules must be extended to all foreign suppliers on a non-discriminatory basis, irrespective of any MFN exemptions listed.

(a) the number of service suppliers;
(b) the total value of services transactions or assets;
(c) the total number of services operations or the total quantity of service output;
(d) the total number of natural persons that may be employed in a particular sector;
(e) specific types of legal entity through which a service can be supplied; and
(f) foreign equity participation (for example, maximum equity participation).

With the exception of (e), the measures covered by Article XVI all take the form of quantitative restrictions. Three aspects of Article XVI are important. First, the Article XVI list does not include all measures which could restrict market access. Perhaps most significantly, fiscal measures are not covered. Thus, a Member could maintain, without being obliged to schedule, a high non-discriminatory tax on a particular service which severely limits market access. Second, Article XVI covers both discriminatory and non-discriminatory measures, i.e. measures of the type 'only five new *foreign* banks will be granted licenses' and also measures such as 'only ten new [*foreign and domestic*] banks will be granted licenses'. Finally, the limitations must be read as 'minimum guarantees' rather than 'maximum quotas', i.e. a country which has promised to allow five foreign banks entry is free to grant entry to more than five.

The scope of Article XVI was a key issue in the recent dispute between Antigua and Barbuda and the United States (Measures Affecting the Cross-Border Supply of Gambling and Betting Services; henceforth Gambling Panel). The Appellate Body confirmed the Panel ruling that the US prohibition of internet gambling amounted to a zero quota and was therefore inconsistent with its specific commitments on market access. The US measures prohibited neither gambling *per se* nor the cross-border supply of gambling, but specifically the supply of gambling services over the internet.[7] The panel invoked the notion of 'technological neutrality' – on which WTO Members had agreed in the context of the E-Commerce Work Program – to argue that full commitments on market access (with no limitations) precluded restrictions on a particular means of delivery. Furthermore, even though the US prohibition applied (at least in principle) equally to foreigners and US providers, the panel ruled against the US because specific commitments on market access preclude even non-discriminatory prohibitions.

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[7] The Panel ruling was substantially reversed by the Appellate Body on other grounds – see below.

The other key pillar of the GATS is the *national treatment* obligation. Article XVII:1 states:

> In the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favorable than that it accords to its own like services and service suppliers.

Unlike Article XVI, Article XVII provides no exhaustive list of measures inconsistent with national treatment. Nevertheless, Article XVII:2 makes it clear that limitations on national treatment cover cases of both *de jure* and *de facto* discrimination.

Consider some examples of limitations on national treatment. If domestic suppliers of audiovisual services are given preference in the allocation of frequencies for transmission within the national territory, such a measure discriminates explicitly on the basis of origin of the service supplier and thus constitutes formal or *de jure* denial of national treatment. Similarly, the WTO Panel in the Autopact dispute between the European Union and Canada (*Canada – Certain Measures Affecting the Automotive Industry*) found that a local content requirement that could be fulfilled by the use of certain locally produced services discriminated against cross-border trade in the same services. Alternatively, consider a measure stipulating that prior residency is required for the issuing of a license to supply a service. Although the measure does not formally distinguish service suppliers on the basis of national origin, it *de facto* offers less favorable treatment for foreign suppliers because they are less likely to be able to meet a prior residency requirement than like service suppliers of national origin.

A Member's specific commitments can be seen as the outcome of a two-step decision. Each Member first decides which service sectors will be subject to the GATS market access and national treatment disciplines. It then decides which measures violating market access and/or national treatment respectively will be kept in place for each mode in that sector. Granting unrestricted market access with full national treatment would be equivalent to establishing free trade, and the flexible structure of rules reflects the desire of most governments to adopt a gradual and conditioned approach to opening up their markets.

Members can make horizontal commitments that apply to modes of supply, rather than sectors. Members also have the option of making additional commitments by listing actions to be taken that do not fall under national treatment or market access. Table 3.2 illustrates the rather complicated format of schedules of commitments. A consequence of the decisions to distinguish between general and specific obligations, to schedule specific commitments

Table 3.2 Format and example of a schedule of specific commitments

Commitment type	Mode of supply	Conditions and limitations on market access	Conditions and qualifications on national treatment	Additional Commitments
Horizontal (across all sectors)	1. Cross-border	None	None	
	2. Consumption abroad	Unbound	Unbound	
	3. Commercial presence (FDI)	Maximum foreign equity stake is 49%	Unbound for subsidies. Approval required for equity stakes over 25%	
	4. Temporary entry of natural persons	Unbound except for intra-corporate transferees of senior managers	Unbound except for categories listed in the market access column	
Specific (on a sectoral basis)	1. Cross-border	Commercial presence required	Unbound	
	2. Consumption abroad	None	None	
	3. Commercial presence (FDI)	25% of management to be nationals	Unbound	Establishment of an independent regulator
	4. Temporary entry of natural persons	Unbound, except as indicated in Horizontal Commitments	Unbound, except as indicated in Horizontal Commitments	

Notes: 'None' implies no exceptions are maintained– that is, a bound commitment not to apply any measures that are inconsistent with market access or national treatment. 'Unbound' implies no commitment of any kind has been made.

by mode of supply, and to allow for MFN exemptions is that very much depends on the content of the schedules. The GATS is not a particularly transparent or user-friendly instrument. Virtually all commitments made in the Uruguay Round were of a standstill nature, that is, a promise not to become more restrictive than already was the case for scheduled sectors (Hoekman, 1996).

Efficient protection The domestic political economic forces that lead to protection may also dictate that is obtained through inefficient instruments. In goods trade, negotiations helped reduce protection, but ensuring that the efficient instruments of protection were chosen was the role of rules. Thus, GATT rules broadly reflect the ranking of instruments suggested by economic theory: quotas are prohibited, tariffs are allowed but progressively negotiated down and bound, and production subsidies are permitted but subject to countervailing action under certain circumstances. The GATS rules on market access do not create a similar hierarchy. In the services context, both the level and the form of protection are the outcome of negotiations between WTO Members.

Ranking alternative instruments Does economic theory in its current state suggest a hierarchy of instruments affecting services trade and is it possible to create rules that favor a choice of superior instruments? The superiority of subsidies over trade restrictions is as valid for services as it is for goods. And, in principle, tariffs are to be preferred to quotas for much the same reason as in the case of goods. But there are at least two reasons why differences may arise. First, in some instances tariffs may not be easy to impose and so the substitution of a more desirable policy instrument for a less desirable one may not be feasible. However, the difficulty of switching to fiscal instruments of protection has probably been exaggerated. As far as cross-border trade is concerned, the imposition of duties is probably most difficult – perhaps impossible, given the current state of technology – when a service is delivered electronically. But in this case, other barriers to trade are also likely to be infeasible. Where quotas are feasible and maintained, as on cross-border trade in transport services, it is easy to conceive of tariff-type instruments, such as a tax per passenger or unit of cargo carried by a foreign company. Moreover, the auction of a quota is analogous in economic effect to the imposition of a tariff. In the case of commercial presence, a number of fiscal instruments are possible, including entry taxes (or auctions of entry licenses), output taxes and profit taxes. Ironically, the legal systems of many countries allow discrimination against foreigners through outright bans and entry quotas but make it difficult to impose discriminatory taxes.

Second, some of the instruments that have a tariff-like effect in terms of inflicting costs on foreign providers (such as overly burdensome regulatory

standards), are not however tariff-like in generating revenue. In this case, part of the loss in consumer surplus is not offset by an increase in tariff revenue. So the loss in national and global welfare is much greater. Similarly, when quotas are imposed, their consequences for (national) welfare could be alleviated if the rents generated accrued domestically to importers or the government rather than foreign exporters. But the difficulties of intermediation in services suggest that quota-rents are more likely to be appropriated by exporters. Or more likely, quotas are likely to lead to socially wasteful administration costs and rent-seeking. Hence, one general conclusion is that if complete liberalization is not feasible, a shift from both quotas and non-revenue-generating measures to fiscal measures would lead to an increase in both national and global welfare.

A prohibition of quotas is unlikely to be politically feasible today. An intermediate step would be to build into GATS rules a legal presumption in favor of fiscal measures. The Uruguay Round Understanding on the Balance-of-Payments Provisions of the GATT 1994 provides a useful model. This Understanding requires Members to give preference to price-based measures and to use quotas only if price-based measures are inadequate, and the choice must be justified. In the GATS context, we would wish to see a shift from both quotas and wasteful discriminatory regulations to fiscal measures. Inducing a shift away from the former would require making the market access provision more stringent. Inducing a shift from the latter has not been anticipated in the structure of the Agreement and may be worth considering. In any case, greater flexibility in the national treatment provision (which prohibits all forms of discrimination) is not necessary. For even if a country has committed to providing national treatment, then it is allowed to modify its commitments (under Article XXI) and switch instruments of protection – as long as the extent of protectionism does not increase.

2.3. Domestic regulation

Article VI (Domestic Regulation) requires that members ensure that qualification requirements, technical standards and licensing procedures are based on objective and transparent criteria, are no more burdensome than necessary to ensure the quality of the services concerned, and do not constitute a restriction on supply in themselves. It requires countries to apply regulations in a 'reasonable, objective and impartial manner' to avoid undermining commitments to market access and national treatment. Moreover, countries must have in place appropriate legal procedures to review administrative decisions affecting trade in services. Article VI is among the more important provisions in the GATS as domestic regulations can have the effect of greatly impeding, if not foreclosing completely the ability of foreign firms to contest a market. Indeed, given the absence of border-type barriers such as tariffs to restrict trade in

services, often access to markets will be impeded, if at all, by domestic regulations. This is one reason why the GATS includes specific market access disciplines. Note, however, that these do not extend to domestic regulation more generally. Nor does Article VI envisage any harmonization of national regulatory policies.

Recognition Article VII of the GATS, dealing with recognition, attempts to strike a difficult balance. On the one hand, it allows a Member at any point of time to recognize standards of one or more Members and not of others, without violating its GATS obligations – even though services and service suppliers of the former group have easier access than those of the latter group. The remaining paragraphs of Article VII seek to ensure that this freedom is not abused. Article VII:2 requires a Member who enters into a mutual recognition agreement (MRA) to afford adequate opportunity to other interested Members to negotiate their accession to such an agreement or to negotiate comparable ones. In this respect, Article VII mandates an openness *vis-à-vis* third countries in a way that Article V, dealing with economic integration agreements, does not. Article VII:3 stipulates that a Member must not grant recognition in a manner which would constitute a means of discrimination between countries.

Members must inform the Council for Trade in Services about existing MRAs and of the opening of negotiations on any future ones. So far, 21 notifications have been received under Article VII:4, of which 10 are from Latin American countries, 4 from the United States, 3 from Switzerland, and 1 each from the European Commission, Australia, Norway and Macau. Not surprisingly, all but one of these pertain to the recognition of educational degrees and professional qualifications obtained abroad. Interestingly, mutual recognition of qualifications is also mentioned as an element of 11 regional integration agreements, notified under GATS Article V:7(a). These agreements include the one establishing the European Union, agreements between the European Union and neighboring countries, and the Closer Economic Relations Treaty between Australia and New Zealand. This raises the question of whether MRAs concluded in the context of a regional integration agreement are still subject to the disciplines in Article VII:2 and 3. One view may be that Article V provides an exception to the fundamental non-discrimination obligation in Article II and therefore an exemption also to similar obligations contained in other GATS provisions, including Article VII. Alternatively, it could be argued that all MRAs, regardless of whether they are concluded by parties to a regional integration agreement or other Members, are covered by Article VII and its disciplines cannot be circumvented by appealing to Article V.

2.4. Other GATS provisions

Article XIV on exceptions is somewhat broader than what is found in the

GATT, providing members with the legal cover to take measures to safeguard public morals, order, health, consumer protection and privacy. The scope of the exceptions provision was tested in the recent WTO Gambling Panel ruling on the dispute between Antigua and Barbuda and the United States. The Panel ruled that the US prohibition could not be deemed necessary because the US had rejected efforts by the complainant to consult on finding alternative means of meeting its regulatory concerns. However, the Appellate Body disagreed with the Panel, and noted that the US failure to consult could not lead to the conclusion that the US had failed to demonstrate the necessity of the measures. It found that most of the non-discriminatory measures could be justified under the GATS exceptions provision because they were necessary to protect public morals or to maintain public order as allowed under Article XIVa.

Monopoly or oligopoly supply of services is allowed under the GATS, but governments are required to ensure that firms granted exclusive rights by governments do not abuse their market power to nullify any specific commitments relating to activities that fall outside the scope of their exclusive rights. Article IX recognizes that business practices of service suppliers that have not been granted monopoly or exclusive rights may restrain competition and thus trade in services, and requires that members consult with others on request with a view to eliminating such trade-restricting practices. However, no obligations are imposed regarding the scope and enforcement of competition policy rules – Article IX only requires the provision of non-confidential information. Given the regulatory diversity prevailing across members in the area of competition policy, going beyond an information exchange obligation was not feasible.

Many GATS disciplines apply only to the extent specific commitments are made. This is a consequence of the 'positive list' approach to scheduling commitments.[8] For example, the balance-of-payments provision (Article XII) applies only for services where specific commitments have been undertaken. It requires that such measures be non-discriminatory, temporary, and phased

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[8] In WTO jargon, the coverage of MFN for each GATS member is determined by a so-called negative list – it applies to all services except those listed in the member's annexes on MFN exemptions. The sectoral coverage of national treatment and market access is determined by a positive list – these disciplines only apply to sectors and modes of supply listed in a member's schedule of commitments, and then only insofar as existing measures that violate either of the two provisions are not exempted. The positive list approach to determining the sectoral coverage of specific commitments emerged in large part because many developing countries felt they did not have the administrative resources required to determine all the measures that applied to each sector and decide which they would want to exempt. As many of these countries did not intend to make substantial commitments in any event, they much preferred a positive list approach.

out progressively as the invoking member's balance of payments situation improves. As in the GATT context, no recognition is expressed that import restrictions are second-best instruments to deal with balance-of-payments difficulties. Article XI requires members to refrain from applying restrictions on international transfers and payments for current transactions relating to their specific commitments – it also does not apply generally.

The WTO Dispute Settlement Body is responsible for disputes under GATS. Retaliation from goods to services and vice versa is possible if this is necessary (so-called cross-retaliation). Thus, if a country finds it needs to retaliate because of noncompliance with a panel recommendation and does not wish to restrict imports of goods, it may retaliate by not complying with some of its service commitments.

The GATS contains no provisions similar to Part IV of the GATT on special and differential treatment for developing countries or accepting the (unilateral) arrangements for tariff preferences that exist for merchandise trade flows (for example, the Generalized System of Preferences). However, Article XIX of the GATS permits developing countries to offer fewer specific commitments than industrialized nations in negotiations, and Article IV calls for special treatment of least developed countries.

The national treatment and market access obligations of the GATS do not extend to government procurement of services or to subsidy policies. The procurement carve-out greatly reduces the coverage of the GATS, as procurement typically represents a significant share of total demand for services such as accounting, consulting engineering, and construction. Dealing with procurement and subsidies proved too complicated and Uruguay Round negotiators left these issues for future deliberations. Article X on industry-specific safeguard actions is also largely a shell, with the Agreement again calling for continued negotiations on this topic. Discussions on all three subjects have continued after the Uruguay Round with little result. All three topics were on the agenda of the negotiations that were launched to extend the coverage of the GATS in early 2000.[9]

3. Sector-specific agreements

Under the GATS, members have negotiated sector-specific rules for financial services and basic telecommunications.

Financial services Negotiations on financial services were concluded successfully in December 1997 – two years after the entry into force of the

[9] No provisions are found in the GATS that are analogous to Art. VI GATT allowing for antidumping actions. See Hoekman and Leidy (1991) for a discussion.

GATS. A total of 56 schedules representing 70 Members were annexed to the GATS as a result of this agreement.[10] The need for additional commitments and clarification for this sector stemmed in part from fears of the implications of liberalization for weak domestic financial institutions, and a perceived absence of reciprocity given that many developing countries are importers and not exporters of financial services. Another concern revolved around the implications of GATS rules for management of capital flows and prudential regulation and supervision. The latter problems were addressed by agreeing that liberalization of capital movements per se is beyond the purview of the GATS, although members are restricted from imposing capital controls that interfere with their specific commitments, for example, those pertaining to cross-border trade in banking services (except if justified for balance-of-payments reasons). More difficult was where to draw the line as regards the types of regulation that are permitted (policies aimed at increasing the strength and quality of prudential regulation and supervision) and those that should be abolished (policies that act as barriers to trade in financial services). An Annex on Financial Services contains a so-called ‘prudential carve-out’ for domestic regulation of financial services. Included at the insistence of financial regulators, the carve-out allows prudential measures to be imposed to protect consumers of financial services and to ensure the integrity and stability of the financial system.

Basic telecommunications The Agreement on Basic Telecommunications was concluded in February 1997, with 55 schedules (representing 69 Members) annexed to the GATS.[11] The telecommunications sector is the focus of two additional sets of rules: the generally applicable Annex on Telecommunications, and the Reference Paper which has been incorporated into their schedules of commitments by around 60 WTO members. At the risk of some oversimplification, the first can be seen as primarily a response to the central role of telecommunications as a medium of transporting services, and the second as a response to the particular difficulties in achieving liberalization in a sector characterized by significant network externalities.

The Annex on Telecommunications: reinforcing access guarantees for users This Annex was drafted during the Uruguay Round by negotiators realizing that, despite Article VIII, telecom operators were in the unique position of

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[10] Mattoo (2000) provides an assessment of the commitments made in this sector.

[11] Fink, Mattoo and Rathindran (2003) analyze the impact of current policies and GATS commitments in this sector.

having the potential to undermine commitments undertaken in schedules not only on telecom but any service sector in which telecommunicating was essential to doing business. Three aspects of the Annex make it a much more powerful defender of the rights of users of telecommunications services than Article VIII. First, it is silent about market structure and therefore applies regardless of whether the services in question are supplied by a monopoly or through competition. This reflects the fact that not just monopolies, but dominant operators in a more competitive regime might also engage in unfair practices restricting access and use. Second, the Annex carries its own non-discriminatory disciplines on telecom service suppliers and, unlike Article VIII, does not depend on the sector-specific obligations undertaken by Members. The suppliers of any service listed in a government's schedule, say financial services, are thus assured of non-discrimination with respect to access to and use of telecom services even if a Member has not committed to national treatment with respect to that particular service. Finally, the Annex offers greater specificity in certain areas than Article VIII. For instance, it requires Members to ensure that relevant information on conditions affecting access to and use of public telecom transport networks and services is publicly available.

The Reference Paper: ensuring competition in the supply of telecom services

In the basic telecommunications negotiations, there was concern that despite the commitments to liberalize both trade and investment, telecommunications markets would still frequently be characterized by dominant suppliers that controlled bottleneck or essential facilities. This could be because this sector has for a long time been monopolized, and despite efforts to break up these monopolies, control over key infrastructural facilities will not immediately be diversified. Or it could be that large fixed costs and economies of scale render some markets inherently incontestable, i.e. given the minimum efficient scale of operation, the market was simply not large enough to accommodate more than one or two suppliers. In any case, the concern was that dominant players in the telecom market, left free to make decisions about how to treat other suppliers, would be capable of frustrating the market access and national treatment commitments made by governments in the negotiations.

Furthermore, participants felt that neither Article VIII nor the Telecom Annex would be adequately equipped to deal with potential anti-competitive practices. In anticipation of these problems, some 60 governments participating in the basic telecommunication negotiations made additional commitments under Article XVIII of the GATS to apply certain regulatory principles contained in a Reference Paper. The Reference Paper is, first of all, wider in scope than Article VIII and its domain is clearer than that of the Annex. Its disciplines apply to any 'major supplier', defined as one who 'has the ability to materially affect the terms of participation (having regard to price and

supply) in the relevant market for basic telecommunications services as a result of: (a) control over essential facilities; or (b) use of its position in the market. Notably, the conditions to qualify as a 'major supplier', and therefore to be subject to the disciplines in the Reference Paper, do not include government responsibility for its existence, unlike in the case of Article VIII monopolies.

The disciplines of the Reference Paper can also be seen as going beyond those contained in Article VIII and the Annex. In the current context, the most interesting relate to interconnection and competition safeguards. Interconnection must be on non-discriminatory, transparent and reasonable terms, conditions (including technical standards and specifications) and rates; of a quality no less favorable than that provided for its own like services or for like services of non-affiliated service suppliers or for its subsidiaries or other affiliates; at cost-oriented rates; in a timely fashion; sufficiently unbundled so that a supplier need not pay for network components or facilities it does not require; at any technically feasible point in the network; and upon request, at points in addition to the network termination points offered to most users, albeit allowing for charges that reflect the construction cost of necessary additional facilities. The requirement to offer interconnection at 'cost-oriented rates', for instance, goes much further than anything in the Annex or Article VIII.

Competition safeguards oblige Members to prevent a major supplier from abusing control over information, or engaging in anti-competitive cross-subsidization, i.e. to prevent a major supplier from using profits made in one segment of the market to subsidize its output sales in another segment and thus drive out rival suppliers. Certain disciplines against cross-subsidization can already be read in Article VIII:2. However, there the discipline is curtailed by reference to a Member's territory and commitments.

The Reference Paper is characteristic of the 'WTO approach' in that the primary concern is to ensure effective market access. Wider concerns about consumer interests and how they may be affected by monopolistic behavior are not addressed, nor is any focal point provided for regulators regarding the need for and modalities of regulation or competition law. It is also not very specific. What the meaning is of 'anti-competitive', 'cost-oriented', 'independence', etc. is not defined precisely – implying that this is something that will be left to case law (Panel and Appellate Body reports).

A start down this path was initiated in 2002 with a dispute between Mexico and the US (*Mexico – Measures Affecting Telecommunications Services*). The dispute revolved around claims by the US that the Mexican government was not abiding by its commitments under the Reference Paper, in particular the requirement that dominant operators provide (and price) international interconnection services on the basis of cost. The US also claimed that Telmex had

established a *de facto* cartel comprising of itself and a 'competitive fringe' that resulted in restricting the access of foreign (US) suppliers. The Panel concluded that the international settlement rates charged by Telmex to US telecommunications service suppliers were not cost based and that Mexico did not provide access to and use of public telecommunications transport networks and services (a violation of Sections 5a, b of the Annex on Telecommunications).[12] Mexico was called upon to remove specific restrictions on the commercial negotiation of international settlement rates and shift towards pricing on the basis of long-run average incremental cost. The Panel also found that Mexico had failed to abide by Section 1.1 of the Reference Paper, which requires signatories to maintain appropriate measures to prevent anti-competitive practices. However, it concluded that Mexico should be permitted to impose restrictions on the resale of international services from Mexico to other countries.

This case was the first 'pure' GATS case in that reference was only made to GATS provisions. It also was the first to address a clear competition issue and to require a WTO member to change its domestic law regulating a service sector. Perhaps most noteworthy is that the Panel did not limit itself to the international dimension of telecom regulation in Mexico (international settlement rates) but extended its finding to domestic interconnection regulation. Moreover, the case illustrates that although the Panel based much of its reasoning on competition policy principles and arguments, at the end of the day the focus was almost exclusively on market access. Sidak and Singer (2004) argue compellingly that from a welfare (consumer) viewpoint, the types of concerns used by the Panel to motivate its decision are appropriately addressed by the two countries' competition authorities, that the Panel used the wrong definition of the relevant market.

The Panel to some extent 'wrote law' by interpreting the meaning of anti-competitive practices as including horizontal price-fixing and market-sharing agreements – on the basis that these tend to be per se illegal under most competition laws. This is nowhere specified in the GATS, the Annex on Telecoms or the Reference Paper (the latter only mentions a list of anticompetitive practices, including cross-subsidization). Whether one agrees or not

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[12] *Mexico – Measures Affecting Telecommunications Services*, Report of the Panel, 2 April 2004, WT/DS204/R. For international phone calls to take place, a telecom carrier must be able to connect into the destination country's telecommunications network. This generally involves either a payment to an operator in the destination country for completing the call, or leasing capacity (lines) in the destination country and routing calls over those lines. The latter is called 'international simple resale'. The latter was also at issue in this case as the US opposed restrictions that were imposed by Mexico on such resale.

that the Panel should have interpreted this language, it is noteworthy that the practices that were deemed anti-competitive were mandated by government regulation (law).[13]

4. Holes, ambiguities and challenges

Certain aspects of the GATS may create uncertainty regarding what specific commitments imply. There are also areas where disciplines will need to be bolstered for the GATS to become more meaningful – especially in the areas of domestic regulation, subsidies, safeguards and government procurement.

4.1. Clarifying the structure and rules of the Agreement

GATS rules distinguish broadly between quantitative measures (the subject of Article XVI, with the exception of XVI:2(e)) and discriminatory measures (Article XVII). But where do *discriminatory quantitative* measures, particularly those affecting establishment of commercial presence, fall? Since the precise extent of overlap between these two Articles is not identified, the precise scope of the national treatment obligation remains unclear. If a country has undertaken only a commitment to provide national treatment, and not to provide full market access, it remains unclear if it has the freedom in future to introduce a discriminatory quantitative restriction, such as a zero quota on entry by foreign firms.

Say a Member has scheduled construction services, with full national treatment commitments, but bound itself to provide market access only to 10 (domestic and foreign) construction companies for 100 building contracts. The Member allocates 10 licenses to domestic and foreign building companies through a non-discriminatory auction, and does not discriminate in any way while 100 building contracts are signed. Then it (a) grants all new licenses (beyond the initial 10) only to domestic companies and (b) insists that all new contracts (beyond the initial 100), be signed only with national companies and not with foreign companies, including those which have already been established. The Member's actions do not violate the market access commitment

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[13] In June 2004, the US and Mexico reached an agreement that implements the panel recommendations. The main features of the agreement notified to the WTO Dispute Settlement Body were that Mexico will remove the provisions of the law relating to the proportional return system, uniform tariff system, and the requirement that the carrier with the greatest proportion of outgoing traffic to a country negotiate the settlement rate on behalf of all Mexican carriers for that country. It will also allow the introduction of resale-based international telecommunications services in Mexico by 2005, in a manner consistent with Mexican law. The United States recognized that Mexico will continue to restrict International Simple Resale (use of leased lines to carry cross-border calls) to prevent the unauthorized carriage of telecommunications traffic.

since, as noted above, it represents a 'minimum' rather than a 'maximum' guarantee. But is the Member behaving consistently with its national treatment obligation?

There are at least three possibilities with regard to the potential domain of national treatment:

(i) *Strong national treatment* would cover both the right to establish, as well as post-establishment treatment. If this were the case, both actions (a) and (b) would be inconsistent with national treatment. The text of Article XVII supports this interpretation, since 'all measures affecting the supply of services' must cover also all quantitative restrictions (QRs), including those affecting the ability to establish commercial presence.

(ii) *Post-entry national treatment* would exclude the right to establish from the scope of the national treatment obligation. Thus, action (a) would not violate national treatment but action (b) would. The scheduling practice (of at least some Members) was based on the view, also reflected by certain elements of negotiating history, that the national treatment obligation is only effective once the foreign company has actually been established in the territory of a Member.

(iii) *Limited national treatment* would exclude all measures falling within the scope of Article XVI, including discriminatory QRs, from the scope of the national treatment obligation. Then, neither (a) nor (b) would be inconsistent with the national treatment obligation.

Which interpretation makes legal and economic sense? If it is technically possible to make commitments on all QRs, including those which are discriminatory, only under Article XVI, then there is little need to define the precise domain of Article XVII. It is as if these measures did not really fall within the scope of Article XVII. But there is a cost: commitments to provide national treatment alone, in the absence of complementary commitments to provide market access, have limited value. It is as if the narrow interpretation in (iii) above were accepted. The liberalizing content of the GATS is accordingly circumscribed. If, however, national treatment commitments could be read to preclude discriminatory QRs, even in the absence of full market access commitments, then the GATS would have a greater liberalizing impact. But how much greater depends on whether the national treatment obligation also includes the right to enter and to establish commercial presence (i.e. whether we accept (i) rather than (ii) above). If it is recognized to do so, then national treatment under the GATS is a powerful obligation, and accordingly the existing commitments to provide it have significant liberalizing force.

It would have been far clearer to make national treatment the primary disci-

pline covering all forms of *de jure* and *de facto* discrimination. Arguably the bulk of empirically important restrictions today are discriminatory measures. Non-discriminatory measures are less of an economic problem and likely to be more of a political issue – because multilateral disciplines in this area are more likely to be seen as intrusive. Nevertheless, if multilateral rules were still thought necessary, there could always have been an additional provision that dealt specifically with non-discriminatory quotas. Whether or not WTO Members choose to adopt strong national treatment as a central pillar of the Agreement, clarifying the relationship between the two key access provisions is essential.

The modes of supply and technologies of delivery The current approach to scheduling by the four modes of supply that define trade raises both economic and legal issues. First of all, national schedules may distort incentives to use the most efficient mode if one mode is treated better, or even offered greater security of access, than another. Legal problems could also arise. There is nothing in the MFN and national treatment provisions of the GATS (Article XVII) which suggests that the mode of supply is a determining factor in defining the 'likeness' of a service. Therefore, in principle, alternative modes of delivery may be used to supply 'like' services. Interpretation of the MFN provision in particular could create problems, for example, in a situation where a Member treats the services from a locally established firm from country A better than the cross-border services supplied by a firm from country B.

The distinction between modes, specifically modes 1 and 2, is also not clear. This problem attracted particular attention in the context of the negotiations on trade in financial services and related to whether a cross-border financial service transaction should be classified as a mode 1 or a mode 2 transaction. This can be virtually impossible to determine under existing definitions. If the transaction is deemed to have originated with a supplier in one jurisdiction selling a service to a consumer in another, then from the point of view of the jurisdiction in which the consumer is located, this would be classified as cross-border delivery, or a mode 1 transaction. If, on the other hand, the consumer initiates the transaction or solicits the service, it could be classified as consumption abroad. This potential confusion between mode 1 and mode 2 transactions obviously becomes important if the commitments scheduled by a Member are not identical in both modes. Suggestions for dealing with the modal definition issue include the amalgamation of both modes into a single one, and the redefinition of mode 2 to require the physical movement of a consumer.

The description of a service under GATS may not be sufficiently developed or explicit for it to be clear whether a commitment is intended to be technology neutral. Technological neutrality refers to the idea that a commitment

covers all means by which the service in question might be delivered within a mode of supply. It became apparent that WTO Members were aware of these kinds of difficulties in the negotiations on basic telecommunications. A Chairman's understanding was developed during those negotiations in order to clarify the coverage of scheduled commitments. The understanding established a presumption that unless indicated to the contrary, the description of a basic telecommunication service in a Member's schedule encompassed the full spectrum of ways in which a service could be supplied. A commitment on voice telephony, for example, would cover radio-based as well as wire-based technologies unless otherwise indicated. Similarly, in discussions in the WTO on electronic commerce and in the Committee on Specific Commitments, Members seem to have agreed that a commitment on a service should be invariant with respect to the means by which the service is delivered. The recent WTO Panel ruling in the Gambling dispute has also confirmed the principle of technological neutrality.

Enhancing transparency It is widely recognized that the 'scheduling technology' used in the GATS does not greatly promote transparency. A fundamental need is to improve the available information on status quo policies. This will facilitate national reform efforts and help identify where the multilateral process can support such efforts. Unfortunately, there is nothing in the GATS or the WTO that encourages and assists countries in generating comprehensive information on applied policies and evaluating the impact of these policies. One option that deserves serious consideration in this connection is to resurrect an Australian proposal made at the 1996 WTO Ministerial meeting to engage in a negative list *reporting* exercise of prevailing policies in services for transparency purposes. This should be accompanied by adequate technical and financial assistance to help developing countries, in particular least developed countries, to participate in the transparency exercise.

4.2. Developing disciplines on domestic regulations

One of the ironies of the GATS is that among its weakest general provisions are those dealing with domestic regulations. The reason is not difficult to see: it is extremely difficult to develop effective multilateral disciplines in this area without seeming to encroach upon national sovereignty and unduly limiting regulatory freedom. Nevertheless, it may be desirable and feasible to develop horizontal disciplines for domestic regulations.

Such a generic approach is to be preferred to a purely sectoral approach for at least three reasons: it economizes on negotiating effort, leads to the creation of disciplines for all services sectors rather than only the politically important ones, and reduces the likelihood of negotiations being captured by sectoral interest groups. It is now widely recognized that the most dramatic progress in

the EU single-market program came from willingness to take certain broad cross-sectoral initiatives. In the WTO context, the experience of the accountancy negotiations shows the propensity for single sectoral negotiations on domestic regulations to produce a weak outcome: while a 'necessity test' was instituted, the elaboration of disciplines on measures such as qualification requirements was disappointing.

Even if a horizontal approach is desirable, is it feasible? The diversity of services sectors, and the difficulty in making certain policy-relevant generalizations, would seem to favor a sector-specific approach. However, even though services sectors differ greatly, they have much in common in terms of the underlying economic and social reasons for regulations. Focusing on these reasons provides the basis for the creation of meaningful horizontal disciplines. The economic case for regulation in all services sectors arises essentially from market failure attributable primarily to three kinds of problems, natural monopoly or oligopoly, asymmetric information, and externalities (Table 3.3).

Table 3.3 Potential rationales for regulation

Market failures	Services sectors	Possible multilateral approach
Monopoly/ oligopoly	Network services: transport (terminals and infrastructure), environmental services (sewage) and energy services (distribution networks)	Non-discrimination and possible generalization of the key disciplines in telecom reference paper to ensure cost-based access to essential facilities, be they roads, rail tracks, terminals, sewers or pipelines
Asymmetric information	Intermediation and knowledge based services: financial services, professional services, etc.	Non-discrimination and possible generalization of the 'necessity' test. Use the test to create a presumption in favor of economically efficient choice of policy in remedying market failure
Externalities	Transport, tourism, etc.	
Social objectives: Universal service	Transport, telecommunications, financial, education, health	

Source: Mattoo (2003).

Dealing with domestic monopolies Market failure due to natural monopoly or oligopoly may create trade problems because incumbents can impede access to markets in the absence of appropriate regulation. Because of its direct impact on trade, this is the only form of market failure that may need to be addressed directly by multilateral disciplines. As noted above, the limitations of the relevant GATS provision, Article VIII dealing with monopolies, prompted the development of the Telecom Reference Paper in order to ensure that monopolistic suppliers would not undermine market access commitments. It might be possible to generalize these principles to a variety of other network services, including transport (terminals and infrastructure) and energy services (distribution networks), by ensuring that any major supplier of essential facilities provides access to all suppliers, national and foreign, at cost-based rates.[14] A key issue, especially in light of the recent Panel ruling on Mexico's telecommunications regime, is whether deeper disciplines of this sort are feasible and desirable from a development perspective. In particular, would such rules provide adequate space for the improvisation that is necessary to develop locally appropriate regulations?

Other sources of domestic market failure In all other cases of market failure, multilateral disciplines do not need to address the problem *per se*, but rather to ensure that domestic measures to deal with the problem do not serve unduly to restrict trade. (The same is true for measures designed to achieve social objectives.) Such trade-restrictive effects can arise from a variety of technical standards, prudential regulations, and qualification requirements in professional, financial and numerous other services; as well as from the granting of monopoly rights to complement universal service obligations in services like transport and telecommunications. Negotiators are struggling with the question of whether the trade-inhibiting effect of this entire class of regulations is best disciplined by complementing the national treatment obligation with a generalization of the so-called 'necessity' test. The test is already applied to technical barriers to trade in goods, and is part of the recently established 'pilot' disciplines for the accountancy sector.

The necessity test is generally seen as an additional discipline on non-discriminatory measures. It has not been recognized that without some such test, applying even the fundamental disciplines of national treatment (Article XVII) and MFN (Article II) is difficult – for it would be impossible to deter-

[14] Even though it would be extremely difficult to determine what cost-based rates are, the provision should at least make it possible to challenge the more egregious departures.

mine if a measure is in effect non-discriminatory.[15] Both Articles prohibit discrimination between *like* services and *like* service suppliers but likeness itself is not easy to establish. If a doctor is a doctor, a regulation that imposed any additional burden on a doctor trained in Country A (abroad) than on a doctor trained in Country B (at home) would violate Article II (Article XVII). If a doctor trained in one country is deemed to not be 'like' a doctor trained in another country, then the disciplines contained in the Articles would simply not apply. The former interpretation may be unduly stringent and politically unsustainable, but the latter is unduly permissive and would open the door to all manner of regulatory protection. A variant of the necessity test would seem to be the solution. Countries are not prevented from imposing additional qualification and training requirements in light of their regulatory objective but these should not be more burdensome than necessary to achieve that objective.

It is important to emphasize that our suggestion is for the inclusion of a necessity test to establish *whether* there is in fact *de facto* discrimination. WTO Members, in the context of the Article VI:4 work program, are in fact considering a necessity rule that would go beyond national treatment. That is, even strictly non-discriminatory measures would be subject to such a test. Since many of the binding trade restrictions today are discriminatory, it is doubtful that the benefit of additional disciplines in terms of generating improved market access would outweigh the political costs of instituting what would be regarded as intrusive multilateral rules.

4.3. Outstanding issues: subsidies, procurement and safeguards

A number of 'outstanding' rule-making issues were left open after the Uruguay Round for further work and discussion: subsidies, procurement and safeguards. The economic case for GATS-specific disciplines in any of these areas is weak. There is nothing services-specific about procurement: any multilateral disciplines should cover goods and services. Of primary importance for foreign firms is to have access to procurement markets, and frequently this can only be achieved if they have a commercial presence in a country. What matters in economic welfare terms is therefore not so much policies of discrimination, but the ability of foreign firms to establish themselves. If the sectoral coverage of the GATS is expanded and foreign providers become able to access markets, the contestability of procurement markets will be enhanced at the same time, independent of whatever discriminatory policies are in place.

Multilateral disciplines on subsidies might help avoid mutually destructive

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15 There is no explicit mention of the necessity test in the national treatment and MFN provisions.

policies from the viewpoint of developing countries – for example, seeking to attract FDI via the use of incentives – and eliminate important sources of distortion in OECD markets for some services and modes (for example, FDI incentives designed to divert investment away from developing countries, or operating subsidies for transportation activities). In the services context any disciplines will have to focus primarily on domestic production or operating subsidies – the distinction between export and production subsidies found in the GATT is much harder, if not impossible, to make in practice. It is also much harder to envisage emulation of the main GATT discipline – countervailing duties – increasing the need to agree to substantive rules (harmonization). Difficulties will immediately arise in distinguishing between what is 'legitimate' and what is not. While there are clearly potential sources of gain for WTO members associated with a set of subsidy disciplines, subsidies will frequently be the most efficient instrument to pursue non-economic objectives – for example, to ensure universal service; promote regional development; offset income inequalities; and so forth. Cross-subsidies of the type that are often regarded as inefficient and nontransparent mechanisms to achieve an objective may sometimes be the best available second-best instruments for developing country governments.

The GATT/WTO negotiating and implementation history illustrates that agreement on subsidy and related disciplines is difficult to obtain, and that any disciplines may easily be circumvented. Even the EU – which goes much further than the WTO in this area – has encountered recurrent difficulties associated with government policies intended to attract FDI and enforcing its restrictions on the use of State aids. NAFTA does not even try to tackle this issue. Given the rationale for subsidies in many contexts and the revealed preference of many governments to use subsidies, it would appear more effective to seek to extend the reach of the national treatment principle to subsidy policies, especially when the subsidy is aimed at firms that have established a commercial presence (FDI). Given national treatment, there should be less concern about the impact of subsidy policies, allowing the principle of 'subsidy freedom' to prevail (Snape, 1987). As in the procurement case, what matters most is market access and national treatment.

The economic case for safeguards instruments is also weak. Insofar as governments are under pressure to (re-)impose protection (discrimination), they already have the opportunity to invoke the re-negotiation modalities that are built into the GATS. GATT-type safeguards (emergency protection) are difficult to rationalize in the services context because in many cases they will require action to be taken against foreign firms that have established a commercial presence (Hoekman, 1993). Why a government would want to do this is unclear, as it can have a major chilling effect on FDI, and will affect negatively the national employees of the targeted foreign-owned firms. If safe-

guards are to be considered, it would therefore most likely exempt mode 3. But then it must be considered that any safeguards instrument that exempts mode 3 can easily act to induce investment, rather than trade (mode 1), thus distorting incentives (leading away from the modal neutrality objective).

There is, however, one potentially compelling argument for seeking to develop a safeguard instrument. A case could be made that the extremely limited nature of liberalization commitments to date on movement of service providers (mode 4) is in part due to the non-existence of safeguards instruments. As this is a mode of supply that is of major interest to developing countries and one on which almost all countries maintain stringent restrictions, one could envisage a safeguard instrument that is limited to mode 4 liberalization commitments, and is explicitly aimed at providing OECD country governments with an insurance mechanism that can be invoked if liberalization has unexpected detrimental impacts on their societies.

4.4. Developing dynamic negotiating methodologies

As countries seek the appropriate approach to international negotiations, they must choose between two broad alternatives. One is a bilateral request-and-offer approach, the other is the use of generally applicable negotiating formulae or model schedules.[16] In the sphere of trade in goods, governments have sometimes agreed to a formula on the basis of which they cut tariffs across-the-board by a uniform amount.[17] With a few notable exceptions, formulae have proved difficult to design for services negotiations because many different non-quantifiable instruments affect access to markets. Moreover, developing countries have supported the request-and-offer approach because it allows considerable freedom to decide on how much to liberalize. It may be possible to develop formulae or model schedules for concerted or more coordinated approaches to liberalization, such that WTO Members end up making more far-reaching commitments on these modes. Reasons to favor formulae/model schedules include the following:

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[16] See Thompson (2000) for a summary discussion of selected liberalization formulae for services. Any quantitative approach that focuses on the magnitude of the barriers to trade implied by services policies would need to start with an attempt to determine their 'tariff equivalent'. See Findlay and Warren (2000) for an effort to do this on a cross-country basis.

[17] In the Tokyo Round (1973–9) a weighted formula was devised so that higher tariffs would be cut more deeply than lower ones. This approach had the effect of moving the liberalization process ahead on multiple fronts, although exceptions to the formula applied in certain sectors.

- In a world of unequal bargaining power multilaterally agreed formulae that must be seen to be equitable and efficient are likely to produce a more favorable outcome for the weaker party than bilateral negotiations.
- Formulae help reduce the transactions costs of negotiations – avoiding the need to barter commitments sector-by-sector, country-by-country. Thus, formulae can help overcome the difficulty in accomplishing an exchange (and balance) of concessions between countries that do not necessarily have a reciprocal interest in each other's markets. This, of course, assumes that the negotiation of formulae itself does not involve large negotiating costs.
- Formulae can help overcome the free-rider problem that arises in negotiations conducted under an MFN-based system. The problem arises in bilateral negotiations because each of the beneficiaries of a concession from a trading partner may be tempted to understate their willingness to pay for it, hoping that offers of reciprocal concessions from other Members will be sufficient to induce the concession. If each Member behaves in this way, the result could be that mutually beneficial deals will not be struck.
- The use of multilaterally applied formulae is perhaps the only credible way of granting credit to the unilateral liberalizers. In contrast, it is much more difficult to ensure compensation for the loss of negotiating coinage caused by unilateral liberalization in a bilateral request-and-offer negotiation.

Finding the right formula is particularly hard in services, given the difficulty of quantifying the protectionist effect of different instruments. Three different 'models' of a concerted approach to liberalization suggest themselves from the experience accumulated so far in the GATS context: model schedules – used for maritime transport and telecommunications; the Understanding on financial services; and the Reference Paper in basic telecommunications. In each case, the premise was that agreement on standardized commitments would secure a higher level of commitment overall than if Members devised their liberalization offers independently. Different elements of these approaches can be used, representing increasing levels of ambition:

- Providing a framework for negotiations. This role is especially relevant when there is some ambiguity about sectoral definition and/or a need for prior consensus between Members on the market access and regulatory issues that should and can be addressed in a particular area. The approach is also likely to be useful in areas where segmentation of sectors is likely to facilitate faster progress in certain areas.
- Creating a focal point for liberalizing commitments and regulatory

principles. This is accomplished by creating a strong presumption in favor of a certain threshold level of commitments built into the model schedule – shifting the burden on a Member to justify its refusal to concede the threshold level rather than on other Members to extract the minimum concessions.
- Representing a formula for liberalizing commitments, analogous to ‘zero-for-zero’ goods formulae, *and* for harmonizing regulatory principles.

How the transition from a focal point to binding obligations is made depends on whether the aim is to create binding obligations (a) for all Members, in which case ambitions for deeper liberalization of some must accommodate the concerns of the most reluctant WTO Member, or (b) a sub-set of WTO Members, in which case depth of liberalization must be traded off against the extent of participation.

An example: securing liberal access for cross-border exports of services In the WTO E-Commerce Work Program, as of the time of writing WTO Members have focused on prohibiting customs duties on electronically delivered products.[18] It is ironic that considerable negotiation energy has been invested in prohibiting the economically superior (and probably infeasible) instrument of protection whereas little attention has been devoted to inferior (and possibly more feasible) instruments such as quotas and discriminatory internal regulation and taxation. Since the bulk of such commerce concerns services, open trading conditions are more effectively secured through deeper and wider mode 1 and 2 commitments. The use of commitments under *both* modes is necessary because Members have not yet arrived at a satisfactory distinction between the respective domains of mode 1 and mode 2.

Since GATS commitments are undertaken according to a ‘positive list’ approach for specified service activities, it is necessary to ensure adequate coverage of services that developing countries export (or could export) in commitments undertaken by trading partners. Two problems immediately arise: the inadequacy of the services sector classification and the poverty of Members’ commitments. The existing GATS Service Sectoral Classification list (W120) does not provide an adequate description of the range of services under consideration. Many of the listed ‘input’ or ‘support services’ (for example, payroll or customer care services) do not have fully corresponding entries in the list. It is also not possible to ‘infer’ commitments on input services from commitments on main service classifications (for example,

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[18] What follows draws on Mattoo and Wünsch (2004).

commitment on insurance claims processing cannot be inferred with certainty from a commitment on non-life insurance services).

In key areas like computer and related services or the 'other business category', there is considerable scope for improved commitments. Even in the regular business services or computer and related services, only around half of the WTO membership made any commitments (full or partial). In accounting services, the majority of the 67 Members who have made commitments list limitations, while in data processing only around two-thirds of the 66 commitments guarantee unrestricted market access. In any event, it is important not to take a static view of current electronic trade, and limit the negotiating focus to a few IT and simple business process outsourcing (BPO) services. Rather, the object should be to obtain full commitments on cross-border trade for the widest range of services.

One option to assure unfettered cross-border trade in services would be to make full horizontal market access and national treatment commitments for GATS modes 1 and 2 that apply to all services (not only the scheduled service activities). This broad forward-looking commitment could allow two exceptions: financial services that necessarily involve the movement of capital, and transport services that necessarily involve the movement of freight and people. The suggested model schedule developed by Mattoo and Wünsch recognizes that these commitments would not deprive a country of the right to maintain and introduce new regulations protecting, *inter alia*, consumers, health, safety, national security, the environment, the financial system, etc. This provision, akin to the 'prudential carve-out' in the Annex on financial services, would help to reassure national regulators that the objective is not to question their judgments but to target only blatantly protectionist measures. While the overall proposal may seem radical, it amounts to no more than a binding of the status quo.

A less ambitious option would be to make targeted commitments to cross-border trade in IT and BPO services. Under a model schedule, Members would be expected to make full market access and national treatment commitments on directly identified business services, as well as elements of other services, such as bookkeeping and auxiliary financial services, which are increasingly outsourced. When necessary, Members would also be asked to update their schedules with commitments on the basis of the revised CPC 1.1 classification.

The thrust of both approaches is to pre-empt the introduction of explicit barriers to cross-border trade in services. A range of complementary initiatives on regulatory transparency, domestic regulation, and clarification of issues like applicable jurisdiction will be necessary to achieve the broad aim of unfettered cross-border trade in services.

5. Concluding remarks

The GATS can be made a more effective instrument of liberalization without fundamental structural changes. The following improvements could be made in the current round of services negotiations in the rules of the Agreement, Members' commitments, as well as the negotiating methodology.

- Wasteful regulations and entry restrictions are pervasive barriers to services trade. Unlike the GATT, the GATS has created no hierarchy of instruments of protection – even though the ranking of instruments in the case of both goods and services is similar. It may not yet be politically feasible to prohibit the use of quota-like measures, but it may be possible to create a legal presumption in favor of instruments (such as fiscal measures) that provide protection more efficiently.
- Many countries have taken advantage of the GATS to create a more secure trading environment by making legally binding market access commitments. But the coverage of commitments for a large number of countries is limited, and in some cases commitments serve to protect the privileged position of incumbents rather than enhance the contestability of markets. Greater advantage could be taken of the opportunity offered by the GATS to lend credibility to past or ongoing reform programs by committing to maintain current levels of openness or by precommitting to greater openness in the future.
- Multilateral rules on domestic regulations can help to promote and consolidate domestic regulatory reform, even when they are designed primarily to prevent the erosion of market access for foreign providers. But at this stage, national treatment is a powerful discipline that could deliver many of the gains from openness. Going beyond national treatment may not have substantial benefits in terms of additional market access, while creating potentially significant political opposition to what would be regarded as intrusive multilateral rules.
- Explicit departures from the MFN rule matter most in sectors like maritime transport, audiovisual services, and air transport services – which have all been excluded from key GATS disciplines. Progress will not be easy but bundling sectoral negotiations together (for example, in transport) may help. Implicit discrimination needs to be prevented by developing rules to ensure the non-discriminatory allocation of quotas, and by clarifying and maintaining the desirable openness of the GATS provision covering mutual recognition agreements.
- To advance the process of services liberalization beyond levels undertaken independently, reciprocity must play a greater role in negotiations. This may be facilitated by devising negotiating formulae that establish credible links across sectors (both goods and services) and across modes of delivery.

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Annex 1. The scope and significance of explicit departures from MFN in services

Around 380 MFN exemptions have been listed by some 70 Members, with many Members listing several exemptions in the same sector (see Annex Table 1). Nearly two-thirds of the exempted measures are to be found in communication services and in transport services. One reason specified for these measures is the existence of sector-specific preferential regional agreements, or other bilateral or plurilateral agreements. For instance, in audiovisual services, more than half of the exemptions mention promotion of common (regional) culture as a motive for limiting access to joint programmes to finance and diffuse audiovisual works; and in maritime transport, nearly half the exemptions are by developing countries for measures implementing the provisions of the United Nations Convention on a Code of Conduct for Liner Conferences.[19] The other reason cited for exemptions is a unilaterally imposed reciprocity condition – which specifies that a Member is willing to guarantee access to its market only to those Members who provide it with access to their markets. These are particularly significant in air transport services and financial services.[20]

Perhaps even more important than the MFN exemptions that were listed are those that did not need to be. The Annex on Air Transport specifically excludes the complex network of bilateral agreements on air traffic rights from GATS rules.[21] Thus, a sector that is in urgent need of liberalization often remains fragmented into duopolies. The same is true for maritime transport, where the MFN obligation was suspended due to concerns by the US that the quality of its trading partners' market-opening commitments did not justify giving up its right to take retaliatory action against foreign restrictive practices.[22]

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[19] These provisions, in principle, divide 80 percent of the liner trade on a traffic route between the shipping companies of the two states at each end, leaving only 20 percent for shipping companies of other nationalities. Full implementation of this rule is apparently rare, and third country ships usually have access to a larger share of the market. Many Members chose to maintain MFN exemptions despite the suspension of the obligation for the sector.

[20] The exemptions listed for air transport services pertain to the services falling within the scope of the GATS, i.e. repair and maintenance, selling and marketing of air transport services, and computer reservation system services.

[21] International air transport services are for the most part governed by arrangements negotiated under the Chicago Convention (i.e. the International Air Services Transit Agreement, concluded at Chicago, 7 December 1944).

[22] The original US MFN exemption for maritime transport services that was put forward in the negotiations reserved the 'right to investigate and take action against foreign carriers to address adverse or unfavourable actions affecting US shipping or US carriers in US ocean borne commerce and the cross trades between foreign ports'.

Annex Table 1. Distribution of MFN exemptions (by sector and conditions)

Sector	Number of Members	Number of measures	Conditions creating the need for exemption			
			Regional Agreements	Other bilateral or plurilateral agreements	Reciprocity	Other
1. BUSINESS SERVICES						
A. Professional Services	11	12	0	2	6	4
B-F. Other Business Services	7	9	2	1	3	3
2. COMMUNICATION SERVICES						
A. Postal Services	1	1	0	0	1	0
B. Courier Services	0	0	0	0	0	0
C. Telecommunication Services	11	17	18	8	1	0
D. Audiovisual Services	33	69	37	26	4	2
3. CONSTRUCTION SERVICES	3	3	1	0	1	1
4. DISTRIBUTION SERVICES	3	4	3	1	0	0
5. EDUCATIONAL SERVICES	0	0	0	0	0	0
6. ENVIRONMENTAL SERVICES	0	0	0	0	0	0
7. FINANCIAL SERVICES	25	36	10	7	15	4
8. HEALTH-RELATED SERVICES	1	1	0	1	0	0
9. TOURISM AND TRAVEL	2	2	0	1	0	1
10. RECREATIONAL SERVICES	3	4	1	1	2	0

11. TRANSPORT SERVICES						
A. Maritime Transport Services	28	55	14	23	8	10
B. Internal Waterways Transport	10	11	1	1	0	9
C. Air Transport Services[1]	19	23	0	6	19	3
D. Space Transport	2	2	0	2	0	0
E. Rail Transport Services	12	14	6	1	4	3
F. Road Transport Services	33	46	24	8	8	6
G. Pipeline	1	1	0	0	1	0
H. Auxiliary	9	16	7	0	2	7
12. OTHER SERVICES NOT INCLUDED ELSEWHERE						
Entry/Visa	23	26	4	18	0	4
Investment	15	17	1	13	0	3
Financial Support	5	5	5	0	0	0
Taxation	3	3	0	3	0	0
Real Estate	3	3	1	0	0	2
Regional Agreements	7	7	7	0	0	0

Notes: [1] Pertaining to: aircraft repair and maintenance services; the selling and marketing of air transport services; computer reservation system services.

Source: Compiled from GATS MFN Exemptions Lists.

On the whole, MFN exemptions would seem to matter most in sectors like audiovisual services and maritime transport where few specific commitments have been made and discriminatory practices seem to be empirically important. In other cases, where the exemptions coexist with specific commitments (as in financial services)[23] or legitimize preferences which do not greatly affect the pattern of trade (as in cross-border supply of land transport services), there is probably less cause for concern. Finally, the exemptions which cover retaliatory legislation need not lead to actual discrimination in trade policy though the credible threat itself may have real effects.

[23] As mentioned previously, market access guaranteed under specific commitments must be extended on a non-discriminatory basis to all trading partners – even if an MFN exemption has been sought. The MFN exemption can provide legal cover only for better treatment for some trading partners than provided for in the specific commitments.

4. International trade: regionalism

Joel P. Trachtman

1. Introduction

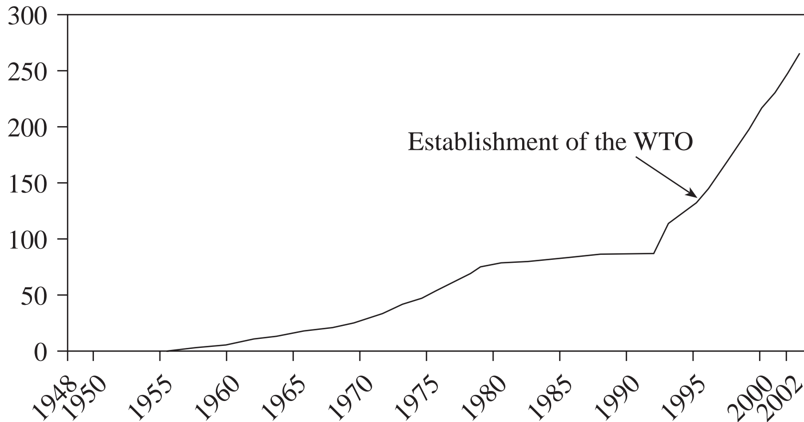
Regional integration agreements (RIAs), like other forms of international economic institutionalization or law, are generally aimed at economic integration: the reduction of barriers to movement of economic factors across borders. However, there can be other aims: the original European Economic Community and European Coal and Steel Community were famously motivated by a desire to make war between Germany and France impossible. Monetary union in the European Union has been criticized by financial economists, but may play a broader role in political or social aspects of integration.

Regionalism is an accelerating phenomenon, as shown in Figure 4.1, although in 1963, Kenneth Dam was able to say that the last dozen years had 'seen a proliferation of customs unions and free-trade areas of unforeseen proportions' (Dam 1963, p. 615). One estimate suggests that more than half of international trade could be covered by RIAs by 2005 (OECD 2003, p. 12). By July 2005, 330 RIAs had been notified to the GATT (General Agreement on Tariffs and Trade) or the WTO (World Trade Organization), with 180 of these still in force. Only Mongolia belonged to no RIA.

The great majority of these RIAs are free trade areas (FTAs), rather than customs unions (CUs). An FTA provides zero tariffs among its members, but each member maintains its own tariff schedule for application to the products of other states, whereas a CU is a free trade area with a common external tariff. Among the best-known regional RIAs are the European Community (EC),[1] the North American Free Trade Agreement (NAFTA), the Southern Common Market (MERCOSUR), the Association of Southeast Asian Nations Free Trade Area (AFTA) and the 2004 Central American Free Trade Area (CAFTA).

Regionalism presents many faces to the international economic law system.

[1] The EC includes the European Economic Community, the European Coal and Steel Community and the European Atomic Energy Community. 'EC' thus refers to the relevant entity for regional economic integration. The European Union consists of three pillars: the EC plus the two intergovernmental pillars of the Common Foreign and Security Policy and Justice and Home Affairs.



Source: WTO Secretariat

Figure 4.1 Number of Regional Trade Agreements 1948–2002

Regional integration creates international economic law subsystems.[2] These subsystems are rather diverse in structure and scope. They have a complex economic relationship with the multilateral system, represented by the WTO: they may both undermine and support multilateral economic integration.

Regionalism, as applied to third countries, is broadly inconsistent with the principle of most-favored nation (MFN) trade: the principle of non-discrimination among trading partners. This is because it applies a different tariff on goods depending on their origin. Therefore, *vis-à-vis* the global setting (as opposed to internally), regionalism will often be inconsistent with the operation of comparative advantage, since it applies tariffs to goods sourced outside the RIA, but not to goods sourced within the RIA.

On the other hand, regional arrangements generally reduce internal barriers to trade and therefore are consistent with comparative advantage internally. The comparison between internal trade creation, and diversion of external trade, initially analysed by Jacob Viner, has been a central, but disputed, part of the analysis of the static welfare effects of regionalism. Regional arrangements may also have dynamic effects by inducing economic restructuring that paves the way for deeper multilateral integration, or serving as comparative laboratories to develop institutional tools for deeper multilateral integration.

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[2] It is important to note that they are not 'subsystems' in terms necessarily of priority or supremacy, but merely in terms of numbers of participants. But see Tiny (2005) for an analysis in terms of priority or supremacy.

Furthermore, regionalism may implicate any or all of the 'four freedoms': trade in goods, trade in services, free movement of investment and free movement of labor.

Regional subsystems also have a complex legal relationship with the multilateral system. Regionalism is regulated under WTO law. The relationship between regional agreements and WTO law is important both in the application of the law of the regional agreements and in the application of the law of the WTO.

This chapter provides an introduction to several critical issues of international economic law raised by regionalism. After providing a taxonomy of regionalism in Section 2, this chapter briefly describes the economic and political relationship between regionalism and multilateralism in Section 3.

Section 4 reviews the GATT and WTO regulation of regionalism in light of the economic and political relationship between regionalism and multilateralism. At the most basic level, Article XXIV of GATT provides an exception from GATT disciplines, notably but not limited to the Article I MFN requirement, with respect to RIAs that meet specific conditions. These conditions include most importantly an 'internal' requirement that participants eliminate restrictive regulations of commerce with respect to substantially all the trade. A CU must apply a common external tariff: it must apply substantially the same duties and other regulations of commerce to imports. Finally, for both an FTA and a CU, duties and other regulations of commerce imposed after formation may not on the whole be higher or more restrictive than prior to formation.

Section 5 examines the emerging issue of choice of law and choice of forum in international economic law disputes in the context of overlapping rules of international economic integration. Section 6 concludes.

2. Varieties of regionalism in trade: from the EU to NAFTA

There is a wide variety of regional economic integration. In point of fact, some of it is not regional at all, such as the US-Singapore Free Trade Agreement. Therefore, the more accurate term for the subject of this chapter would be 'sub-multilateral integration' or 'preferential trade agreement'. However, since much sub-multilateral integration has traditionally been regionally based, and since these terms are conventional in the literature, we refer to regional integration inclusively.

This part reviews some traditional categories, but also recognizes some of the newer variations that have developed among regional integration agreements. These variations include the manner by which non-tariff barriers are addressed, the treatment of services and investment, and the institutional structure of the RIA. Indeed regional integration defies simple categorization, as the topics addressed vary according to the circumstances of the parties.

2.1. Traditional categories

Since its founding in 1957, the EC has been the leading example and the 'gold standard' of regionalism. Not only has it established in large measure the 'four freedoms',[3] but it has also developed a high level of policy coordination, international relations coordination, and redistribution. Furthermore, the EC has developed a complex federal legal system, covering a broad spectrum of subject areas and dealing in a highly sophisticated way with issues of legal relations between the RIA governance and the member states. There are many examples of circumstances in which other regional and multilateral integration bodies have learned lessons from, or emulated, the EC. Of course, customs unions can be precursors of states, as in the formation of Germany and Italy.

Balassa (1962) developed a system of categorizing regional integration.[4] We begin with an FTA, in which tariffs and quotas are abolished for imports from within the area, but each member maintains its own external trade barriers. The next step is to a CU, which in addition to establishing an FTA, establishes a common external tariff. A common market includes additional removal of barriers to movement of factors of production, and may include further coordination of external commercial policy. An economic union includes some degree of harmonization of economic policy. Total economic integration includes unification of monetary, fiscal, social and counter-cyclical policies, plus a supranational authority that can bind member states.

Thus, the EC may be understood as an example of a common market with some features of total economic integration, while NAFTA is essentially an FTA with a few additional features. These additional features include coverage of investment, intellectual property and services. However, as the multilateral system since 1994 has included intellectual property and services, the additionality offered by NAFTA is largely in the area of intra-regional zero tariff treatment, plus investment. More recent FTAs have provided greater additionality, with more intense coverage of intellectual property and services than may be found in the multilateral system: so-called 'WTO plus'.

The Balassan stages are not necessarily expected to be followed in order, and there is no compelling reason to expect an FTA to 'evolve' into a CU or toward total economic integration (see Evenett 2004). But each type of regionalism requires additional legal rules and institutions internally, and raises additional legal issues externally.

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3 Free movement of goods, services, labor and capital.
4 For an updated analytical structure, see Pelkmans (1997).

2.2. *Regulatory non-tariff barriers*

The decline of tariff barriers has lent greater importance to non-tariff barriers. Non-tariff barriers take varying forms. In this chapter, we address two types: (i) regulation that may impede market entry, and (ii) trade policy measures such as safeguards, anti-dumping and anti-subsidies measures.

Regulation may impede entry through either *de jure* or *de facto* discrimination. However, it may also impede entry in other ways deemed undesirable, as when the costs in lost welfare from trade exceed the regulatory benefits. RIAs may address regulatory non-tariff barriers through either negative integration or positive integration. Negative integration involves judicially applied disciplines such as national treatment, most-favored nation treatment, proportionality or other tests that may be applied to find illegal a domestic regulatory measure. Positive integration entails centralized legislative power to establish new regulation at the RIA level. There is an important relationship between negative integration and positive integration. Positive integration capacity makes negative integration less necessary. Positive integration may reduce the potential deregulatory bias that may arise with negative integration.

2.3. *Trade policy non-tariff barriers*

Safeguards mechanisms, anti-dumping measures and anti-subsidies measures (collectively, 'trade policy measures') may serve as non-tariff barriers to trade (this definition is commonly accepted even though these measures may be implemented using additional tariffs). RIAs may take varying approaches to trade policy measures. For example, trade policy measures are not normally permitted among states of the EC (although certain subsidies are illegal under EC law). Another example is NAFTA, which provides special requirements for safeguards measures, and provides special international judicial review for anti-dumping and anti-subsidies countervailing duty measures. Within the Australia-New Zealand Closer Economic Relations Agreement, anti-dumping duties are generally prohibited, countervailing duties are sharply limited, and safeguard measures are generally prohibited.

2.4. *Services*

RIAs may or may not extend beyond goods. However, most major RIAs include a services dimension (Mattoo and Fink 2002). To the extent that they address services, they may follow a variety of approaches. For example, the EC addresses trade in services through prohibition of discrimination and certain other more explicit types of barriers, and a program of essential harmonization and mutual recognition to address less explicit barriers. These categories correspond to the negative integration and positive integration categories established

above. NAFTA contains extensive provisions liberalizing North American trade in services. The US and Mexico have had a dispute regarding trade in cross-border trucking services.

2.5. *Investment*

More recent RIAs, especially those of the US, often cover investment, by including provisions that are similar in nature to a bilateral investment treaty within the text of the RIA. NAFTA is an important example. These provisions generally cover the standard of treatment of foreign investment, including prohibitions on expropriation and violation of the international law minimum standard. In addition, these provisions often cover market access for investment. One of the most contentious components of these investment chapters, although it is similar to the provisions found in typical bilateral investment treaties, is the provision of private rights of action to investors in connection with violations. These private rights of action relate to investment arbitration, often provided at the International Center for the Settlement of Investment Disputes (ICSID). One of the loudest complaints of anti-globalization protesters has targeted the facility for private rights of action for private investors under these RIAs. In the recent Australia-US FTA, these types of private rights of action in arbitration were not included.

2.6. *Institutional structure*

Finally, RIAs have varying institutional structures. Here, the EC, as suggested above, is the gold standard, to such an extent that it may be in a different category altogether from other RIAs. Indeed, the EC is somewhat comparable to a federal system such as that of the US, Australia or Switzerland, insofar as it combines centralized authority with local autonomy. Other RIAs lack the capacity for majority voting and the strong secretariat that the EC possesses. Furthermore, while other RIAs have dispute resolution mechanisms or even courts, none have become constitutional courts with the broad power and prestige that the European Court of Justice possesses.

2.7. *Patterns of regionalism*

The US and the EC have programmatic approaches to regionalism, and may be viewed as hubs of various arrangements. The EC has entered into customs union agreements and free trade area agreements with individual countries, and is in discussions for an association agreement with MERCOSUR. The US has entered into a number of free trade area agreements with other countries, in cases where those other countries do not necessarily have free trade area arrangements with one another. The EC also uses regional agreements as a development tool.

3. Regionalism and multilateralism

Economists have devoted much research to the question of whether regional arrangements for free trade areas or customs unions are welfare-enhancing or welfare-reducing. This chapter does not seek to provide a review of this literature, but merely to introduce some of the salient concepts (for reviews, see Panagariya 2000; Kowalczyk 1999; Baldwin and Venables 1995).

The modern economic study of regionalism began with the seminal work of Jacob Viner (1950), comparing the trade-creating (welfare-enhancing) effects with the trade-diverting (welfare-reducing) effects of regional integration. In the years since 1950, economists have critiqued and extended the static Vinerian analysis in a number of ways.

Economists have also importantly added to Viner's 'static' analysis by consideration of what Bhagwati has called the 'dynamic' time-path issue (Bhagwati 1993). This dynamic question includes the question of the relationship between the growth of regional trade integration and the growth of multilateral trade integration: whether regional integration agreements are building blocks or stumbling blocks on the path to global economic integration (Bhagwati 1991). (This question was already being asked in Dam 1963.)

3.1. Static analysis: trade creation, trade diversion and spaghetti bowls

Static welfare analysis of RIAs considers changes in volumes of trade subject to domestically captured rents (such as tariffs) and rents that are not captured domestically (such as quota rents), as well as terms of trade effects (Baldwin and Venables 1995). Quota rents result from the scarcity of imported goods that arises from quotas, giving the exporter the power to price them at a higher level than if quotas did not create artificial scarcity. Quota rents accrue to the exporter, and so are not captured domestically. On the other hand, tariffs accrue directly to the importing government, and so they are domestically captured.

The changes in volumes of trade subject to domestically captured rents are considered under the well-known concepts of trade creation and trade diversion. Trade creation occurs when the reduction of internal barriers leads private persons to import from a supplier that is a lower cost producer than domestic producers. Trade diversion occurs when the reduction of internal barriers, while leaving in place external barriers, leads private persons to import from an RIA producer rather than a lower cost non-RIA producer.

For example, before the formation of NAFTA, a Brazilian manufacturer of a particular textile product might have been able to price its goods more competitively for the US market than a particular Mexican manufacturer. Under pre-NAFTA MFN tariffs, the Brazilian manufacturer would be able to gain more market share: greater trade volumes compared to the Mexican manufacturer. After the formation of NAFTA, the tariff on the Brazilian

textiles remained in place, while the tariff on the Mexican textiles was reduced to zero. To the extent that this results in the Mexican manufacturer becoming able to sell in the US market at a price lower than that offered by the Brazilian manufacturer, trade diversion takes place. (Importantly, this very phenomenon results in a dynamic effect: the Brazilian manufacturer may lobby its government to enter into an FTA with the US.)

On the other hand, assume that before the formation of NAFTA, a US manufacturer of furniture was able to compete effectively with a more efficient Mexican manufacturer, because of the protective barrier provided by US MFN tariffs on imported furniture. Upon the formation of NAFTA, this protective barrier was removed, and the Mexican manufacturer became able to take market share from the US manufacturer. This is trade creation. (For a more formal illustration of trade diversion and trade creation, see Panagariya 2000, pp. 290–93.) The fundamental theorem of welfare economics holds that trade creation enhances welfare.

One way of understanding RIAs is to examine whether the welfare reduction resulting from trade diversion is greater or less than the welfare enhancements resulting from trade creation. This kind of test, though, is difficult enough to apply *ex post*, and seems impossible to apply reliably *ex ante*. It also leaves out consideration of rents that are not captured domestically, and terms of trade effects. Moreover, once we drop the unrealistic assumption of zero elasticity of demand, even a wholly trade-diverting RIA may lead to an increase in welfare (Lipsey 1957; Panagariya 2000). Bhagwati (1971) shows that in order to eliminate the possibility of trade diversion, it is necessary to assume that *both* the elasticity of demand for imports is zero, *and* the elasticity of supply for exports is zero.

Rents that are not captured domestically often arise from non-tariff barriers (Baldwin and Venables 1995). Baldwin and Venables point out that if all barriers were of this type, then a state gains from any RIA that reduces its average tariff-equivalent trade barriers. The extent of trade creation and trade diversion are irrelevant in this case.

If countries in the RIA have sufficient market power, then welfare may also be affected by terms of trade changes both in the internal trade of an RIA member and in its external trade. Baldwin and Venables conclude that where the RIA is small (meaning that there are no terms of trade effects) and there is perfect competition, an RIA that does not raise external barriers would have no effect on external welfare. Would countries raise external trade barriers? Article XXIV of GATT specifically prohibits this, as discussed in more detail below. The threat of retaliation may also induce states not to raise external barriers. While in a two-country single-play model, a small country's threat to retaliate may be insufficient, repetition or the ability to receive compensation may induce large RIAs not to raise barriers (Kowalczyk 2000; Konishi et al. 2003).

Panagariya (2000) describes a Kemp-Wan-Vanek-Ohyama theorem whereby two countries may enter into a customs union while setting a common external tariff that maintains imports into the customs union at pre-union levels. This would keep the welfare of third states constant, and allow intra-union free trade to increase the welfare of member states. Even under these circumstances, the welfare of member states would not necessarily be increased. A similar result can be achieved for FTAs (Panagariya and Krishna 1997).

Bhagwati has criticized the proliferation of RIAs in terms of transaction costs. He has used the term 'spaghetti bowls' to refer to the varying tariff structures that exporters encounter, and even more substantively, the varying rules of origin that exporters encounter and customs officials apply (Bhagwati 1996).

3.2. Dynamic analysis: building blocks and stumbling blocks

Another approach to RIAs is to evaluate them in terms of their dynamic effects. Several parameters may be evaluated. First, is there a pro-competitive effect of integration? Second, does RIA liberalization spur growth through investment? Third, does regional liberalization result in a reduction of political power of protected industries, or of the value of multilateral protection to protected industries, and therefore a reduction of political demand for protection? Lastly, does bureaucratic experience with regional integration pave the way for multilateral integration? On the other hand, does path dependence result in reduced possibilities for multilateral integration, after states engage in regional integration?

Pro-competitive effects may arise from the creation of a larger market within the RIA. The European Community's single market program in the 1980s and early 1990s was motivated by a desire to establish a breeding ground for 'world class' competitors that could match US and Japanese firms. Pro-competitive effects may be substantial, leading to significant increases in firm scale (Baldwin and Venables 1995).

Growth may arise from integration where firms increase investment in order to capture increasing returns. One important issue here is investment diversion. For example, did the creation of NAFTA cause a shift in investment from the US to Mexico? In fact, the inclusion of Chapter 11 in NAFTA may be seen as an attempt to accentuate this effect by providing market access and protection for US and Canadian investors in Mexico.

Another source of dynamic effects is in political economy. To the extent that regional integration reduces the rents from protectionism that a firm is able to reap, the firm will have less incentive to seek protection, and fewer resources to do so. This may open the way to further integration on the multilateral front.

3.3. Laboratories of multilateralism and path dependence
RIA disciplines may serve as an example or a pathfinder for future multilateral disciplines: as laboratories of integration[5] and sources of intellectual capital. On the other hand, especially in the area of regulatory non-tariff barriers, there are questions about the extent to which RIA disciplines may result in circumstances where the RIA proceeds along a path that makes multilateral integration more difficult (Bhagwati 1993, p. 22), or that may pre-determine the path of multilateral integration (Mattli 2000): path dependence. Thus, the RIA may take advantage of 'first mover' advantages, and use its prior action to impose outcomes on other states.[6] More importantly, regional integration creates advantageous positions, including those enjoyed by new investors in RIA members, with its own demand for continued preference.

3.4. The regional 'card' and the demand for integration
In addition, states sometimes appear to engage in regional integration as an alternative to multilateral integration. This may occur simply as a BATNMA: a 'best alternative to a negotiated multilateral agreement'. In this sense, states would be expected to examine their alternatives to proposed multilateral integration arrangements. States may strategically cultivate RIAs in order to enhance their BATNMA, and therefore their leverage in multilateral negotiations. It appears that the setback in WTO Doha Development Agenda negotiations in the 2003 Cancun Ministerial Conference precipitated negotiations on a number of RIAs. Finally, all states, but especially developing states, have finite capacity to negotiate international economic integration agreements. Therefore, work on RIAs reduces the ability to engage in multilateral integration.

4. WTO regulation of regionalism
RIAs are generally inconsistent with the basic most-favored nation (MFN) principle in WTO law: the principle that each member state treat all WTO member states equally. This principle is expressed in Article I of GATT as to goods in the following terms: any liberalization granted by any member state to any product originating in any other country must be accorded to the like

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5 For an elaboration, see Cho (2001).

6 For an example, see the Consultation Document Prepared by the European Commission's Directorate General for Enterprise on the Review of the New Approach, 13 December 2001, available at http://europa.eu.int/comm/enterprise/consultations/new_approach_rev/documents/consultation_doc.pdf, at 6 ('A more consistent implementation of the New Approach within the European Community will help the Community to encourage international alignment with its regulatory framework . . . strengthening the Community's negotiating position with third parties').

product originating in all other contracting parties. Similar provisions are included in the General Agreement on Trade in Services (GATS) and in other WTO agreements.

Therefore, in order for an RIA – either an FTA or a CU – to comply with WTO law, an exception is necessary in order to permit differential tariffs as between member states and non-member states, among other things. Article XXIV of GATT provides such an exception, subject to the satisfaction of specified conditions.

Article XXIV was proposed for addition to the original GATT by US negotiators, in anticipation that the US would enter into an FTA with Canada (Chase 2005). Interestingly, the Havana Charter, which would have provided for the broader International Trade Organization, but was never ratified, only provided an exception for customs unions, not for free trade areas (Chase 2005). Earlier customs unions had quickly led to full political integration. The original GATT, which was intended merely to hold in place certain tariff concessions until states could ratify the Havana Charter, added an exception for FTAs in order to facilitate the proposed, but frustrated, treaty with Canada.

There is wide agreement among economists that the conditions specified by Article XXIV are not congruent with economic theory. There is less agreement on a replacement. For example, in analyzing Article XXIV, Bhagwati suggests that

> A different, and my preferred, approach is not to pretend to find rules of thumb to exclude CUs and FTAs 'likely' to be trade-diversionary, but rather to examine the different ways in which trade diversion could arise and then to establish disciplines that would minimise its incidence. (Bhagwati 1993, p. 16)

Bhagwati suggests that Article XXIV:5 operates in this spirit, by seeking to ensure that external barriers are not increased at the formation of an RIA, although 'it is evident to trade economists that *maintaining* external tariffs unchanged is, in any event, not the same as eliminating trade diversion' (Bhagwati 1993, p. 16). Therefore, Bhagwati recommends rules that would require a reduction in external tariffs. McMillan recommends simply asking the question whether the agreement results in less trade between member countries and outside countries – he would in effect require some reduction in external barriers in order to counter the trade-diversionary effects of internal integration (McMillan 1993, p. 306). It is useful to consider whether Article XXIV accommodates a test that would meet the requirements of welfare economics (Mathis 2002, p. 108).

This section first reviews the basic structure and operation of Article XXIV and the Understanding on the Interpretation of Article XXIV. Core issues include the question of how customs unions are to establish common external

tariffs. This section examines the ambiguity regarding the treatment of product standards, safeguards, dumping and subsidies measures under Article XXIV. It considers the amenability of disputes regarding the interpretation or application of Article XXIV to WTO dispute settlement. It also describes the facility for RIAs among developing countries under the Enabling Clause.

4.1. Article XXIV of GATT and the Understanding on Interpretation of Article XXIV

Article XXIV:5 provides a conditional, and limited, exception from GATT requirements. It states that the GATT shall not prevent, as between the territories of contracting parties, the formation of a CU or of an FTA, or an interim agreement necessary for the formation of a CU or FTA, provided that external duties and other regulations of commerce are not 'on the whole . . . higher or more restrictive' than the general incidence prior to formation. This is known as the 'external' requirement.

In addition, the availability of the Article XXIV exception depends on the existence of a customs union or free trade area, or an interim agreement. However, the definitions of 'customs union' and 'free trade area' are also restrictive, and impose an 'internal' requirement. The internal requirement, contained in Article XXIV:8, requires that 'duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated with respect to substantially all' trade. Finally, the definition of 'customs union' contains an additional external requirement, requiring that 'substantially the same duties and other regulations of commerce are applied by each of the members . . .' to external trade.

The internal and external requirements include a number of difficult interpretative issues. This chapter can only highlight a few of them. With respect to the internal requirement, first, what are 'other restrictive regulations of commerce', and is the enumeration of exceptions in the parenthetical quoted above exhaustive or not?[7] Second, what is 'substantially all' trade? The public policy question behind both these doctrinal questions is what restrictions are permitted between RIA partners – in effect, it asks what level of integration will be set as a hurdle for permission to depart from the MFN obligation and other obligations of GATT. Third, for an interim agreement, how long an interim is permitted, and how gradual may be the phasing-in of integration? For the external requirement, interpretative issues include the question of the meaning of 'other regulations of commerce' and how to calculate whether duties and other regulations of commerce are 'on the whole higher or more

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[7] For a useful review of the history of this provision, see Mathis (2002).

restrictive'. Here, there are important questions of economic policy and analysis. There are also questions about requirements to compensate third states for any raised tariffs or other restrictions.

4.1.1. The Uruguay Round Understanding The 1994 Understanding on the Interpretation of Article XXIV (the 'Understanding') provides some clarifications, as well as some additional requirements with respect to RIAs.

The Understanding provides some specification with respect to the method of calculation of whether the general incidence of duties and other regulations of commerce has been raised in the formation of a customs union under Article XXIV:5. This issue has long been the subject of dispute, with the interpretative questions focusing on the method of averaging and the scope for offsetting increases in duties by reductions, and the determination of a prior reference period. The Understanding states that assessment shall be made on a tariff line basis. Thus, normally, a reduction in one tariff line will not balance an increase in another tariff line. Formation of a customs union usually involves some averaging, with each state raising some duties, while reducing others. If reduction on the same tariff line is not sufficient to provide the necessary compensatory adjustment, the Understanding provides that the customs union must offer compensation, which may take the form of reductions of duties on other tariff lines. The member states having negotiating rights with respect to the binding being modified or withdrawn are required to take that compensation into account. However, where negotiations on compensation are unsuccessful, the customs union is free to modify or withdraw the concessions, and affected member states are then free to withdraw substantially equivalent concessions in accordance with Article XXVIII of GATT.

The Understanding specifies that applied rates, rather than bound rates, shall be used for calculation purposes. The Understanding also provides some specification of what is meant by a 'reasonable length of time' during which an interim agreement must be completed. Generally, this period should exceed 10 years only in exceptional cases.

Finally, the Understanding provides for procedures for notification, negotiation and review of proposed RIAs. A WTO Committee on Regional Trade Agreements (CRTA) was established in 1996. The CRTA considers the systemic implications of RIAs for the multilateral trading system and the relationship between them. More specifically, it examines RIAs in goods notified to the WTO. This examination ensures the transparency of RIAs and allows other member states to evaluate and discuss the proposed RIA's consistency with WTO law. The proposed parties to the RIA provide information that forms the basis for the evaluation and discussion. Consultations are conducted toward the formulation of a CRTA report, but no reports have achieved

consensus and been issued since 1995. The WTO Dispute Settlement Understanding (DSU) may be invoked with respect to any matters arising from the application of relevant provisions of Article XXIV.

4.1.2. The Role of Article XXIV: the Turkey – Textiles jurisprudence In the *Turkey – Restrictions on Imports of Textile and Clothing Products* decision,[8] the Appellate Body examined the relationship between Article XXIV and other provisions of GATT. In particular, the question arose whether Article XXIV applies to provide an exception only to the MFN principle, or whether it provides an exception to other requirements of GATT.

The case concerned the final phase of the creation of a CU between Turkey and the EC. As of 1 January 1996, Turkey harmonized its tariffs, and its textiles and clothing quantitative restrictions, with those of the EC. India claimed that the imposition of these quantitative restrictions on textiles and clothing violated GATT Articles XI and XIII, as well as Article 2.4 of the Agreement on Textiles and Clothing, and was not justified by Article XXIV.

The Appellate Body found that the words 'shall not prevent' (with reference to the formation of a customs union or a free trade area) in the chapeau of Article XXIV:5 are critical to a determination of the scope of the exception under Article XXIV.

The panel had found that Article XXIV does not provide an exception from the rules against quantitative restrictions contained in Articles XI and XIII of GATT 1994.[9] The Appellate Body determined that the panel did not fully analyze the chapeau of Article XXIV:5, and proceeded to do so.

The Appellate Body emphasized the words 'shall not prevent' and held that 'Article XXIV can justify the adoption of a measure which is inconsistent with certain other GATT provisions only if the measure is introduced upon the formation of a customs union, and only to the extent that the formation of the customs union would be prevented if the introduction of the measure were not allowed'.[10] 'It follows necessarily that the text of the chapeau of paragraph 5 of Article XXIV cannot be interpreted without reference to the definition of a "customs union".'

As noted above, with respect to customs unions, Article XXIV:8(a)(i) sets the internal requirement to eliminate duties and other restrictive regulations with respect to substantially all trade. Article XXIV:8(a)(ii) sets the external

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[8] WT/DS34/AB/R, adopted 19 November 1999 [*Turkey – Textiles* Appellate Body Report].

[9] Panel Report, *Turkey – Restrictions on Imports of Textiles and Clothing Products*, WT/DS34/R, adopted as modified on appeal, 19 November 1999, paras 9.188 and 9.189.

[10] *Turkey – Textiles* Appellate Body Report, *supra* note 8, para. 46.

requirement for a 'common external trade regime'.[11] In addition, Article XXIV:5(a) imposes an additional external requirement to the effect that duties and other regulations of commerce 'shall not on the whole be higher or more restrictive than the general incidence' prior to formation.

The Appellate Body found that Article XXIV:4, and the preamble of the Understanding, provide an important part of the context for interpretation of the chapeau of Article XXIV:5, to the effect that a balance must be struck between the positive internal effects of customs unions, and any negative trade effects on third parties: this is an economic test.[12]

The Appellate Body held that the state using the Article XXIV defense has a burden of proof as to whether the requirements of Article XXIV:5 and 8 are met, and that the measure for which the defense is sought is *necessary* to the customs union: that compliance would prevent the formation of the customs union.[13] The Panel failed to examine compliance with Article XXIV:5 and 8.[14]

With respect to the necessity criterion, Turkey asserted that if it had not imposed the quantitative restrictions at issue here, the EC would have 'exclud[ed] these products from free trade within the Turkey/EC customs union'.[15] The EC would have done so to prevent trade diversion: to prevent these products from flowing into the EC through Turkey, and thereby avoiding the application of the EC's quantitative restrictions. These goods accounted for 40 percent of Turkey's trade with the EC, thus raising concerns that, if they were excluded, Turkey's regional arrangement with the EC would not satisfy the 'substantially all trade' criterion.

However, the Appellate Body agreed with the panel that there existed less trade-restrictive alternatives, including the use of rules of origin to distinguish between Turkish and third country textiles.[16] This would have addressed the problem of trade diversion, and obviated the need to exclude the textiles and clothing sector from the EC-Turkish customs union. However, the Appellate Body did not address the fact that such rules of origin

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11 *Turkey – Textiles* Appellate Body Report, *supra* note 8, para. 49.

12 *Turkey – Textiles* Appellate Body Report, *supra* note 8, paras 55–7, *citing* Panel Report, para. 9.120.

13 *Turkey – Textiles* Appellate Body Report, *supra* note 8, para. 58.

14 The panel expressed that it is arguable that it did not have jurisdiction to consider such compliance, but the Appellate Body noted in this respect its opinion in *India – Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products*, to the effect that a panel has jurisdiction to examine matters that are also committed to political evaluation. WT/DS90/AB/R, adopted 22 September 1999, paras 80–109.

15 Turkey's appellant's submission, para. 56.

16 *Turkey – Textiles* Appellate Body Report, *supra* note 8, para. 62–3.

would require administration, and would prevent the formation of the kind of customs union that the EC and Turkey wished: one that would not require border controls on goods, consistent with the principle of 'free circulation'.[17]

Under the Appellate Body's approach, the EC and Turkey are not entitled under Article XXIV to an exception necessary for features that go beyond those required by the definition of 'customs union' in Article XXIV itself. That is, states forming an RIA are not permitted to exceed the minimum standards set forth in Article XXIV if to do so would entail violation of another provision of GATT.

The Appellate Body concluded that Turkey failed to satisfy its burden of proof that formation of a customs union between the EC and Turkey would have been prevented if Turkey were not allowed to adopt the quantitative restrictions at issue.

4.2. Treatment of product standards

The requirements of Article XXIV of GATT and the Understanding with respect to RIA regulation of national product standards, technical regulations, and sanitary or phytosanitary measures (collectively, 'standards') are somewhat unclear, in large measure due to the imprecision of the definitions of 'other restrictive regulations of commerce' in Article XXIV:8, and 'other regulations of commerce' in Article XXIV:5 and 8. Under the analysis of *Turkey – Textiles* provided above, the following difficulty arises: harmonization or rules of mutual recognition that might otherwise violate GATT are only permitted to the extent that they are required under Article XXIV.

However, Article XXIV:8 does not appear to require harmonization or mutual recognition arrangements. To the extent that RIAs engage in harmonization, their harmonized standards measures must conform to the requirements of WTO law, namely the GATT, the Agreement on Technical Barriers to Trade (TBT Agreement) and the Agreement on Sanitary and Phytosantiary Measures (SPS Agreement). The regulation of RIA rules of mutual recognition, under the MFN obligation of Article I:1 of GATT, and under Article XXIV, is unclear, and rules of mutual recognition may present some opportunities for RIA protectionism. It would be useful to clarify the

[17] *Turkey – Textiles* Panel Report, para. 4.3, quoting a response to written questions by the EC as follows: 'The use of rules of origin benefiting only Turkish exports would have been an exception to the principle of free circulation within the customs union and would have required the maintenance of customs and border checks within the customs union designed to ensure that Turkey would not become a transit point of goods in circumvention of the Community's quota system arising from Turkey's adoption of the Community's rates of tariffs, etc.'.

meaning of 'other restrictive regulations of commerce' in Article XXIV:8, and 'other regulations of commerce' in Article XXIV:5 and 8 in order to clarify what Article XXIV requires and what it prohibits.

The core question raised in this area has to do with the treatment of recognition arrangements (see Bartels 2005). Do recognition arrangements violate the MFN obligation of Article I:1 of GATT? Should RIAs be permitted to maintain exclusive recognition arrangements, effectively discriminating against similarly situated third states and 'like' third state products? Or should they be required, as under Article VII of the GATS, to practice what might be termed 'open recognition' (Trachtman 2003)? Open recognition would establish RIA *conditions* for recognition, but permit third states to meet those conditions. Although the legal requirements are not clear, open recognition may be required under Articles I:1 and XXIV of GATT. It would be useful to clarify these requirements. It would also be useful to clarify whether Article XXIV may serve as an exception to the requirements of the TBT Agreement or the SPS Agreement. The specific text of Article XXIV states only that it provides an exception to obligations in the GATT itself.

4.3. Treatment of safeguards measures

Another important, and contentious, issue is whether a state member of an RIA may, may not, or must apply safeguards measures to other members of the RIA. Here, a central question under WTO law is whether these trade policy measures are 'other restrictive regulations of commerce' within the meaning of Article XXIV:8. This issue was discussed in the Uruguay Round negotiations, but was not resolved. The Agreement on Safeguards provides in footnote 1 that 'nothing in this Agreement prejudges the interpretation of the relationship between Article XIX and paragraph 8 of Article XXIV of GATT 1994'. Under the *Turkey – Textiles* line of reasoning, if a member of an RIA is prohibited by Article XXIV from applying safeguard measures to other RIA members, then Article XXIV would serve as a defense to any requirement elsewhere in GATT to apply safeguard measures on an MFN basis. If it is not prohibited to apply safeguard measures to other RIA members, then it may well be required to do so.

One way of understanding this issue is in the context of a conflict between an RIA treaty that prohibits application of safeguards measures to other RIA members, and WTO requirements of MFN application of safeguards measures. This issue is addressed more fully in Section 5, below.

So far, the Appellate Body has not spoken directly to this issue, although it has held that the scope of countries included in a safeguards investigation may not exceed the scope of countries included in the safeguard measure. This concept of 'parallelism' was applied in several Appellate Body

decisions,[18] and provides that imports included in the determinations of serious injury made under Articles 2.1 and 4.2 of the Safeguards Agreement should correspond to the imports included in the application of the resulting measure under Article 2.2.

For example, in *Line Pipe Safeguards*, the Appellate Body, reversing the Panel, agreed with Korea that including imports from Canada and Mexico in the domestic investigation, but excluding these imports from the application of the safeguard measure without a reasoned and adequate explanation, violated Articles 2 and 4 of the Safeguards Agreement. The Appellate Body found that the US administrative agency's report, while distinguishing between NAFTA and non-NAFTA imports, did not establish explicitly 'that increased imports from non-NAFTA sources by themselves caused serious injury or threat of serious injury'.[19]

Under these circumstances, the Appellate Body noted that it did not have to rule on the contentious issue of whether Article XXIV could serve as an exception here to the obligation to provide MFN treatment in the application of safeguard measures under Article 2.2 of the Agreement on Safeguards. (Recall that Article XXIV is nominally only an exception to the obligations under GATT itself.) According to the Appellate Body, this question becomes relevant only in two possible circumstances. The first is when the investigation by the competent authority does not consider the imports that are exempted from the safeguard measure. The second is when the imports that are exempted from the safeguard measure are considered in the determination of serious injury, and the competent authority has also established explicitly, through a reasoned and adequate explanation, that imports from sources outside the free-trade area, alone, satisfied the conditions for the application of the safeguard measure. Neither of these two circumstances pertained in that case.

4.4. Dispute settlement and the Committee on Regional Trade Agreements

For a variety of reasons, RIAs were rarely challenged through dispute settle-

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[18] Appellate Body Report, *Argentina – Safeguard Measures on Imports of Footwear*, WT/DS121/AB/R, adopted 12 January 2000; Appellate Body Report, *United States – Definitive Safeguard Measures on Imports of Wheat Gluten from the European Communities*, WT/DS166/AB/R, adopted 19 January 2001; Appellate Body Report, *United States – Definitive Safeguard Measures on Imports of Circular Welded Carbon Quality Line Pipe from Korea*, WT/DS202/AB/R, adopted 8 March 2002; Appellate Body Report, *United States – Definitive Safeguard Measures on Imports of Certain Steel Products*, WT/DS248, 249, 251, 252, 253, 254, 258, 259/AB/R, adopted 10 December 2003.

[19] Appellate Body Report, *Line Pipe Safeguards*, para. 196.

ment during the GATT period.[20] First, there were a number of ambiguities in the legal requirements. Second, the working party process by which RIAs were reviewed was generally indeterminate: no RIAs were disapproved and only a handful were approved. Third, the dispute settlement process required consensus to begin and to reach a legal conclusion; given the other uncertainties, and the contention by the EC that RIA legality was not amenable to GATT dispute settlement, it was difficult to bring a case.

As noted above, Article 12 of the Understanding specifically authorizes dispute settlement with respect to any matters arising from the application of Article XXIV to RIAs. On the issue of the jurisdiction of panels to consider member state actions under Article XXIV, in *Turkey – Textiles*, the Appellate Body, following its decision in *India – Quantitative Restrictions* (in a different context), asserted the authority of panels to examine these issues. Although in *Turkey – Textiles* the panel expressed doubt regarding the ability of a panel to evaluate compliance of an RIA with Article XXIV, the Appellate Body found not only that a panel may make this determination, but that a panel must do so in order to evaluate the availability of a defense under Article XXIV.

It should be emphasized that there seems to be no protection for pre-existing RIAs from scrutiny in dispute settlement. Thus, it would be possible for any existing RIA to be challenged under Article XXIV. *Turkey – Textiles* suggests that RIAs are potentially subject to rather strict scrutiny. This scrutiny may put increased pressure on revision of Article XXIV, or on greater deference to a political process of approval.

Under GATT, no working party ever disapproved an RIA, and only a few RIAs were approved. At the 1996 Singapore Ministerial, member states established the Committee on Regional Trade Agreements (CRTA) to review RIAs.

4.5. The Enabling Clause

The 1979 Enabling Clause,[21] which became a part of WTO law pursuant to

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[20] The exception is the first two Bananas cases, which were unadopted.

[21] *Differential and More Favourable Treatment Reciprocity and Fuller Participation of Developing Countries*, Decision of 28 November 1979, L4903. The relevant portions provide as follows:

> 1. Notwithstanding the provisions of Article 1 of the General Agreement, contracting parties may accord differential and more favorable treatment to developing countries, without according such treatment to other contracting parties.
> 2. The provisions of paragraph 1 apply to the following:
>
> . . .
>
> (c) Regional or global arrangements entered into amongst less-developed contracting parties for the mutual reduction or elimination of tariffs and, in accordance with criteria or conditions which may be prescribed by the CONTRACT-

Annex 1A of the WTO Charter,[22] provides exceptions from the MFN obligation of Article I of GATT in two ways. First, it allows contracting parties to offer non-reciprocal preferential treatment to imports from developing countries. The Enabling Clause also permits the establishment of RIAs among less-developed contracting parties.

The prerequisites for RIAs established under the Enabling Clause vary considerably from those detailed in GATT Article XXIV. The Enabling Clause does not impose the internal requirement of eliminating barriers from 'substantially all trade'. Moreover, its formulation of the external requirement is weaker, contemplating only that RIAs 'Not . . . constitute an impediment to tariff reduction or elimination on a MFN basis'.

The WTO Secretariat opined in 1995 that 'the Enabling Clause does not contain references to Article XXIV, an omission which has left unclear whether the Enabling Clause applies in situations where that Article does not, or affects the terms of the application of that Article, or represents, for developing countries, a complete alternative to the Article' (WTO 1995). This ambiguity has not been clarified in dispute settlement.[23]

4.6. Rules of origin

FTAs do not include common external tariffs. Therefore, there might be incentives for exporters to export through the FTA member that maintains the lowest tariff and then transfer the goods to higher tariff members. CUs, such as the EC, often maintain regimes of 'free circulation', meaning that once a good enters the CU it may be transferred freely to any other member of the CU. In order to prevent transshipment to evade differential tariffs – 'trade deflection' – FTAs cannot maintain regimes of free circulation, and must establish rules of origin to distinguish between goods that originate within the FTA and goods that do not.

ING PARTIES, for the mutual reduction or elimination of non-tariff measures, on products imported from one another. . . .

. . .

3. Any differential and more favourable treatment provided under this clause:
   (a) shall be designed to facilitate and promote the trade of developing countries and not to raise barriers to or create undue difficulties for the trade of any other contracting parties;
   (b) shall not constitute an impediment to the reduction or elimination of tariffs and other restrictions to trade on a most-favoured-nation basis. . . .

[22] *See* Appellate Body Report, *EC – Conditions for the Granting of Tariff Preferences to Developing Countries*, WT/DS246/AB/R, adopted 20 April 2004.

[23] The Appellate Body has addressed the Enabling Clause in the context of the generalized system of preferences in *EC – Tariff Preferences*.

These rules of origin may be designed with trade, and investment, policy in mind. That is, a rule of origin that requires a certain value added or certain processes to take place within the FTA determines the minimum investment by a foreign investor in the FTA, provided that the foreign investor wishes to take advantage of FTA tariff-free treatment. Complex rules of origin may also be an important source of transaction costs burdening trade.

While the WTO has plans to work toward harmonizing MFN rules of origin, there are presently no plans to harmonize or otherwise discipline through rules RIA rules of origin. RIA rules of origin may be designed to focus on substantial transformation, change in tariff classification, value added, or particular processes performed. There is some debate as to whether Article XXIV of GATT disciplines rules of origin, either as 'other regulations of commerce' under Article XXIV:5 or as 'other restrictive regulations of commerce' under Article XXIV:8. Rules of origin could be disciplined under the Article XXIV:8 requirement of elimination of restrictive regulations of commerce with respect to 'substantially all trade' by considering whether rules of origin restrict too large a fraction of trade (WTO 1998; see also McQueen 1982, arguing that rules of origin that are more restrictive than necessary to counter trade deflection are internally discriminatory; and Mathis 2002).

4.7. Regionalism in GATS

First, it is critical to note that Article XXIV of GATT only textually provides an exception from the requirements of GATT, not from the requirements of other WTO agreements. Thus, it is necessary that GATS contain its own provisions dealing with RIAs, to the extent that an RIA would violate particular provisions of GATS. Here, for example, GATS Article II contains an MFN rule. Article V of GATS plays a role in GATS parallel to that of Article XXIV of GATT, but differs in important respects.

First, instead of requiring RIAs to eliminate barriers with respect to 'substantially all trade', Article V of GATS establishes the cognate concept of 'substantial sectoral coverage'. This is to be 'understood in terms of number of sectors, volume of trade affected and modes of supply' and no mode of supply (cross-border, movement of service consumer, commercial presence, and movement of service supplier) may be a priori excluded. Further, within the covered sectors, substantially all discrimination must be eliminated.

Second, again paralleling Article XXIV of GATT, Article V provides that the overall level of barriers to third countries may not be raised by the formation of the RIA.

Finally, Article VII of GATS permits 'open' recognition arrangements, as discussed above. These arrangements are required to be open to member states that are able to meet the requirements for recognition. The relationship

between Articles V and VII is somewhat uncertain. Yet there is some concern that states may provide *de facto* preferences through recognition or other arrangements regarding technical regulations, licensing and qualification requirements in services (Mattoo and Fink 2002).

5. Choice of law and choice of forum problems

One of the most difficult sets of technical legal problems raised by RIAs is the relationship among different sources of international law, and the application of these different sources in dispute settlement (Kwak and Marceau 2003; Pauwelyn 2004b). In the international legal system, these are questions of choice of law and of choice of forum.

There are several types of substantive problem. First, what happens where RIA law requires action that WTO law forbids, or vice versa? Second, what happens where RIA law permits action that WTO law forbids, or vice versa? Third, may WTO law be applied in RIA dispute settlement, either as the basis for a claim or as a defense? Fourth, may RIA law be applied in WTO dispute settlement, either as the basis for a claim or a defense? Fifth, may a claimant bring identical, or similar, claims in more than one forum at a time, and does a doctrine of *res judicata* or collateral estoppel apply to prevent repeated litigation of the same claims and of the same issues? Finally, how do these divergent sources of law influence one another in terms of interpretation? This chapter cannot respond definitively to these questions, but we attempt to outline some of the issues. Many of these issues will seem familiar to those who have studied federal or other divided legal systems, where there are multiple sources of law and multiple tribunals with varying scopes of jurisdiction.

In fact, in the international legal system generally, '[t]his is not a unique situation as States are often bound by multiple treaties and the dispute settlement systems of those treaties operate in a parallel manner' (Kwak and Marceau 2003). Many have remarked on the proliferation of international tribunals, not to mention diverse sources of law (Charney 1998).

In some cases, treaty provisions in the WTO or in an RIA will specifically address these issues. For example, as a matter of choice of forum, Article 23 of the DSU would seem to provide for exclusive jurisdiction in the WTO for claims arising from WTO law. Of course, some actions may give rise to claims arising from both WTO law and RIA law; Article 23 does not specifically address this possibility. Furthermore, in cases arising under both NAFTA and the GATT, Article 2005 of NAFTA allows the complainant to select the forum, except in certain cases involving environmental, standards or SPS matters. Other RIA agreements specify that similar choices shall be exclusive (Kwak and Marceau 2003).

However, as a matter of choice of law, there are substantial questions as to whether a WTO panel would apply the provisions of RIA agreements speci-

fying exclusive jurisdiction in order to 'oust' the WTO Dispute Settlement Body of jurisdiction. WTO panels are mandated to apply directly only WTO law. Therefore, they could not apply RIA law to bar a claim by a WTO member state. Furthermore, Article 23 of the DSU claims exclusive jurisdiction for the WTO over WTO law claims.

So it may be that WTO law would require what an RIA prohibits, or vice versa. This certainly seems possible in the Article XXIV context, where an RIA requires integration in a form that violates Article XXIV. This type of conflict would have a certain outcome within WTO or RIA dispute settlement, respectively, which may differ from the outcome that would obtain at general international law.

That is, at general international law, all law is applicable, and conflict may often be settled in accordance with a 'last-in-time' rule. However, even if, for example, the RIA were the last in time, the state relying on it would be responsible for any violations of WTO law under the rules of state responsibility, pursuant to Article 30(5) of the Vienna Convention on the Law of Treaties. It would also generally be responsible within the WTO legal system. The panel in *Turkey – Textiles* stated that 'a bilateral agreement between two Members . . . does not alter the legal nature of the measures at issue or the applicability of the relevant GATT/WTO provisions'.[24]

In the recent dispute between Mexico and the United States with respect to high fructose corn sugar, Mexico argued to the WTO panel that the panel should decline to exercise its jurisdiction in favor of arbitration under NAFTA, in order to address both Mexico's claims regarding market access in the US for Mexican cane sugar under NAFTA and the United States' claims, brought in the WTO, with respect to Mexico's tax measures. This was similar to a *forum non conveniens* claim in private litigation (see Pauwelyn 2004b). Mexico did not argue that NAFTA prohibited the US bringing the relevant litigation to the WTO. However, the panel found that, under the DSU, it had 'no discretion to decide whether or not to exercise its jurisdiction in a case properly before it'.[25]

The panel related the choice of forum issue to the choice of law: 'any findings made by this Panel, as well as its conclusions and recommendations in the present case, only relate to Mexico's rights and obligations under the WTO covered agreements, and not to its rights and obligations under other international agreements, such as the NAFTA, or other rules of international law'.[26]

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[24] Panel Report, *Turkey – Restrictions on Imports of Textiles and Clothing Products*, WT/DS34/R, adopted as modified on appeal, 19 November 1999, para. 9.178.

[25] Panel Report, *Mexico – Tax Measures on Soft Drinks and Other Beverages*, WT/DS308/R, 7 October 2005, para. 7.1.

[26] *Id.* at para. 7.15.

6. Conclusion

While in 1947, Article XXIV may not have been very important, and while at that time, the rise of FTAs could not be anticipated, Article XXIV has taken on great importance. One of the most important questions in international economic policy today is the relationship between regional integration and multilateral integration. For better or worse, Article XXIV (and its cognates in services and elsewhere) provides the framework for articulation of this relationship.

Article XXIV of GATT presents a facially compelling case to seek to align international trade law with the dictates of welfare economics. It would be useful to redesign or reinterpret Article XXIV so as to increase global welfare: permitting only those RIAs that result in an increase in global welfare. However, there are two potential obstacles. First, it is not clear that the goal of governments is to increase global welfare. Second, it is not clear that an Article XXIV rule oriented more directly to global welfare would be possible or administrable.

Article XXIV is not well developed, and contains many uncertainties, perhaps reflecting in part the ambivalence in states' attitudes towards RIAs. This ambivalence, for example, makes it difficult to know how Article XXIV will deal with safeguards and with certain SPS or TBT measures in RIAs.

Yet, RIAs may serve as laboratories of institutional development, assisting our understanding of the potential institutional solutions to international economic integration problems. The question of whether RIAs may indeed serve as building blocks toward greater integration is still open.

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5. International trade: dispute settlement[1]

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1. Introduction

A considerable amount of academic interest has been shown in the dispute settlement (DS) mechanisms of the GATT and the WTO, particularly during the last decade. The purpose of this chapter is to present and discuss what we see as the main themes of this body of research.

Due to the enormous volume of research in the field, it is necessary to focus our attention to a few areas, concentrating on themes that we find particularly interesting and omitting many other (and surely to other observers more interesting) issues. Moreover, the constraints of our format prevent us from covering everything that has been written, even within our area of focus. Rather, our aim will be to discuss what we view as the central issues addressed in the literature. A noticeable omission is that we will not deal with enforcement issues, the literature being too extensive to be covered in this survey.

The chapter is structured as follows. Section 2 highlights quintessential elements of the DS mechanism in the WTO – the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (DSU). The DSU is often referred to as one of the main achievements of the Uruguay Round.

Section 3 briefly discusses the role of dispute settlement from the angle of economic theory. The more policy-oriented literature often views the objective of dispute settlement as being to resolve conflicts, to enhance transparency and predictability, or to implement the agreed liberalization of trade. But such explanations are not satisfactory from the point of view of economic theory, which seeks to explain *how* the DS mechanism may help achieve the various aims that have been suggested, and how these aims may interact with one another. For example, the desire to ease the resolution of disputes may conflict with the desire to maintain system integrity, and while transparency may increase the predictability of the system, it can make settlement, and trade liberalization, more difficult. Economic theory certainly does not offer satisfactory explanations for all of these matters, but does provide at least a few insights into the intricacies of dispute settlement.

[1] We are grateful to Alan Guzman for helpful comments on an earlier version of this chapter.

Section 4 discusses the two main themes in the empirical literature on dispute settlement, the first being determinants of participation in dispute settlement processes, and the second, the role of the DS system in the settling of disputes. In this section we also point to a number of aspects of this body of research that we believe are in acute need of improvement. Some of these cases are clearly 'researchable', while it is less clear in other cases how the problems should be addressed.

Finally, Section 5 points to some additional areas that we believe are important for understanding how the DSU operates, and which we believe are deserving of more attention.

2. The WTO mechanism for dispute resolution: the DSU

In this section, we will provide a very brief introduction to the salient features of the DSU. A more detailed description can be found in Palmeter and Mavroidis (2004).

The DSU is one of many annexes to the agreement establishing the WTO. The administration of disputes is entrusted to the Dispute Settlement Body (DSB), comprised of representatives of all WTO members. The system is highly decentralized: disputes cannot be initiated *ex officio*; there is no authority assigned to a supra-national entity (a watchdog) to initiate complaints against WTO members; and disputes are launched at the initiative of a WTO member.

There are three forms of legal challenges that can be raised in the context of the WTO: 'violation complaints', where the complaining party argues that a measure adopted by another WTO member is inconsistent with the latter's obligations under the WTO; 'non-violation complaints', where the complaining party argues that it has lost trade opportunities as a result of another WTO member's behavior, irrespective of whether this is consistent with its obligations; and finally 'situation complaints', which cover any situation not envisaged in one of the two previous forms. It is difficult to conceive what could exist beyond violation and non-violation complaints, however, and since there is no case law on situation complaints. we are in the dark as to their precise parameters.

Although the membership of the WTO can, at various levels ranging from Ministerial Conferences down to Committees, adopt acts with legal validity that may affect WTO Members, such acts are not justiciable: Article 1 DSU explains that legal challenges can only be directed against measures taken by another WTO member.[2]

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[2] Perhaps surprisingly from an economic perspective, the question whether an omission can be challenged is still open. Panels tend to interpret the term 'measure' appearing in various places in the WTO agreement as suggesting some sort of positive

Adjudication in the WTO system has two phases: one (in principle) bilateral, and one multilateral. The first phase consists of bilateral consultations between the complainant and the defendant.

Few disputes are of a purely bilateral nature however and even if this is the case, other WTO members may have an interest in the interpretation of the rules pertinent to this particular transaction since, arguably, such interpretation may be influential in interpreting their own commitments in the future. To this effect, when requesting consultations, the complainant has to notify the WTO as to the subject-matter of the dispute. Other WTO members wishing to join as co-complainants can do so, provided that the defendant accepts their request (Art. 4.11 DSU).

The subject-matter of a particular dispute can range from disagreement over a particular transaction and its consistency with the relevant WTO law (e.g., A believes that B imposed antidumping duties without having demonstrated any injury resulting from dumped imports), to disagreements over the consistency of a certain legislation with WTO rules (e.g., A believes that B, by enacting legislation which precludes its investigating authorities from conducting injury-analysis in the context of an antidumping investigation, is violating its obligations under the WTO). The standard of review however, is more demanding in the latter case.

There is no prerequisite to quantify the damage suffered as a result of an illegal trade barrier for a complainant to be in a position to win a dispute. WTO case law has made it clear that legal interest – the interest to see that the WTO agreement is respected by all at all times – suffices for a complaint to be legitimately launched. As we shall see later however, trade damage is crucial for the quantification of countermeasures, assuming that the defendant is found to be acting in a manner inconsistent with the rules of the WTO. Hence, a complainant with only legal interest can at the most inflict reputation costs on the defendant.

Assuming that no solution has been reached between the parties during the consultations stage, the complainant can request the establishment of a panel to adjudicate the dispute. A request of this nature moves us to the second, multilateral phase consisting of two parts: the first is the panel procedure, the panel being the analog to a first instance court; the second part is the procedure before the Appellate Body, the last instance court. Whereas panels are *ad hoc* adjudicating bodies, the composition of which depends, in principle, on the wishes of the parties to the dispute (and, in case of disagreement between

action. It is true that the WTO agreement, for the most part, does not impose 'to do'-, but rather 'not to do'-type obligations. Presumably, however, even inactions could come under the purview of a legal challenge, at least in the context of a non-violation complaint; see Hoekman and Mavroidis (1994).

them, panelists are appointed by the Director General of the WTO), the Appellate Body is composed of seven judges appointed on four-year terms, renewable once. Panels have competence to review the factual record and the legal issues before them, whereas the Appellate Body's review is limited to the latter.[3]

Following a request for establishment of a panel, other WTO Members have a limited time within which they can request to appear before the panel as third parties and present their views on a particular case. Jurisprudence has clarified that, provided certain conditions are met, entities other than WTO Members (usually non governmental organizations) can also participate as *amici curiae*.

The complaint is heard by a panel of three judges. They are advised by members of the WTO secretariat (usually lawyers, and occasionally economists as well). The role of the secretariat should not be under-estimated: it is normally the secretariat that drafts the reports, even though panelists of course have the last word. Of equal importance, and with the exception of secretariat members working for the Appellate Body, members of the secretariat do not operate as clerks (as this function is known in the US system). In addition to advising members of the panel (WTO 'judges') to whom they are assigned, members of the WTO Secretariat also advise WTO Members on issues of competence. A WTO clerkship assignment conforms with the practice of the US judiciary and requests that Secretariat members perform exclusively the former, and not the latter function.

According to case law, a WTO Member making a claim/argument carries the burden of proof to demonstrate that its claim/argument holds. The burden of proof will shift to the other party, once the party originally carrying the burden of proof has made a *prima facie* case (e.g., has created a presumption) that its claim/argument holds true. In practice however, there is nothing like a 'red light – green light' system whereby the burden of proof shifts to the other party only when the WTO adjudicating body is satisfied that the original burden has been honored. Instead, parties are invited to present their claims/arguments assuming that the other party has already absolved its burden. WTO adjudicating bodies ultimately determine which party made the more persuasive case.

The decisions made by panels are not limited to evidence brought before them by the parties. Rather, panels retain their own discovery powers and may, in principle, search for evidence anywhere. WTO adjudicating bodies (panels

[3] However, the distinction between a factual and a legal issue is often overstated in legal literature, since many disagreements about facts can be formulated in terms of a legal issue.

and the Appellate Body alike) cannot, however, exceed the legal claims that they have been requested to adjudicate – a legal principle denoted *non ultra petita*.

The standard of review applied by WTO adjudicating bodies calls for an objective examination of the subject-matter brought before them. In practice this means that WTO adjudicating bodies must motivate their findings, and respect the established working procedures as established (e.g., they cannot accept evidence submitted to them after the deadline).

Assuming that the Appellate Body accepts the original complaint,[4] the defendant will be requested to implement the judgment. Implementation should, if possible, occur immediately, although this is hardly ever the case since defendants are granted an implementation period that is agreed either bilaterally, or through recourse to binding arbitration.

Defendants do not always have sufficient guidance to implement a judgment against them. The lack of guidance is the direct consequence of adjudicating body reports that merely recommend rather than specify that the losing respondent bring their measures into compliance with their obligations. In the unusual instance where the adjudicating body reports do recommend specific ways to implement the final judgment, those responsible for implementing them are nevertheless free to choose their own form of compliance, since suggestions are not legally binding.

As a result, disagreements as to whether the implementing activity has occurred in compliance with the final judgement frequently arise. In such cases, the dispute is referred to a compliance panel whose task it is to determine whether implementation occurred, the panel's report can, however, be appealed.

If the complainant believes that no implementation has occurred, they can request authorization to suspend concessions. If granted, they can request the complainant has the right to raise its bound duties to the level necessary to inflict on the defendant damage equal in value to the damage it suffered as a result of the practice that was found to be illegal. Quantification of the damage is therefore necessary in this process; the WTO law requires that there is absolute equality between the value of the damage inflicted and the value of the suspension of concessions; the law does not, however, specify from what point in time the quantification should be based. With one exception so far, WTO case law supports (with one exception so far) the view that remedies should be prospective, that is, damage exists from the end of the implementation period.

[4] If the Appellate Body rejects the original complaint, the case will, of course, be closed.

The entire adjudication process can, in practice, take up to three years. Nothing, however, prohibits WTO members from reaching a mutually agreed solution (MAS) at any stage in the process. A MAS must be notified to the DSB, where any WTO member can raise questions as to its consistency with the WTO rules.

The DSU provides for two other dispute resolution mechanisms. The first is mediation by the Director General, a rather informal means of dispute resolution, and one which has not been used so far. The second is to take recourse to binding arbitration. This avenue was used once, but only to adjudicate part of a dispute: the European Community and the United States agreed to request an arbitrator to set the amount of compensation owed by the latter to the former, as a result of its illegal trade practices. On another occasion, recourse was made to an extra-DSU mechanism whereby the parties requested the Director General to mediate. The Director General appointed his deputy to the task, while the parties made it clear that this mediation was not akin to the process covered by the DSU. There is no official record of this dispute.

Having presented the salient features of the DSU, we will now turn to studies that may help shed light on the working of the system. In the following section we will briefly set out some ideas concerning the possible role of such a system in a trade agreement. In Section 4 we then turn to empirical work that seeks to shed light on the actual working of the system.

3. The role of a dispute settlement mechanism

An important aim (implicit or explicit) of the empirical literature discussed below, is to evaluate whether the DS mechanisms in the GATT and the WTO have fulfilled their purposes. This task obviously requires an understanding of what these purposes are and how they are meant to be achieved, and it is natural to start from objectives expressed by legislators in the agreement, or elsewhere. But, such stated objectives are often expressed in very imprecise language. To appreciate the role of the DS mechanism, it is therefore necessary to view it from a more systematic, theoretical point of view.[5]

The question of what role a formal DS system might serve may at first glance seem superfluous, the answer being seemingly obvious: to help adjudicate, and possibly also avoid, disputes. Upon closer scrutiny, however, matters are not so simple, particularly once one takes into account the possibility for members to let informal mechanisms solve the same problem. Nevertheless, one can identify several possible rationales for a formal settlement system and in order to do so, first we must highlight two central, and in the literature often

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[5] For a survey of the economic theory literature on trade agreements, and on dispute settlement, see the survey by Staiger (1995).

emphasized, constraints on the scope of any international trade agreement of such a broad nature as the WTO.

3.1. Two basic constraints on trade agreements

There is a fundamental difference between the circumstances under which a trade agreement operates, and those under which parties contract under domestic law. In the latter case, contracts can be enforced by third parties, such as the courts who have at their disposal the ability to issue physical action, such as a police intervention. This allows the contracting parties to include provisions that for certain contingencies specify courses of actions that would not otherwise be voluntarily undertaken by all parties to the contract. For example, the payment of an *ex ante* agreed liability should something go wrong, may not be in the *ex post* interest of the liable partner. It is easy to see that if a liability clause is unenforceable, the transaction may not take place at all. The gains to the parties from a trade agreement may be limited in the absence of an external enforcer.

In the case of trade agreements there is no outside party who can ensure that the members to the agreement abide by their obligations. As a result, the agreement must be *self-enforcing*.[6] The crucial implication of this is that the agreement, and its dispute resolution mechanism, must be such that it is *always in the interest of each member to behave so as to preserve the integrity of the agreement*. In other words, members must not be put in positions where they would prefer to sacrifice collaboration for short-run gains. The essential mechanism that allows the parties to make a meaningful agreement is thus the threat of withdrawal from the agreement by an adversely affected party. That is, the repeated interaction between members provides an alternative avenue to contractual agreements enforced by third parties, to form an agreement that takes the countries out of an adverse, protectionist situation. Countries are in this respect often in a better position than private parties to reap gains from trade. Concerns about reputation may certainly be important for private parties, but such concerns are undermined by the presence of alternative contracting parties, and by limitations on the exchange of information between different parties. Countries are largely stuck with one another however, and typically expect to remain so for the foreseeable future. Thus contract breach by a country is likely to be observed not only by directly affected partners, but also by the membership as a whole.

The second constraint on an agreement with the scope of the GATT or the WTO stems from the fact that such an agreement applies to a huge number of

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[6] We are not aware of any legal-economic analysis of the extent to which members to a trade agreement may contract third countries to help in the enforcement of the agreement.

products, government policies and different types of contingencies. A complete and exact regulation for each conceivable product, policy and circumstance would clearly make the agreement extremely costly to negotiate. As a result, the contract must for practical reasons be *incomplete*: it will contain relatively few explicit, detailed specifications obligations (such as tariff bindings specified at a rather disaggregated product level), but much or most of its ambit will be contained in vaguely specified provisions, such as that of National Treatment. As a result, the determination of the exact ambit is left to be decided in the future, when a conflict arises.

If the agreement contains a dispute resolution mechanism, it is likely to carry a heavy burden in two respects. First, it is likely to have to administer a large number of disputes due to the fact that so much is left unspecified. And, second, a significant responsibility rests on this mechanism, since it is likely to play a very prominent role in shaping the practical ambit of the agreement.

3.2. The pros and cons of an explicit dispute settlement mechanism

Trade agreements must, out of necessity be incomplete as well as self-enforcing. Clearly, this will limit the impact of the agreement but the threat of future punishment for violations by the respective parties may deter 'asocial' behavior. It is necessary to explain, however, why such an understanding may benefit from the inclusion of an *explicit dispute settlement mechanism,* such as the DSU. We must also ask why the parties cannot rely only on an implicit understanding of the agreement.

One might assume that the fairly extensive economic literature on trade agreements should provide explanations for the rationale for such agreements. However, the bulk of this literature focuses on the determinants of the tariff levels that a cooperative outcome would yield, rather than on the legal form in which such an outcome would be packaged. Indeed, the formal structure of many of the models employed in this literature (such as models of so-called repeated games) is basically identical to the structure of the models employed to analyze collusion in product markets. The more recent literature on the subject has made much of the finding that there need not be any difference from an economic point of view between a collusive outcome resulting from implicitly coordinated price setting, and an outright cartel. That is, in these models there is no particular role played by the fact that the agreement between the firms is explicit, rather than implicit.[7] For the same reason, economic models of trade agreements typically do not distinguish between tariff reductions resulting from an implicit understanding between trading

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[7] The role of communication and coordination for achieving collusive outcomes in product markets is currently a very active (and complex) area of research.

partners, and those resulting from an explicit agreement. From an economic point of view, the question remains as to why one form is chosen over another.

The two central aspects of trade agreements provide these agreements with several different possible roles. One of these roles stems from the fact that in order for the agreement to be self-enforcing, there must be a common understanding of what constitutes cooperative behavior, and what amounts to a violation of the implicit agreement. However, for very much the same reasons that gave rise to the incompleteness of the contract, it is extremely difficult for the trading partners to implicitly form a common understanding. An explicitly agreed format for the interpretation of the agreement, and for the resolution of disputes, may, therefore, help *coordinate members' expectations* concerning the more precise implications of the vague agreement. An explicit fomat can achieve coordination in at least two ways. First, the case law it produces may gradually fill the 'gaps' in the agreement, thus slowly making the agreement less incomplete.[8] Second, it specifies an agreed-upon *procedure* for adjudication. The legislators thus to avoid the difficulty of working out the details of the contract by agreeing to let a third party – a judge, for example – adjudicate on their behalf; the legislators accept the outcome of the ruling as the outcome of the unfinished negotiation.[9] [10]

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[8] It is sometimes argued that this is only a temporary role, since once the collaborative outcome is established, there is no need for further coordination. This might possibly be correct as a theoretical proposition, but considering the extreme degree of incompleteness of agreements as far-reaching as the WTO Agreement, it does not seem plausible that this task will be completed within the foreseeable future. Also, problems previously not encountered are likely to steadily arise due to changes in the underlying economy. However, it should be noted that adjudicating bodies may have conflicting incentives with regard to completing the contract in this way. In particular, they may fear that when creating the current case law, they do not fully take account of its implications for the future, and that it may therefore tend to constrain future decisions in unforeseeable ways. To prevent this, adjudicating bodies may want to keep the gaps in the agreement unfilled to some extent.

[9] Two comments are in order. First, the 'tie-breaking' task could actually be performed by any method that is agreed upon in advance. For instance, an agreement to flip a coin would serve this purpose. But there would then be no relationship between the characteristics of the case at hand and its outcome. It is thus not likely to have a particularly beneficial within-dispute impact, even if it would help keep the agreement together.

Second, and on a more technical note, coordination problems might exist also in the context of complete agreements, since there is typically a multiplicity of equilibria in infinitely repeated games (this is the so-called 'folk theorem' for repeated games). However, in the presence of such multiplicity, there is normally a well-specified frontier of the bargaining set with Pareto-efficient agreements. The bargaining situation the countries are in should then suggest one point on this frontier as a focal point, that is, as a natural candidate for the agreement.

[10] Another coordination function a DS system could serve would arise if

A second reason why there is scope for an explicit DS mechanism stems from the complexity of the issues at stake. There will be a large number of measures that fall in a grey zone between what is clearly allowed and what is clearly illegal. The decision of where to draw the boundary cannot be done with any degree of scientific precision and it would therefore be tempting for parties to interpret the scope of the agreement with an eye to their own interests. The potential for this kind of moral hazard suggests that adjudication should be compulsory, and that the adjudication process should be performed by a disinterested party, so that the adjudication gains a *reputation for transparency and impartiality*. An explicit agreement greatly eases this task for third parties.

Third, the incomplete contract problem – the fact that the agreement does not specify exactly what is requested of the parties in all circumstances – could be circumvented if the agreement instead specified that the complainant could unilaterally decide the course of action whenever the agreement left this open. However, countries know *ex ante* the signing of the agreement that their positions are not static and that they will, at times, find themselves in the role of either the complainant or the respondent. As noted by Ethier (2001a), it is therefore likely that each member has an interest in ensuring that while there are punishments for violations of an agreement, these are not too strong.[11] The DSU has indeed chosen an intermediate form of punishment, with remedies that should be (at most) commensurate with committed illegalities. Given the incentives for complainants to impose very strong countermeasures, there are advantages in letting a third party determine what is commensurate in any particular situation – this is clearly a role for a formal dispute settlement mechanism.

Finally, a formal DS system may ease the problem of enforcement by helping to instil in members of the agreement a sense of 'international obligation'. This notion has considerable support particularly in the international relations literature, but has been much less commonly examined in the economics literature (a noticeable exception being the work of Kovenock and Thursby, 1992).

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members that are not participants in a dispute could participate in the withdrawal of concessions. The advantages of such systems are examined by Maggi (1999), and by Bagwell *et al*. (2004). The role of retaliation (countermeasures) is discussed in a comprehensive manner in Lawrence (2003).

[11] It could possibly be argued that it is not necessary for countries to potentially find themselves in the roles of both complainants and respondents in order for them to agree on limited punishments. Even if their roles as complainants and respondents were predetermined, they might in an ex ante negotiation over the rules of the DS mechanism agree on limited punishments, realizing that draconian punishments, as desired by complainants, as well as very limited punishments, as desired by respondents, might deter countries from liberalizing trade. Whether or not this is the case is likely to depend on the exact bargaining format.

Similarly, a third-party evaluation of alleged breaches of the agreement is likely to have a stronger naming-and-shaming effect, than if the parties themselves were to determine inconsistencies and adjudicate conflicts, as emphasized by, for example, Schwartz and Sykes (2002).

The above-mentioned benefits of a DS mechanism must of course be set against its costs. There are the obvious costs in terms of administration, even though it is far from clear that a centralized mechanism is more costly then a decentralized system; if anything, the opposite seems more likely. But there are also less obvious drawbacks associated with an explicit dispute resolution mechanism in a self-enforcing agreement, due to the fact that this may weaken the forces maintaining system integrity.

The weakening of the incentives to retaliate may come about for at least two reasons. To set out the first, we very briefly sketch a model developed by Hungerford (1991), who adapts the so-called Green and Porter model in a trade agreement context.[12] In Hungerford's model, countries have access to tariffs as well as non-tariff barriers (NTBs). Tariffs are assumed to be readily observable by members, as are their terms of trade. However, members cannot directly observe other members' NTBs, nor can they directly observe other exogenous random events that may affect their terms of trade, such as changes in world market prices, consumer incomes, etc. Hence, an exporting country cannot tell whether bad terms of trade are due to unfortunate random events, or to NTBs imposed by partners. Due to the unobservable nature of the NTBs, countries cannot form an explicit agreement to reduce these barriers, since NTBs cannot be directly monitored. But Hungerford (1991) shows that absent a DS system, there is nevertheless an equilibrium where members abstain from invoking NTBs, due to the repetitive nature of the interaction. But this equilibrium has the undesirable feature that when a member suffers a sufficiently severe terms-of-trade shock, the source of which could be either unobservable NTBs or unobservable demand shocks, it will have to punish the partner by withdrawing a concession, and thus increasing its observable tariff temporarily, regardless of its origin. The reason is that if members did not systematically act in this way, there would be incentives for partners to cheat on the agreement. In this equilibrium one would over time witness periods where countries traded 'peacefully', interspersed with temporary 'trade wars' resulting from adverse external events for importing countries.

What effect would a DS system then have? An essential feature of a DS system is that it typically requires members (as well as adjudicating bodies) to investigate the reasons for the shift in terms of trade, before withdrawing

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[12] Similar frameworks have also been employed by Riezman (1991) and Furusawa (2003).

concessions. If these investigations fully reveal these reasons, all unnecessary punishments could be avoided. Hence, *by ensuring that information is gathered, the DS system reduces the need for misplaced retaliatory action designed to maintain the integrity of the agreement.* This would be a desirable consequence of a well-functioning DS system (closely related to the one mentioned above) related to the benefit of a transparent third-party adjudicator.

A DS system is not merely an information-gathering device, it typically also *imposes restrictions on members' rights to take unilateral action* when they perceive they have been cheated. Such a feature may indeed appear desirable to members since it is a move away from the 'law of the jungle'. However, it also implies that the force for maintaining the integrity of the agreement is weakened or removed. This aspect of a DS mechanism may have severe consequences. For the sake of argument, consider in the context of the Hungerford (1991) model, the extreme situation where the investigation required by the DS system is completely *un*-informative. In this case the existence of a (compulsory) DS system will only serve to weaken the trade agreement, and would thus reduce the joint welfare of the parties.

One may conclude therefore that it is crucial that if a DS system imposes restrictions on members' ability to retaliate, it also offers a reliable mechanism for information extraction. More generally, as also pointed out by, for example, Staiger (1995), *there is an inherent conflict between the desire to maintain rule integrity and the desire to facilitate the resolution of disputes*.

A second special feature of the DSU is that it encourages a *negotiated settlement*:

> A solution mutually acceptable to the parties to a dispute and consistent with the covered agreements is clearly to be preferred. (3.7 DSU)

Laudable as it may seem to seek to cushion conflicts between the parties, it provides another reason why an explicit DS system may threaten system integrity. The problem is demonstrated by Ludema (2001), who reasons (roughly) that the DS system opens a door to bilateral negotiations, should conflict arise. Once members find themselves in such a situation, they tend to have incentives to resolve the dispute without unnecessary delay, forgetting past grievances.[13] The softening of the repercussions of violations of the agreement can be seen at an earlier stage. That is, by forcing members to try to resolve conflicts in a 'civilized manner', the threat of such conflicts loses

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[13] One can note here the fact that the majority of disputes that are notified to the WTO never reach the panel stage.

some of its deterrence, and thus reduces the incentives for members to avoid conflicts.[14]

Yet another drawback of an explicit DS mechanism is highlighted in Guzman (2002), who attempts to explain why not all international agreements have mandatory dispute resolution mechanisms. At the core of Guzman's (2002) theory is the assumption that naming and shaming causes net joint costs to the members of the agreement: the reputational loss to the losing respondent is not compensated for by an equal gain for the other party. Against the gains from improved system integrity in situations where members abide by the agreement where, absent the naming and shaming, they otherwise would not, must thus be set the costs caused in cases where there is anyway no compliance.

3.3. What needs to be better understood?

The theory that has been laid out above forms part of a much larger economic literature on trade agreements. We have examined only those ideas that we see as directly addressing the role of a DS mechanism. However, the literature highlights a number of other issues that are highly relevant to those at stake here, such as enforcement. It is indeed difficult to separate such aspects from dispute settlement, but maintaining a narrow focus on DS, we see several areas where there is a need for further work, or rather, where matters are understood especially poorly.

An obvious question is the role of an explicit as opposed to an implicit mechanism. We have in the above tried to focus on work that examines explicit mechanisms, but it is often not clear why it would not also apply to an informal mechanism. Intuitively, it would clearly be impossible to coordinate on an implicitly agreed DS mechanism with as much detail as DSU. What is less clear, however, is exactly why the alternative necessarily has to be worse.

A second area that we feel is poorly understood is the role of dispute settlement in the context of an incomplete contract. Intuition would suggest that the problems facing a DS mechanism, and its role, would be very different if the agreement only contained easily verifiable commitments, such as tariff bindings, compared to the situation where there are a number of other provisions, such as that of National Treatment. We would therefore like to see more analysis of the optimal design of dispute settlement in the context of incomplete contracts.

The empirical literature on dispute settlement can hardly be said to seek to

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[14] Without drifting into the issue of remedies, let us just note that several authors, such as Schwartz and Sykes (2002), and Ethier (2001b), suggest that the purpose of the DSU is indeed to *limit* the bite of remedies.

shed light on the fundamental question of what role the DS mechanism serves. At the same time, much of this literature seems to rely on an implicit understanding of such a role. For instance, when analyzing the propensity of different categories of countries to complain under the DSU, an implicit assumption seems to be that the DSU is potentially as important for one set of countries as for another, possibly adjusted for the magnitude of 'trade interests' such as the size of exports. But suppose the main role of the DSU is to complete the contract, to allow negotiators to postpone decisions on highly complex issues to a later date in order to save time and effort during the negotiations. An 'unbiased' use of the DSU should then reflect differences across countries in the composition of their imports and exports, since it seems highly likely that the problems giving rise to this incompleteness vary greatly across products. In the same vein, by choosing other roles of the DS system, we would find other determinants of what participation in the DS system would look like in an 'unbiased world'. More generally, there is something unsatisfactory about the fact that the empirical literature on the DS system in the GATT and the WTO attempts, to a large extent, to evaluate performance of the system, without explicitly specifying what it is meant to achieve.

4. Two main themes in the empirical literature

We now turn to a discussion of empirical research on dispute settlement in the GATT/WTO. There is a very large body of writings on this general topic, far too large to be surveyed in a single chapter. In order to make the discussion more manageable, we will in this section discuss papers focusing on what we see as the two main themes in this area: the determinants of participation in disputes, and the impact of DS settlement in the GATT/WTO on the process (and particularly likelihood) of settlement. Due to space limitations, we cannot provide detailed descriptions of studies on these topics, but only say a few words about the issues papers address, the methods they employ, and the results obtained.

We will concentrate on papers that in terms of methods are more rigorous than most of the writings in the quantitative legal literature on these topics. For instance, the papers we discuss do not only compile tables or compute averages. Careful statistical/econometric analysis is in a sense more necessary in the context of the issues addressed here, than when addressing more narrow economic issues, due to the often complex and multifaceted relationships under study. For example, it is obvious that the finding that developing countries have complained an average of x times, and developed countries an average of y times, is not very informative as such. There is need for both a conceptual framework (i.e., a theory) and closer statistical scrutiny to interpret such a finding.

Due to the complexity of the object of study, and the resulting inadequacy of theory, it is inevitable that any study on these issues can be criticized on a number of grounds. Thus, while results from econometric studies should always be consumed with caution, this is perhaps more true here than is normally the case in economics. We therefore tend to see the results reported as suggestive of empirical relationships, rather than as 'proofs' of the existence (or non-existence) of these relationships. For this reason we refrain from criticizing individual papers, and instead determine what we see as desirable directions in which to develop the literature more generally.

Finally, we would like to point out that there are many similarities between our presentation and the survey provided by Busch and Reinhardt (2002).

4.1. What determines participation in disputes?

A frequent allegation that arises in the policy debate over the operation of the DSU is that participation in the DS mechanism in the WTO is biased to the disadvantage of poorer/smaller countries. These claims take various forms: for instance, it is argued that developing countries do not launch complaints as frequently as they should, or that they are targeted more frequently by richer countries than they should be. There is an empirical literature that seeks to examine the correctness of these claims, and that attempts to highlight the determinants of participation in the DS more generally.

4.1.1. A basic issue: what is the unit of account? Intuitive as these claims may seem, the literature confronts several severe conceptual problems. We will return to some of these below, but it is necessary for us to first briefly examine the issue of choosing the *unit of account*. In order for a claim such as 'developing countries do not complain as often as they should' to be meaningful, there must be a way of counting participation, and the manner in which this is done may have an important impact on the outcome of the investigation. A simple solution is of course to say that whenever there is a consultation request registered by the WTO Secretariat (as indicated by the Dispute Settlement number assigned by the Secretariat), there is a dispute. This is indeed the path that has been followed in much of the descriptive, quantitative legal literature. Such an approach would be based on a number of (typically implicit) assumptions. For instance, the *Bananas* dispute DS27, which involved five countries as complainants, and in which four additional countries requested to join consultations, would count as just one dispute. An alternative might be to consider this case as five *bilateral* disputes.

There are also other complications. For instance, what essentially seems to be the same dispute as DS27 was filed earlier by four of the five countries, as DS16. Should this count as an independent dispute(s)? Furthermore, a request for consultation may involve a very specific aspect of a very specific measure,

or it may address a number of aspects of a number of different measures. However, in both cases the investigation would count as only one dispute. It is easy to identify questions for which these features of the unit of account would be clearly undesirable, but it is typically much more difficult to determine a satisfactory definition of 'a' dispute. There is not, in general, a correct way to define a dispute. Rather, what is appropriate for a given investigation depends on the particular question at stake. It should also be noted that the problem of choosing unit of account is not restricted to studies of participation, but affects any study that seeks to draw inferences across disputes.

4.1.2. Trade interests as a determinant of participation As already mentioned, the determinants of participation in the WTO DS system have been examined in a number of papers. Horn *et al*. (1999) focus on the question of whether participation as complainant in the WTO DS system is somehow biased to the disadvantage of smaller and poorer members, or whether such members do not complain more than they 'should' according to their trade interests. Clearly, in order to address this issue, there is a need for a definition of an unbiased benchmark. For instance, it is highly likely that a country that exports many products to many markets is more likely to encounter illegalities than the country that mainly exports one product to one market. Consequently, the former should have more issues to complain about, but how much more? Furthermore, larger traders are more likely to trade products in such large volumes as to make it profitable to carry the partly fixed costs of litigation, and should therefore be expected to feature more often as complainants. Should this be taken into account in the definition of the unbiased benchmark? As can be seen, the definition of the unbiased benchmark is far from trivial.

Horn *et al*. (1999) start from the premise that the unbiased benchmark should allow members to complain proportionally to the number of questionable trade measures they encounter. Lacking a convincing theoretical prediction for the number of illegalities committed per country, and hence faced by trading partners, they assume that countries commit illegalities for each imported product with the same frequency, regardless of the nature of the exporting country or of the product. Using data for the first four years of the WTO DS system, and with products defined at the four-digit Harmonised System (HS) level, Horn *et al*. (1999) show that the actual distribution of bilateral disputes across members can be fairly well predicted by their suggested non-biased benchmark, in particular when the latter is adjusted in order to exclude exports with smaller values (assuming that such values are not worth litigating about).

Bown (2004a) substantially refines this analysis. As noted, countries can choose to pursue disputes by themselves, they can participate as co-complainants or as third parties. Or they can decide not to participate at all,

free-riding on the efforts of other countries, or perhaps, on the contrary, being hurt by the litigation. Bown (2004a) considers the determinants of these choices on the basis of the 116 disputes during 1995–2001 in which importing countries were found to illegally restrict imports. Disputes are divided into two separate sets, depending on whether they concern discriminatory measures, or non-discriminatory measures. For each of the disputes involving discriminatory measures, exporters to the market (defined at the six-digit HS level) are divided into two groups: those that are harmed by the measure, and those that benefit (by being exempted, for example). For approximately half of the group of disputes involving discriminatory measures, Bown (2004a) further identifies other countries that were also harmed by the measure, but who did not participate in the legal process. This data is then employed in a multinomial logit model in order to examine the impact on the propensity to complain, to be a third party or to free-ride, of various factors that may plausibly affect participation.

With regard to disputes over measures that adversely affect many trading partners, it is shown that the size of imports is positively related to the propensity to complain, in line with the finding of Horn *et al.* (1999). It is also positively related to participation as a third party, and negatively related to the propensity to free-ride.

4.1.3. 'Legal capacity' and 'power' as determinants of participation Some notion of trade interest can go quite far in explaining the distribution of disputes across countries, but it does not go far enough. Two intuitively appealing hypothesis have therefore been examined in the literature. According to the 'Legal Capacity Hypothesis', the lack of legal capacity prevents poorer countries from participating as complainants as much as they 'should'. The second hypothesis, dubbed the 'Power Hypothesis', holds that smaller/poorer countries complain less against larger/richer countries that they 'should' due to their lack of 'power'. Various reasons have been suggested, such as that they do not expect to be able to enforce rulings, or that they fear a backlash in other ways, such as loss of preferential treatment in trade, or some form of non-trade retaliation such as reduced foreign aid, or military assistance.

Several studies have highlighted the role of these suggested explanations for participation in the DSU in particular. The two explanations have often been juxtaposed, even though they are by no means mutually exclusive. Horn *et al.* (1999) make a simplistic examination of the two popular claims. Using the size of countries' WTO delegations in Geneva as a proxy for countries' legal capacity, Horn *et al.* (1999) find some, albeit weak, support for the notion that countries with more legal capacity litigate more, controlling for trade interests. To shed some light on the Power Hypothesis, Horn *et al.*

(1999) aggregate WTO members into four groups – G4, other OECD countries, developing countries other than LDCs, and LDCs – and consider whether the pattern of litigation between these groups suggested any bias, using the above-described definition of a non-biased benchmark. Contrary to what the Power Hypothesis would seem to suggest, they find that developing countries other than LDCs are *over*-represented as complainants against both G4 countries and against other OECD countries, and that they are *under*-represented as respondents against G4 countries, while the pattern as respondents against other OECD countries is more mixed. It is difficult to draw any strong conclusions concerning LDCs. The crude measure employed suggests that they are under-represented both as complainants and respondents against developed countries, but the numbers involved are so small that this finding is hard to interpret.

Bown (2004a) also examines the role of the Legal and Power Hypotheses. Bown (2004a) finds some, albeit weaker, support for the Legal Capacity Hypotheses, in that the coefficients for the variables GDP per capita and the size of WTO delegations have the expected signs, even though they are not highly significant. But Bown (2004a) also finds strong evidence for some form of Power Hypothesis, showing that the nature of the bilateral relationship between the importing country and exporters plays an important role in determining whether to complain, act as a third party, or abstain, in disputes involving illegalities that have an adverse effect on a number of countries. Thus a high share of the respondent's exports going to a certain country makes it more likely that this country will be a complainant (and less likely that it will free-ride). A possible interpretation here is that 'power' matters in the decision to complain, since such a high share makes the enforcement possibilities stronger. However, this relationship also holds when considering only a subset of fairly large exporters, where there would intuitively seem to be less of a role for 'power' to play. The interpretation is therefore that either this intuition is flawed, and that 'power' is important also in the relationship between more developed countries, or that the relationship captures something other than what is associated with 'power'.

Guzman and Simmons (2004) shed further light on the determinants of participation by examining the relative merit of the Legal Capacity and Power Hypotheses. Guzman and Simmons (2004) interpret the Power Hypothesis as referring to the amount of power a member can exert outside the system (such as the withdrawal of aid), and do not include in this concept power exerted within the multilateral system (such as the number of concessions that a complainant can credibly threaten to withdraw). Their data set is based on bilateral disputes in the WTO between 1995 and April 2004, as defined by requests for consultations. Their method is to regress the GDP of the defendant against a number of explanatory variables, and controls. The GDP of the

defendant is interpreted as a measure of both its market size and its political power. A main explanatory variable is the GDP of the complainant. GDP is a natural measure of the (absolute) power of the complainant, and to the extent that this is an important factor driving the decision of whether to complain, one would expect there to be a positive relationship with the GDP of the respondent: only economically large countries would challenge other large countries. But it should also measure a country's capacity to pursue disputes: a large country is likely to have more resources to use for disputes. If it plays an important role in this respect, one would expect to see a negative relationship between this variable and the GDP of the defendant: a capacity-constrained exporter will concentrate on the disputes that involve the highest stakes, and they typically concern large markets. Countries with more resources – a higher GDP – can also go after the smaller fry, and will thus be more likely to litigate against small countries.

Guzman and Simmons (2004) also include other proxies for legal capacity. In addition to the commonly employed variable capturing the size of countries' Geneva delegations, they include the number of embassies abroad, countries' non-military government expenditures, and an index for the quality of government bureaucracies drawn from the International Country Risk Guide. They also use a number of controls.

Several ordinary least squares (OLS) model specifications are run. One specification includes the size of complainants' GDP, which is found to be negatively and significantly correlated with the GDP of respondents, thus supporting the Legal Capacity Hypothesis and refuting the Power Hypothesis. The remaining specifications exclude complainant's GDP, but include GDP per capita, which is negatively related to the GDP of the respondent (although not always significantly so). They also include one of the other above-mentioned measures of legal capacity. For each of these specifications, the variable emerges as highly significant and with the expected result, except for the measure of the quality of the government bureaucracy.

Also positively and significantly related to the GDP of respondents is the value of the imports by the complainant from the respondent. One interpretation of this finding is that it supports the Power Hypothesis. However, Guzman and Simmons (2004) prefer to see this variable as a control, and interpret the finding merely as indicating that large respondents tend to export a lot. There are also a number of other controls that are significantly correlated with respondent GDP.

Overall, Guzman and Simmons (2004) see their results as supporting the primacy of the Legal Capacity Hypothesis over the Power Hypothesis as an explanation of the choice of respondents. More generally, they conclude that even though it is very difficult to determine a non-biased benchmark for developing country participation, these countries seem constrained by limited legal

resources from suing the system as frequently as richer countries. Because of such constraints, developing countries are more selective as to which cases they challenge before the WTO. However, lack of 'power' does not seem to be an important explanatory factor.

4.1.4. Membership of a preferential trading arrangement as a determinant of (non-)participation Several authors find that countries tend to complain less against other members of the same preferential trade agreement to which they themselves belong. For instance, Bown (2004a) finds that a highly significant, and also quantitatively important factor is whether the potential complainant belongs to the same preferential trading arrangement as the country with the illegal import measure: exporters are much less likely to complain against countries belonging to the same preferential trade agreement, or act as third parties in such disputes. Furthermore, it is shown that the importance of the importing country as a donor of foreign aid to potential complainants tends to vary positively with the propensity of the latter to abstain from participating in disputes, and negatively with the propensity to act as third party.

4.1.5. The form of political governance as a determinant of participation A different perspective on participation in the DS system is provided by Reinhardt (2000), who considers the role of the form of political governance for participation. The decision by a country to launch a dispute is the result of a domestic political process, and one should expect the nature of such a process to be highly dependent on the political institutions in the country, particularly since private parties do not have standing before the WTO, and the selection of conflicts to be brought to the WTO is thus made by government institutions or politicians. Reinhardt (2000) examines a number of aspects of this issue, one being whether democracies are more or less likely to complain before the WTO. A number of theoretical arguments can be made in either direction, so while it seems plausible that the political system may affect the propensity to complain, the direction is unclear.

Reinhardt (2000) uses a rich data set comprising all 604 'bilateral' disputes that occurred during the period 1948–98. The statistical models employ, in addition to indices for democracy, a number of explanatory variables capturing aspects of GATT/WTO members, and use various probit specifications.

A main finding is that the more democratic a state is, the *more* it will initiate disputes, controlling for the trading countries' relative size, and for one country's dependence on trade with the other. Furthermore, this effect is very strong, quantitatively speaking. Reinhardt (2000) also shows that not only are democracies more likely to initiate disputes, there is also a strong tendency for democracies to be targeted more often. The offered explanation is that democratic governments will be more susceptible to domestic pressure for protec-

tion, and will as a result be more prone to implement illegal measures, or not to implement agreed-upon liberalization, and thus become the targets of litigation. Furthermore, a country is more likely to initiate disputes against other countries that account for a large share of the first country's imports and exports, and also against countries that depend on it for their imports and exports, partly in line with the findings of Bown (2004a).

Reinhardt (2000) also considers the impact of the creation of the DSU, revealing that it had no significant impact on the probability of dispute initiation between developed countries. However, it significantly lowered the probability of disputes being filed by developing countries. The creation of the DSU did however significantly increase the probability for a developing country to be targeted. Reinhardt (2000) concludes that the rise in the number of disputes in the multilateral trading system is not the result of the introduction of the DSU, but stems from the underlying increased dependence on foreign trade, in line with the trade interest explanation of participation, and on the general democratization of the world.

4.1.6. Retaliation as a determinant of participation Casual observation suggests that countries occasionally complain in retaliation for previously being the target of complaints. This is a special case of the situation where complaints are not only based on the merits of the case, but also on the characteristics of the potential adversary. The literature contains a few tests of the prevalence of this type of behavior. Reinhardt (2000) includes for this purpose a binary of variables capturing whether in the previous year the respondent initiated a dispute against the complainant side. This variable is highly significant, indicating that a dispute in the previous year increases the probability of a dispute in the opposite direction the year thereafter with a factor of 55.

Bown discusses the role of retaliation in several of his papers. In Bown (2002) he examines circumstances under which a WTO member will choose to implement protection in violation of the agreement instead of using the relevant safeguards provisions. Bown (2004b) finds substantial evidence showing that threat of retaliation by the victorious complainant yields credibility so as to allow defendants to honor their commitments. In a related paper, Bown (2004c) finds that developing countries have recognized the importance of retaliatory threats, and have responded by changing their pattern of initiation of disputes, so as to take greater advantage of the instances where they have leverage to threaten retaliation and thus induce compliance.

At a more disaggregated level, Blonigen and Bown (2003) find that the threat of a retaliatory antidumping investigation makes it less likely that a WTO member will name the country that will likely retaliate among the countries that will be investigated for alleged dumping practices. They also find that the prospect for a particular WTO member might launch a complaint (in

any field of the WTO), makes it less likely that a member investigating dumping practices will end up with a positive finding of injurious dumping against companies originating in the country threatening with a complaint.

4.2. What determines the duration of disputes?

The majority of the requests for consultation that are filed with the WTO are not determined by WTO adjudicating bodies, but by the parties alone. The majority of disputes thus lead either to an officially announced (as requested by the DSU) Mutually Agreed Solution, or simply remain inactive indefinitely, and are therefore presumed solved. As mentioned above, the DSU sees a MAS as the preferred mode of resolving disputes, so a settlement is from this point of view desirable; this view is understandable in that a decision to move the dispute to a panel stage constitutes an escalation of the dispute. Such a move is likely to increase the stakes both by increasing the direct costs of administering the proceedings, and the associated opportunity cost from the use of legal and administrative resources for the particular dispute, as well as indirect costs (and possibly also benefits) associated with its impact on the reputation of the participants. In this regard, avoiding an escalation of the dispute is desirable from this point of view.

Another aspect to take into account is that the problem of defining the unit of account is as pervasive here as in studies of participation. Another aspect is the selection of conflicts that lead to requests for consultations. Presumably they are not a random selection, but tend to be special in some sense. What are these special characteristics? How was it that the conflict could be solved once it reached the consultation stage, but not before? Why does the interaction between the parties change as the dispute is filed with the WTO? From a theoretical point of view, the answers to these questions are far from obvious, even though one might intuitively identify some explanations.[15] There are also other aspects of settlements that one may wonder about, such as the terms of the solution when these are not made public, for instance, to what extent do they abide by the Most-Favored Nation provision?

Several empirical papers have examined various aspects of the time profile disputes, and in particular, the propensity for settlement, during the GATT and the WTO periods.

4.2.1. Does the DS mechanism ease settlement? A first issue of interest is whether the DS mechanism actually eases settlement. One way to approach the issue is to consider whether the introduction of changes to the DS system

[15] For instance, Busch and Reinhardt (2001), Reinhardt (2001), and Guzman and Simmons (2002), discuss theoretical aspect of settlements.

that can be expected to enhance the system can be shown to actually lead to more settlement. Busch (2000) takes this approach when he studies the impact of the 1989 Dispute Settlement Procedures Improvement reform, which provided for the right to a panel. The study estimates several logit models employing data on bilateral disputes for the whole GATT period. Three separate binary dependent variables are included, indicating whether partial or full remedies are agreed during the consultation phase, whether the dispute was paneled, and whether there are concessions during the panel stage. The independent variables include a dummy for whether the year is before or after the 1989 Improvement, and a variable capturing the dyad's joint democracy score. A number of additional explanatory variables are used, indicating, for instance, the number of complainants joining the dispute, whether it is brought by a developing country against a developed country, the degree of trade dependence, and the trade openness of the parties.

A main finding by Busch (2000) is that the 1989 Improvement, which allegedly sharpened the DS mechanism, did *not* foster more concessions under either the consultation or panel stage. The study also found that respondents with a larger share of trade in GDP tend to settle less under the consultation stage, contrary to what might perhaps be expected.

Busch and Reinhardt (2003) present empirical evidence suggesting that the advent of the DSU significantly improved the propensity of respondents to concede, when considering aggregate numbers, even though this depiction is not valid for developing country complainants, nor is it valid for disputes between the EC and the US. However, the more favorable picture during the WTO years does not stem from an increase in early settlement due to the introduction of the DSU, but is instead argued to be the result of the expanded scope of actionable cases, and more rich country complaints against developing countries. During the WTO era, richer complainants (in terms of GDP per capita) have been more likely to induce settlement than poorer countries, controlling for differences in GDP. But contrary to what one might assume, the authors argue that this is not because richer complainants find it easier to induce compliance, nor is that poorer countries disproportionally lose disputes, but because they are less successful at inducing other countries to settle.

The WTO impact on the lifespan of disputes is highlighted by Grinols and Perrelli (2003). They develop a theoretical model that predicts that the DSU should lead to more, and to shorter, disputes before the WTO. In order to empirically investigate these predictions, the authors examine three types of disputes, all of which involve the US, by means of various forms of duration analysis:[16] USTR Section 301 disputes 1975–2000, GATT disputes 1975–94,

[16] The main application of duration analysis in economics has been to labor

and WTO disputes 1995–2000. An initial finding shows that the increase in the number of disputes during the WTO era cannot readily be explained by the expansion of membership that occurred during this period – most respondents that the US litigated against during the WTO era were also members of the GATT. Nor can the trend be explained by trade volumes; something else must lie behind it, such as the change in the nature of dispute resolution under the DSU.

Grinols and Perrelli (2003) indeed find that the advent of the WTO had a positive and significant impact on the number of multilateral disputes (still involving the US), but that it did not significantly affect the number of Section 301 cases. The reason seems to be an increased propensity by the USTR to use the GATT/WTO dispute resolution mechanism. Grinols and Perrelli (2003) also show that the average lifespan of disputes has been significantly shorter since the advent of the WTO, even though identifying the exact impact is rather complex and depends on the nature of the dispute.

4.2.2. When is settlement most likely? A second issue that has attracted interest in the literature is *when during the process settlement is most likely.* Reinhardt (2001) uses two ordered probit models, applied to data on GATT disputes initiated between 1948 and 1994. The dependent variable is an ordinal measure indicating whether the respondent conceded fully, partially or not at all, to the demands of the complainant.[17] One model runs this variable against a few variables such as when the panel was established, and the direction in which the panel outcome went, whereas the other model includes these variables and a large number of other variables capturing various characteristics of the countries involved, the measure at stake, and the dispute itself (most of which turn out to be insignificant).

A striking feature of both these models is that the establishment of a panel makes concessions significantly more likely. As expected, a ruling in favor of the defendant makes a concession less likely, but even more surprising is that this is also true in case it goes *against* the respondent. The publishing of the panel verdict as such therefore tends to make concessions less likely (this effect is significant in the first model only). It is the *threat* of an adverse

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market issues, such as the movement in and out of unemployment, but it has recently been found to be applicable to a number of economic phenomena where there is movement in and out of different groups. But these methods have not been employed elsewhere in the context of dispute settlement, as far as we are aware. Grinols and Perrelli (2003) provide brief explanations of a number of the parametric, semi-parametric and non-parametric duration analysis methods they employ.

[17] Much of this classification stems from Hudec (1993), but it has also been revised and updated by Reinhardt (1996), Reinhardt (2000), and Busch (2000).

ruling for the respondent, rather than the verdict itself, that induces a settlement.[18]

The study by Busch (2000), while not focusing directly on this issue, is consistent with the findings of Reinhardt (2001). Busch and Reinhardt (2003), considering concluded GATT/WTO disputes between 1980 and (2000), bring further evidence to bear on this issue. They show that the reason why these countries are less prone to extract concessions is not that they lose disputes more frequently compared to richer members, but because of their inability to take advantage of the pre-panel publication stage for settlement. This in turn is explained by lack of legal capacity, rather than power to retaliate.

4.2.3. The role of political governance in the propensity to settle A third theme in the literature is *whether there are differences between democratic and less democratic states in their propensity to settle.* A number of arguments can be made in either direction. Examining this question empirically, Busch (2000) finds that during the GATT period, disputes between democracies were more likely to be settled during the consultation stage, compared to when either of the parties to the dispute were less democratic. The pattern did not persist however once a panel had been constituted. Busch (2000) also shows that countries with a large trade-to-GDP ratio were less likely to settle both before and after the constitution.

Guzman and Simmons (2002) examine the role of democracy for the propensity to settle, but from a different angle. Their argument is based on the assumption that transfer payments among states are costly, and that trade measures that are of an all-or-nothing nature are likely to be harder to settle on than those concerning measures of a more continuous nature. A natural solution to this indivisibility problem is to introduce some form of side payment or broaden the negotiation by introducing additional issues. Guzman and Simmons (2002) argue, however, that democracies will find it more difficult to do this, since the opposition to the broadening that will come from the exposed sectors will be much harder to withstand in a democracy.

In order to examine the empirical validity of their theory, the authors look at the extent to which the complexity of the issues involved in disputes can explain whether disputes lead to panels or not. To this end, all WTO disputes are classified into one of two groups: those addressing continuous measures (tariffs, non-zero quotas or subsidies), and those involving discontinuous measures (bans, health and safety regulations, product classification issues and

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[18] Reinhardt (2001) also develops an incomplete information model that shows, among other things, why the threat of a ruling by an adjudicator, rather than the ruling itself, may induce compliance.

absence of required laws). A number of controls are also introduced. A first set is intended to capture the relative power of the parties to the dispute, and includes dummies for whether it is a developing country against a developed country, etc., various measures based on GDP, and the complainant's dependence on the respondent's market (hypothesizing that the larger this dependence, the more prone the complainant will be to accept a proposed solution). There are also controls for institutional factors such as whether the complainant and respondent are both parliamentary rather than presidential, the idea being that parliamentary governments tend to be less exposed to protectionist legislative pressure. Another institutional control captures whether the countries involved are democracies. Since democratic governments are likely to find it more difficult to withstand protectionist pressure, they should be expected to be more prone to leave decisions to panels, rather than settle themselves. Finally, Guzman and Simmons (2002) also control for general trade dependence, arguing that more trade-dependent states should be more prone to take a dispute to a panel in order to obtain a clear ruling.

The variables are used in a number of logit models. Generally, speaking, the results support the notion that the lumpiness of the issue affects paneling decisions, but the relationship is more complex than was hypothesized, since it interacts with the nature of the political structure in a complex fashion. Both lumpiness and the degree of democracy tend to *reduce* the propensity to panel, thus contradicting what was expected to be the case. However, the combination of a lumpy issue and a democratic pair tends to have a positive impact on the paneling propensity. There is also a certain tendency for large complainants to settle more often, but this seems unrelated to the relative size of the complainant and the respondent as such.

4.3. Weaknesses in existing studies

Although it is difficult to synthesize the literature outlined in this chapter, the general picture that emerges is as follows. Export values, or the diversity of exports, go a long way toward explaining the distribution of the number of disputes that have reached the WTO. But developing countries still seem to be at a disadvantage in their propensity to act as complainants. The Legal Capacity Hypothesis finds support, while the picture is more mixed with regard to the Power Hypothesis. Finally, the nature of the mode of government is important, with more democratic countries seeming more prone to be involved in disputes on either side.

So what remains to be done? As already mentioned, the issues under study in this literature are highly complex, and it uses a very large brush when painting its (normally non-formalized) theory. There are therefore a number of problems in this literature that need to be resolved in order for their findings to become more than just suggestive. In what follows we will briefly point to

some of the problems we see (the order is not meant to indicate the relative importance we attach to these issues).

(i) A first issue is the choice of *unit of account*. There is indeed an awareness in the literature of the importance of this matter. In particular, several studies use other definitions, capturing various aspects of the bilateral nature of disputes. However, we are not aware of any study that seriously contemplates what is 'one' issue in a complaint. Was the *Banana* dispute about one issue – such as the EC banana import regime – or was it about several issues, such as the distribution system, quantitative import restrictions, etc.? Or, to take the *Sardines* dispute: was it about the labeling of sardines, or about the role of international standards, or both? More generally, we are not aware of any attempt to derive the definition of 'one' dispute from any underlying theory. At the same time, we add up numbers and seek to draw inferences on the basis of these numbers. In our view, this problem is sufficiently severe to lead us to seriously question the meaningfulness of the whole literature on 'bias' in participation. At the very least, one would like to see much more systematic analysis of the sensitivity of the findings to the choice of unit of account.

(ii) Another critical issue for studies of biases in participation, is obviously the *definition of the non-biased benchmark*. For instance the notion employed by Horn *et al*. (1999), that in an unbiased situation, each country would complain in proportion to how often it encounters illegalities, as long as the trade values involved exceed some lower threshold, is highly dubious in that it ignores the fact that a market with a $1 million turnover may be as important to a small country, as is a market with a $100 million turnover to a country 100 times larger. Here, there is an urgent need for formulations that are much better grounded in theory.

(iii) A somewhat related problem in this context is how to deal with the *indivisibility of disputes*. For instance, if a group of countries according to some measure should have 0.4 disputes, but has none, is this group to be treated symmetrically to the situation where a country should have 9.4 disputes, but has 9?

(iv) The proxies for capturing legal capacity, in particular, seem very crude. There is a need to identify exactly what type of capacity is needed, and when. For instance, is it the capacity to detect illegalities, or to litigate once they are detected? How do we take account of the fact that even developed countries tend to hire private counsel when litigating? Perhaps this suggests that it is not legal capacity, but the lack of budgetary resources that is significant? Thus, there is also a

need for a clearer conceptual view of what the differences might be between rich and poor countries, as well as better proxies for whatever is decided to be the appropriate variables to capture. There is also a need to refine the proxies employed to measure power, even though we see less of a problem here. In particular, one would want to see measures that are more sensitive to the nature of the bilateral relationship between countries than those commonly employed.

(v) Closely related to the question of how to define an unbiased benchmark is that of why and when countries commit illegalities? For instance, is it typically done in order to defuse domestic political pressures that would otherwise pose a more serious threat to the country's ability to maintain its commitments, are illegalities mainly the result of obscure agreements, or of the aggressive pursuit of national (or interest group) interests? Understanding such questions is crucial to the formulation of an unbiased benchmark for the propensity to litigate, among many other questions. For instance, if small countries face proportionally more illegalities than larger countries, perhaps a non-biased benchmark should require that small countries use the DS system more than proportionally. There are a few papers that provide theoretical explanations for why illegalities may be committed, such as Bown (2002), Bütler and Hauser (2000), Grinols and Perrelli (2003), and Guzman (2003). However, there is little empirical work that sheds light on this issue. An interesting first step has been taken by Bown (2004c), who examines the determinants of countries' choices of whether to violate or adhere to GATT rules when making trade policy changes during rounds. But more theoretical and empirical work on these issues is highly desirable.

(vi) A more general issue is *how to interpret the selection of requests for consultations.* To date, a little more than 300 such requests have been filed in the WTO, but it is inconceivable that this would represent the totality of grievances that WTO members have had with other members during the 10 years since the advent of the WTO. On the contrary, what has been registered with the WTO Secretariat is not just the tip, but the tip of the tip, of the iceberg. This raises the extremely important question for this literature of whether we can, by studying these relatively few disputes, draw *any* inferences about the working of the DS system for all those markets and trades where no complaint is filed? If we believe this to be the case, then how do we explain the fact that these particular conflicts ended up as formal disputes at the WTO, while other conflicts did not? That is, what determines the *selection* of disputes that appear before the WTO? Perhaps there is something special about them, and it is for precisely this reason that

they are brought to Geneva? There are reasons to suspect that the disputes in the WTO are not representative of conflicts in general. While a member can always decide unilaterally to litigate, in most cases such a decision will be preceded by contacts between the two sides to the conflict. It is only when they both decide not to give in that there will be a consultation request. Similarly, the DSU requests a period of consultation before proceeding to the panel stage. Since litigation uses substantial resources on both sides, one would normally expect the parties to settle before this stage, unless their subjective probability distributions over the outcome of the litigation diverge significantly. The disputes we see in the DS system, at least those that reach the panel stage, are those where both sides find it worthwhile to participate in costly litigation. Indeed, it is plausible that this would be the case for the bulk of trade conflicts. The registered disputes are thus most likely different from other conflicts. The question of *how* they differ remains unanswered.

(vii) A closely related issue is how to interpret the observation that *a certain group of countries* have (relative to some benchmark) launched few complaints? This may be due to the fact that the mere threat of complaints from this group has sufficed to keep its trading partners from invoking policies that the group would complain about. Or maybe, on the contrary, this group distrusts the system to such a degree that it does not find it worthwhile to pursue disputes, or maybe it lacks the resources to identify the issues that would be worthwhile to contest, or to litigate about issues it has identified. Our intuition may suggest one answer or another to these questions, but this does not suffice if we want to make methodologically more well-founded claims concerning the effects of the system.

(viii) Yet another problem is the fact that what is ultimately of interest is presumably the extent to which the *whole DS system* provides sufficient benefits to, for instance, developing countries. It is possible, at least in theory, that countries that are not active complainants (or third parties) still benefit from the efforts of more active members. If member A successfully attacks an import measure maintained by member B, member C, who happens to export the same product may also benefit from A's victory. Hence, if we are to evaluate the beneficiaries of the system in general, we have to take into consideration these indirect effects. In other words, it seems likely that there will often be positive externalities from complainants to other exporters, at least as long as rulings are implemented respecting the Most-Favored Nation principle. One should therefore also expect there to be problems of free-riding between members. And it is not inconceivable that

there may also occasionally be negative spillovers. Regardless of the direction of these externalities, they need to be taken account of in an assessment of the pros and cons of the DSU relative to some benchmark.

5. Other areas in need of research

The previous section examined the two main themes in the empirical literature. We will end by mentioning some other areas that we feel are important, but where very little work has been done to date.

5.1. Does the DS mechanism serve its purpose?

A difficult but crucial question is whether dispute settlement mechanisms in the GATT and the WTO have actually served their purpose? As was seen above, the literature on settlements can be viewed as an attempt to answer this question, assuming that the purpose is to foster settlement. But as we have seen, there may be a conflict between fostering settlement and maintaining system integrity. Consequently, it is possible, at least as a theoretical proposition, that by enhancing settlement, the DS system in, for example, the WTO, has reduced trade liberalization. While such a statement may appear far-fetched, it should be recalled that some recent econometric studies suggest that membership of GATT/WTO typically does *not* lead to further trade liberalization.

This leads us to the basic question of what is the real purpose of WTO, say, and for whom? Economists, at least, would almost by reflex assume that the purpose is to liberalize trade, and the Preamble to the *Agreement Establishing the WTO* also mentions substantial tariff liberalization (and non-discrimination) as a purpose. At the same time, there is a real issue whether trade is much more liberal today than it would be absent a multilateral agreement. For instance, would trade barriers be significantly higher between say the EU and the US absent the WTO? If the WTO could not be shown to have a significant liberalizing effect for its main players, could the purpose of the agreement be better understood as being something other than trade liberalization? Indeed, in the policy discussion, proponents of the WTO often mention stability of rules, transparency, etc., as main objectives of the agreement. Others may argue that a main purpose of the GATT, at least, was political rather than narrowly economic.

The reason for mentioning this issue in this context is that the role of the DS mechanism might be very different if the purpose is to improve the transparency or stability of economic or political relationships, rather than to foster trade liberalization. Whenever we are asked to evaluate the achievements of the DSU, we cannot avoid openly or implicitly taking a stance on the question of what the agreement is to achieve in the first place.

5.2. *The quality of adjudication*

The discussion thus far has dealt primarily with the quantitative aspects of dispute settlement in the GATT and the WTO, even though we have occasionally touched on more qualitative questions such as the possibility of countries settling before paneling. As noted above, the resolution of disputes may indeed be the main purpose of a dispute settlement mechanism. However, it seems reasonable to assume that its purpose is not only to induce settlement, but also to promote a desirable form of implementation of the agreement. This raises a new set of issues concerning both the terms upon which settlement occurs, and in particular about the *qualitative nature of determinations by the adjudicating bodies*.

Of course, decisions from the adjudicating bodies of the GATT/WTO have been subject to much analysis in legal literature. There seem to be fewer attempts to discuss these issues from the point of view of a joint legal and economic perspective, however. But an assessment of the case law would be very partial if performed from a legal perspective only: it can hardly be denied that a main purpose of the GATT, and perhaps even more the WTO, is to achieve various economic aims, as is also stipulated in the Preamble to the Agreement. Whether decisions by the adjudicators contribute to achieving these aims cannot be evaluated without an economic analysis of the case law.

The literature does contain some joint economic and legal analyses. For instance, Sykes (2003a) discusses the WTO case law on safeguards and concludes that inherent problems with these provisions have been exacerbated by a lack of acknowledgement, by panels and the Appellate Body alike, of the problem before them. Sykes (2003b) examines the case law on the necessity-test, the notion that WTO members, when deviating from their obligations, have to ensure that they choose the least restrictive means (in terms of the impact on international trade transactions) to reach their ends. Sykes (2003b) argues that it is typically hard to detect any systematic criteria being employed by adjudicating bodies. Horn and Mavroidis (2004a) discuss the case law on tax discrimination cases. They come to a similar qualitative conclusion, being unable to discern what method of analysis the adjudicating bodies employ.

The studies from the American Law Institute project, *Principles of International Trade Law: The World Trade Organization*, also largely support this critique of the quality of the case law.[19] In this project, a group of economists and lawyers have been scrutinizing all Appellate Body reports, as well

[19] These studies are published in Horn and Mavroidis (2004c), 2005 and (2006). Besides the two editors, the reporters are: Kyle Bagwell, Gene Grossman, Robert Howse, Damien Neven, Robert W. Staiger, Alan Sykes, and Joseph Weiler. Merit Janow was a reporter the first year.

as un-appealed panel reports, issued since January 1, 2001, from a joint law and economics perspective. While not always disputing the outcome of the determinations, a very common finding is that decisions are extremely deferential to the words used in the WTO agreement, which are often read in clinical isolation from their context, that is, without WTO judges asking, and answering, the question of what function any given legal instrument has been assigned to play. Rulings are also very often criticized for lacking economic logic.

To conclude, the few attempts to put the adjudication in the WTO into a joint economic and legal perspective tend to be rather critical of the methodological side of rulings. However, most of the studies of this type provide *ad hoc* evaluations of either specific rulings, or less frequently, the case law under certain provisions. There is therefore a need for much more systematic analyses of the quality of the case law.

5.3. Evidentiary standards

A special aspect of the quality of the case law concerns the evidentiary standards employed by the adjudicating bodies. Horn and Mavroidis (2004b) discuss one special aspect: the role of the burden of proof in disputes involving the interpretation of National Treatment. In their view, the burden has too easily been shifted over to respondents, with the consequence of leading to too many 'convictions'. Grossman and Sykes (2006) consider some principal aspects of another facet of evidentiary standards – the rule of waiver. They examine how such rules affect the number of claims brought before the adjudicators, and thus also litigation costs.[20]

The distribution of the burden of proof (production), as well as the associated required level of persuasion, is critical for determining the ambit of many of the central provisions of the WTO. This will become increasingly the case since, as a result of the continuing reduced relevance of protection through classic trade instruments, disputes arise more and more frequently between one informed (the regulating party) and one uninformed (the challenging) party. This process will become even more pronounced if the Appellate Body starts practicing its policy of treating regulatory intent as part of the standard of review in such cases.

5.4. The role of the judge

As a final area in a far from exhaustive list of lacunae in the literature, we would like to mention the question of the role of the judge. For instance, the

[20] Yet another aspect of the evidentiary standards concerns the appropriate role of scientific expertise.

European Community has recently submitted a proposal to replace the existing regime of *ad hoc* panels with one of permanent panelists. It has been suggested that this proposal would have a dramatic effect if implemented. However, we are not aware of any research from a law and economics perspective of how the composition of the adjudicating bodies might systematically effect rulings.

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6. International investment

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Introduction

International rules related to investment issues have a long history. They are multifaceted and span the bilateral, regional and multilateral levels.[2] They can take the form of binding or voluntary instruments setting out different types of commitments, which often overlap.[3] Providing a concise but reasonably comprehensive summary account of the international legal framework for foreign investment is thus a difficult task, because there are so many international rules that have a clear impact on foreign investment, spanning such fields as taxation, intellectual property, trade in services, antitrust, labour relations and corporate social responsibility. The approach followed in this chapter is to describe the main 'substantive' rules of a binding nature that set out the basic international legal framework governing the foreign investment relationship, admittedly a subjective choice, dividing such rules between bilateral, regional and multilateral rules. Only brief reference will be made to the large array of dispute settlement rules, ranging from the arbitral rules established by private institutions, such as the International Chamber of Commerce, to

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[1] The views expressed are strictly personal . The authors are grateful to Mark Koulen, Michael Gestrin, Martin Molinuevo, Elisabeth Tuerk and Christopher Wilkie for helpful comments and discussions on the issues taken up in this chapter.

[2] The texts of a large number of investment instruments are collected in the United Nations Conference on Trade and Development (UNCTAD), *International Investment Instruments: A Compendium*, various years (New York and Geneva: United Nations). Texts of bilateral investment treaties as well as the documents included in the *Compendium* are available in the UNCTAD Investment Instruments On-line Database at www.unctad.org.

[3] An example of voluntary investment rules are the 1992 World Bank Investment Guidelines (The Guidelines on the Treatment of Foreign Direct Investment, published in the Legal Framework for the Treatment of Foreign Investment, 1992, Washington, DC: World Bank). Among the many other non-binding international rules that have an influence on foreign investment activities, see the ILO Tripartite Declaration of Principles Concerning Multinational Enterprises and Social Policy 2000, 41 ILM 184 (2002) and the UNCTAD Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices adopted by the General Assembly with resolution 35/63 of 5 December 1980. The set is reproduced in UNCTAD doc. TD/RBP/CONF/10/Rev.2.

widely accepted multilateral rules, such as those of the 1965 Washington Convention.[4] The existence of such a vast range of substantive and procedural rules has also given rise to a large body of jurisprudence, particularly of an arbitral nature, the examination of which lies beyond the scope of this chapter despite its obvious importance and its contribution to the recent debate about the impact of investment rule-making on the exercise of domestic regulatory sovereignty.[5]

Bilateral rules

Friendship, commerce and navigation treaties

Friendship (or amity), Commerce and Navigation (FCN) Treaties were common instruments throughout the 19th century and the beginning of the 20th century, primarily concerned with the trade and shipping rights of individuals.[6] One important feature, sometimes regulated in separate treaties on establishment, was the reciprocal granting to citizens (but generally not to corporations)[7] of the other party of rights to entry, commercial establishment, protection of property, access to courts and recognition of foreign legal personality. A series of treaties negotiated before World War II also gave corporations legal status and access to foreign courts.[8] However, as corporate

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4 Convention on the Settlement of Investment Disputes between States and Nationals of Other States, opened for signature 18 March 1965, 17 UST 1270, 575 UNTS 159 (entered into force 14 October 1966).

5 See, for instance, M. Sornarajah (2000), *The Settlement of Foreign Investment Disputes*, The Hague: Kluwer Law International.

6 See, for instance, with regard to US practice, Treaty of Amity and Commerce with France, 8 Stat. 12, TS No. 83 (1778); Treaty of Amity, Commerce and Navigation with Great Britain, 8 Stat. 116, TS No. 105 (1794); Treaty of Commerce and Friendship with Sweden and Norway, 8 Stat. 232, TS No. 347 (1816); Treaty of Commerce and Navigation with the Netherlands, 8 Stat. 524, TS No. 251 (1839); Treaty of Commerce and Navigation with Belgium, 8 Stat. 606, TS No. 19 (1845); Treaty of Commerce and Navigation with Italy, 17 Stat. 845, TS No. 177 (1871); Treaty of Commerce with Spain, 23 Stat. 750, TS No. 337 (1884); Treaty of Commerce with Germany, 31 Stat. 1935, TS No. 101 (1900); Treaty of Commerce with China, 33 Stat. 2208, TS No. 430 (1903).

7 Although the words 'citizens', 'nationals' or 'subjects' could be, and at times were, argued to cover corporations.

8 Treaty of Commerce and Navigation with Japan, 37 Stat. 1504, TS No. 558 (1911); Treaties of Friendship, Commerce and Consular Rights with Germany, 44 Stat. 2132, TS No. 725 (1923); Estonia, 44 Stat. 2379, TS No. 736 (1925); Hungary, 44 Stat. 2441, TS No. 748 (1925); El Salvador, 46 Stat. 2817, TS No. 827 (1926); Honduras, 45 Stat. 2618, TS No. 764 (1927); Latvia, 45 Stat. 2641, TS No. 765 (1928); Austria, 47 Stat. 1876, TS No. 838 (1928); Norway, 47 Stat. 2135, TS No. 852 (1928); Poland,

involvement in international trade and production expanded, old commercial treaties became insufficient and it became necessary to negotiate new treaties granting corporations legal status and the right to function abroad.

Following the demise of the 1948 Havana Charter[9] that featured a set of controversial provisions on investment, FCN treaties were retooled and rebalanced to serve primarily investment protection purposes. After World War II the US negotiated a series of FCN treaties aimed at giving corporations of each signatory legal status in the territory of the other party, and at allowing them to conduct business in the other country on a comparable basis with domestic firms.[10] Several of these treaties, such as the ones with Italy, Germany and the Netherlands are still in force. An approach similar to that of the US was also followed by other countries, such as the United Kingdom.[11]

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48 Stat. 1507, TS No. 862 (1931); Finland, 49 Stat. 2659, TS No. 868 (1934); Treaties of Friendship, Commerce and Navigation with Siam, 53 Stat. 1731, TS No. 940 (1937); Liberia, 54 Stat. 1739, TS No. 956 (1938). Rights given to corporations by these treaties were quite limited. For example, Article VII of the 1911 Treaty with Japan provided: 'Limited liability and other companies and associations . . . already or hereafter to be organized in accordance with the laws of either High Contracting Party and domiciled in the territories of such Party, are authorized, in the territories of the other, to exercise their rights and appear in the courts either as plaintiffs or defendants, subject to the laws of such other Party. The foregoing stipulation has no bearing upon the question whether a company or association organized in one of the two countries will or will not be permitted to transact its business or industry in the other, this permission remaining always subject to the laws and regulations enacted or established in the respective countries or in any part thereof.' 37 Stat. 1506. Similar provisions were contained in the other treaties.

[9] For the text of the Havana Charter, see United Nations Conference on Trade and Employment, Final Act and Related Documents, E/CONF.2/78, United Nations publication, Sales No. 1948.II.D.4.

[10] See, for example, Treaties of Friendship, Commerce and Navigation with China, 63 Stat. 1299, TIAS No. 1871 (1946); Italy, 63 Stat. 2255, TIAS No. 1965 (1948); Israel, 1954. 5 UST 550, TIAS No. 551 (1951); Greece, 1954. 5 UST 1829, TIAS No. 3057 (1951); Japan, 1953. 4 UST 2063, TIAS No. 2863 (1953); Federal Republic of Germany, 1956. 7 UST 1839, TIAS No. 3593 (1954); The Netherlands, 1957. 8 UST 2043, TIAS No. 3942 (1956); and Pakistan, 1961. 12 UST 110, TIAS No. 4683 (1959). See Herman Walker Jr., (1956), 'Provisions on Companies in United States Commercial Treaties', *American Journal of International Law*, 50 (373); Herman Walker Jr., (1956), 'Treaties for the Encouragement and Protection of Foreign Investment: Present United States Practice', 5 *American Journal of Comparative Law*, (229) (1956); Robert Wilson (1960), *United States Commercial Treaties and International Law*, New Orleans: Hauser Press.

[11] See, for example, the Treaty of Commerce, Establishment and Navigation between Japan and the United Kingdom of 1962, UNTS 478, p. 86 and the Agreement on Commerce and Economic Co-operation between the United Kingdom and the Republic of Cameroon of 1963, UNTS 478, p. 150.

The postwar FCN treaties are broad in scope, dealing with such matter as the right to entry and sojourn, freedom of conscience, of information gathering and dissemination, the protection of persons, treatment of nationals and companies, access to domestic courts and tribunals, transparency and publication of laws and regulations, acquisition and disposal of property, protection of property and expropriation, taxation, competition, transfer of payments, shipping, social security and prevention and settlement of disputes. As under general international law the host state has the right to regulate the legal situation of aliens and foreign companies in its territory, within the boundaries of an uncodified, and thus controversial, 'international minimum standard', the purpose of FCN treaties was to extend and clearly define the rights of the contracting parties' nationals and companies beyond that minimum standard required by international law. The general aim was not to give foreign corporations greater rights than domestic companies, but rather to assure them of the right to conduct business on an equal basis without suffering discrimination due to their foreign origin.[12]

Bilateral investment treaties

Starting in the 1960s, FCN treaties have gradually given way to more specialized instruments, the Bilateral Investment Treaties (BITs), mainly – if not entirely – focused on investment protection issues.[13] Since the adoption of the

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[12] The significance of this advance was emphasized in the Senate hearings on an early set of postwar Friendship, Commerce and Navigation Treaties: 'Perhaps the most striking advance of the postwar treaties is the cognizance taken of the widespread use of the corporate form of business organization in present-day economic affairs. In the treaties antedating World War II American corporations were specifically assured only small protection against possible discriminatory treatment in foreign countries. In the postwar treaties, however, corporations are accorded essentially the same treaty rights as individuals in such vital matters as the right to do business, taxation on a nondiscriminatory basis, the acquisition and enjoyment of real and personal property, and the application of exchange controls. Furthermore, the citizens and corporations of one country are given substantial rights in connection with forming local subsidiaries under the corporation laws of the other country and controlling and managing the affairs of such local companies.' Commercial Treaties: Hearing on Treaties of Friendship, Commerce and Navigation between the United States and Colombia, Israel, Ethiopia, Italy, Denmark and Greece before a Subcommittee of the Senate Committee on Foreign Relations, 82d Cong., 2d Sess., 4–5 (1952) (opening statement of Harold Linder, Deputy Assistant Secretary of State for Economic Affairs).

[13] The last FCN-type treaty concluded by the US was that with Thailand in 1966 (Treaty of Amity and Economic Relations with Exchanges of Notes. Signed at Bangkok, 29 May 1966; entered into force, 8 June 1968. 19 UST 5843; TIAS 6540; 652 UNTS 253). The last unsuccessful negotiation took place with the Philippines in the early 1970s. The US started negotiating BITs in the early 1980s.

first BIT in 1959, the number of such treaties that have been concluded has grown significantly, particularly since the early 1990s, a trend that now engulfs countries at all levels of development.[14] The total number of BITs in 2005 exceeds the 2400 mark, although only about 1700 are actually in force.[15]

The network of BITs grew significantly throughout the 1970s, prompted in large measure by a defensive impulse on the part of home (i.e. capital-exporting) country governments in the wake of the increasing number of expropriations and nationalizations, notably in Latin America. The trend accelerated anew in the 1990s, albeit in a markedly changed policy and ideological environment, as host country (i.e. capital-importing) governments in both developing and transition countries sought to exploit the putative signalling properties of BITs. The period saw a significant increase in treaties linking a wider range of countries along south–north lines as well as, most recently, along south–south lines.[16]

BITs are designed to protect, promote and facilitate foreign investment and constitute to date the most widely used instrument for these purposes. Unlike FCN treaties, BITs have traditionally been negotiated between developing countries seeking to attract international investment and developed countries as the principal homes to foreign investors. Developing countries, as hosts to foreign direct investment (FDI), concluded BITs in order to create a favourable climate and in some cases to become eligible to participate in political risk insurance programmes organized by capital-exporting countries.

The content of BITs has become increasingly standardized over the years and has largely influenced rule-making at the regional level, particularly during the last 15 years, even if as a consequence of the sheer number of BITs, formulations of individual provisions remain rather varied. In particular, there

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[14] The first BIT was concluded by the Federal Republic of Germany and Pakistan on 25 November 1959. Countries such as France and Switzerland rapidly followed suit. Not all the BITs concluded over time are in force. For a survey of the existing network of BITs see UNCTAD (2000), *Bilateral Investment Treaties 1959–1999* (New York and Geneva: United Nations), available at: http://www.unctad.org/en/docs/poiteiiad2.en.pdf. See also Zachary Elkins, Andrew Guzman and Beth Simmons (2004), 'Competing for Capital: the Diffusion of Bilateral Investment Treaties, 1960–2000', UC Berkeley Public Law Research Paper No. 578961 (August).

[15] Exact counting is difficult because of the mere number of such treaties, see UNCTAD (2005), 'Occasional Note: Many BITs have yet to enter into Force', UNCTAD/WEB/ITE/IIA/2005/10.

[16] Parallel to BITs, and of key importance to foreign investors, countries have also been concluding agreements for the avoidance of double taxation, the number of which exceeded 2500 at the end of 2004. They address, among other things, the allocation of taxable income, with a view to reducing incidents of double taxation. See UNCTAD (2005), *World Investment Report 2005*, Geneva: United Nations, p. 28.

are differences between the provisions of BITs signed some decades ago and the more recent ones.[17] A typical BIT's main provisions deal with the scope and definition of foreign investment; admission of investments; national and most-favoured-nation treatment; fair and equitable treatment; guarantees and compensation in respect of expropriation; guarantees of free transfer of funds and repatriation of capital and profits; and dispute-settlement provisions, both State-to-State and investor-to-State. This latter feature is one of the main innovations which differentiate significantly FCN treaties and BITs, together with a curtailment of the wide right of entry which characterized many of the FCN treaties. The acceptability of investor–State arbitration was significantly advanced by the conclusion in 1965 of the Washington Convention.

The most relevant new development in international practice of the last few years appears to be the frequency with which developing countries and countries in transition are concluding agreements with each other. In terms of content their practice does not seem to depart from the traditional BITs between developed and developing partners. From a legal perspective, the increasingly uniform state practice means that it is nowadays possible to argue that 'the BIT movement has moved beyond *lex specialis* (or better, *leges speciales*) to the level of customary law effective even for non-signatories'.[18]

From an economic perspective, capital-importing country activism in concluding BITs underscores the keen interest that such countries appear to have in creating a domestic environment that is conducive to FDI. Indeed, the policy and regulatory environment of developing countries plays an important role both in attracting (or discouraging) investment flows and in ensuring that the ensuing benefits are maximized and costs minimized. By potentially contributing to the creation of an investment-friendly regulatory environment

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[17] For a comprehensive examination of existing BITs practice, see UNCTAD (1998), *Bilateral Investment Agreements in the Mid-1990's*, Geneva: United Nations. See also G. Sacerdoti (1997), 'Bilateral Treaties and Multilateral Instruments on Investment Protection', *Recueil des Cours*, The Hague: Academy of International Law, pp. 251–40, available online at http://www.ppl.nl/bibliographies/all/showresults.php?ibiography=recueil&keyword1ppn=076240150&keyword=Treaties. Andrew Guzman (1998), 'Why LDCs Sign Treaties that Hurt Them: Explaining the Popularity of Bilateral Investment Treaties', *Virginia Journal of International Law*, 38 639; P.T. Muchlinski (1999), *Multinational Enterprises and the Law*, Oxford: Blackwell Publishers, revised paperback edn, 1999; K. Vandevelde (2000), 'The Economics of Bilateral Investment Treaties', *Harvard International Law Journal*, Spring, 468–502; M. Sornarajah (2005), *International Law on Foreign Investment*, Cambridge: Cambridge University Press; Jeswald W. Salacuse and Nicholas P. Sullivan (2005), 'Do BITs Really Work?: An Evaluation of BITs and Their Grand Bargain' *Harvard International Law Journal*, 46(1).

[18] See A. Lowenfeld (2003), 'Investment Agreements and International Law', *Columbia Journal of Transnational Law*, 42(1) 123–31, 129.

and by committing (or signalling a reinforced commitment) to a high standard of protection for foreign investment, BITs are commonly assumed to play a positive – albeit limited – role in the promotion of FDI flows and thus to contribute to the economic development of the host country.[19] This is of course in as far as FDI can be harnessed to contribute to the realization of the specific development objectives that each individual country has set for itself, while minimizing any attendant costs that the presence of FDI may entail. However, BITs predominantly remain instruments of investment protection. Over the years there has not been any significant change in their core objective. It is thus still true that, 'a striking feature of BITs is the multiplicity of provisions they contain that are specifically designed to protect foreign investments, and the absence of provisions specifically designed to ensure economic growth and development'.[20]

Scope of application The main objective of BITs is to protect investment made by investors of one party in the territory of the other party. In order to maximize such protection, there is a marked tendency in current BIT practice to use a broad, asset-based, definition of the term 'investment'. The latter typically includes movable and immovable property, tangible and intangible assets, intellectual property, as well as equity and other interest in companies. Most BITs do not distinguish between direct and portfolio investment. Both minority and controlling interests are generally protected.[21] Furthermore, a broad definition

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19 See M. Hallward-Driemeier (2003), 'Do Bilateral Investment Treaties Attract FDI? Only a bit . . . and they may bite', *World Bank Policy Research Paper* No. 3121, Washington, DC: World Bank; Eric Neumayer and Laura Spess (2005), 'Do Bilateral Investment Treaties Increase Foreign Direct Investment to Developing Countries?', (May), mimeo.

20 See P. Robinson, (1998), 'Criteria to Test the Development Friendliness of International Investment Agreements', *Transnational Corporations*, 7(1) (April), at p. 84.

21 The US treaty practice provides for extensive coverage. See, for example, Art II of Treaty between the Government of the United States of America and the Government of the State of Bahrain concerning the Encouragement and Reciprocal Protection of Investment: '. . . (d) 'investment' of a national or company means every kind of investment owned or controlled directly or indirectly by that national or company, and includes, but is not limited to, investment consisting or taking the form of: (1) a company; (2) shares, stock, and other forms of equity participation, and bonds, debentures, and other forms of debt interests, in a company; (3) contractual rights, such as under turnkey, construction or management contracts, production or revenue-sharing contracts, concessions, or other similar contracts; (4) movable and immovable property; and intangible property, including, but not limited to, rights, such as leases, mortgages, liens and pledges; (5) intellectual property, including, but not limited to: copyrights and related rights, patents, rights in plant varieties, industrial designs, rights in semiconductor layout designs, trade secrets, including, but not limited to, know-how

may cover new forms of investment that parties did not consider specifically at the time of negotiation. Instead a more restricted definition may require re-negotiation of the treaty in order to enlarge the scope over time.

Some BITs specify that the afforded protection is conditional on the investment being made in accordance with local laws and regulations. This may allow host countries to confine the application of BITs to investments that respond to the country's policy objectives as embodied in domestic laws and regulations. The same result can be pursued through provisions dealing with the admission of investment.

As regards the application of BIT provisions to investments made prior to the entry into force of the treaty, current practice remains mixed. Some BITs allow the extension of protection, while others exclude it. And some BITs require prior investments to go through the prescribed admission procedures before extending treaty protection. A similar issue refers to the continuation of treaty protection with regard to existing investments in the event of treaty termination. With a view to ensuring a stable legal environment for investment, current practice tends to allow for such continued protection, with some BITs limiting the coverage to investments established before the notice of termination, while others focus on the effective date of termination.

BITs must also define to which investors the substantive provisions set out in a treaty apply. A capital importing country may be reluctant to grant the benefits of a BIT to persons and companies having only a tenuous relationship with its treaty partner (for example, so-called 'shell' or 'mail-box' companies). Establishing the nationality of the investor is thus fundamental. The definition of the term 'investor' usually includes natural persons and juridical entities, often referred to generically as 'companies'.

With respect to natural persons, most BITs give protection to persons who are 'nationals' of each of the contracting countries concerned. The general practice is then to provide that a natural person possesses the nationality of a State if the law of that State so provides.[22] Some BITs, perhaps inspired by the customary international law doctrine of effective nationality,[23] require the

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and confidential business information, trade and service marks, and trade names; and (6) rights conferred pursuant to law, such as licenses and permits; . . .'.

[22] For instance, the 1992 BIT between Argentina and the Netherlands refers, with regard to either Contracting Party, to 'natural persons having the nationality of that Contracting Party in accordance with its law'. (see Agreement on Encouragement and Reciprocal Protection of Investments between the Kingdom of the Netherlands and the Argentine Republic, of 20 October 1992, Art. 1(b)(i)).

[23] The principle of effective nationality has long been applied to resolve conflicts of nationality in international arbitration. See, for instance, the Nottebohm Case, (*Liechtenstein v Guatemala*) Second Phase, Judgment, *ICJ Reports 1955*, Rep 4, also on the concept of the 'genuine and effective link'.

existence of a genuine link between the individual and the country granting nationality in the form of residence or domicile.[24] However, in general, BITs do not resolve the problem of the treatment of natural person investors with dual or multiple nationalities.

With regard to legal persons, BITs generally take an expansive approach in terms of the kinds of entities that are meant to be covered. In defining the term 'investor', many treaties include legal persons constituted under the law of a party, thus covering companies, as well as other legal entities.[25]

BITs extend protection to companies that are deemed to have the nationality of one of the signatories. Problems arise because in most cases, and increasingly with the spread of multinational corporations and international production networks, places of incorporation, the location of business activities and/or the nationality of ownership and control often involve multiple jurisdictions. In most instances a multinational corporation operates in a host state through a subsidiary incorporated therein. Such a subsidiary acquires the nationality of the host state and cannot avail itself of the diplomatic protection of its home state. A multinational corporation could also choose to do business through an entity incorporated in a third state, whose corporations may not be entitled to the same treatment as the home state companies in the host state.

BITs have in recent years tried to address such complexities, often by combining the traditional nationality tests or criteria, namely the place of incorporation; the location of the 'seat' of the corporation (sometimes referred to as the *siège social*, real seat, or the principal place of management); and the nationality of the shareholders who own or control the corporation. The place of incorporation, organization or constitution of a company is a widely used criterion to determine nationality thanks to its ease of application.[26] However, if used in isolation, such a test lends itself to granting nationality to a company

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[24] See, for instance, the 1976 BIT between Germany and Israel (Art. I(3)(b)) and 1968 BIT between Denmark and Indonesia (Art. I(a)).

[25] Other BITs define the term 'company' quite broadly to comprise, as in the case of the 1991 BIT between Tunisia and Turkey 'any kind of juridical entity, including any corporation, company, business association or other organization that is duly incorporated, constituted or otherwise duly organized under the applicable laws and regulations of a Party'. Art. I(1)(h).

[26] For instance, the 1996 Foreign Investment Protection Agreement (FIPA) between Canada and Panama provides that an investor means: 'In the case of Canada: . . . ii. any enterprise incorporated or duly constituted in accordance with applicable laws of Canada . . . In the case of the Republic of Panama: . . . ii. any enterprise incorporated or duly constituted in conformity with the laws of the Republic of Panama'. See Treaty between the Government of Canada and the Government of the Republic of Panama for the Promotion and Protection of Investments, of 12 September 1996, Art. I.h.

that has only a formal link with the country of incorporation and does not engage in any economic activity there. Indeed, the place of incorporation could be chosen exclusively to enjoy treaty advantages reserved to nationals of signatories.

Such a situation has prompted two main types of responses. Some BITs combine the place of incorporation test with criteria focusing on a company's 'seat'. This test attributes the nationality of the place where the *siège social* is located. The 'seat of a company' often refers to the place of effective management decision-making, and as such, while more difficult to determine, reflects a more significant economic relationship between the corporation and the country granting nationality.[27] Other BITs instead include a denial of benefits clause meant to prevent, under certain circumstances, nationals of third countries from obtaining BIT treatment by incorporating in one of the signatory countries. This approach is typical in the practice of the United States.[28]

Admission and promotion of investment Under customary international law states have the sovereign right to regulate and prohibit or condition the admission of investment and investors in their territory, in line with their right to admit or not aliens. The exercise of such a right may be motivated by a desire to preserve national economic or other public policy goals. The current practice in BITs is to follow this approach. Only a very few BITs confer any right

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[27] For instance, the 1992 BIT between Argentina and the Netherlands considers investors of either Contracting Party 'legal persons constituted under the law of that Contracting Party and actually doing business under the laws in force in any part of the territory of that Contracting Party in which a place of effective management is situated'. See Art.1(b)(ii). A similar approach can be found in the Acuerdo entre el Gobierno de la Republica de Venezuela y el Gobierno de la Republica Argentina para la promocion y proteccion reciprocas de inversiones, of 16 November 1993, which provides, at Art. 1.1, that 'El término "inversor" designa: (a) toda persona juridica constituida de conformidad con las leyes y reglamentaciones de una Parte Contratante y que tenga su sede en el territorio de dicha Parte Contratante . . .'.

[28] For instance, the 1995 Honduras–US BIT provides that 'Each Party reserves the right to deny to a company of the other Party the benefits of this Treaty if nationals of a third country own or control the company and (a) the denying Party does not maintain normal economic relations with the third country; or (b) the company has no substantial business activities in the territory of the Party under whose laws it is constituted or organized'. See Treaty between the Government of the United States of America and the Government of the Republic of Honduras concerning the Encouragement and Reciprocal Protection of Investment, of 1 July 1995, Art. XII. See also Agreement between the Government of Japan and the Government of the Republic of Korea for the Liberalization, Promotion and Protection of Investment, 22 March 2003, Art. 22.

of establishment to investors. In general, treaty protection only comes into play after the investment has been admitted.

With regard to admission, consolidated BITs' practice refers to the need to admit investment in accordance with the laws and regulation of the host country. This may mean that admission can be subject to the fulfilment of special conditions, such as the training of local personnel or the reinvestment of profits. Most BITs stress, with various formulations, the importance of facilitating or encouraging investment, creating favourable conditions and the like. Other areas that are often mentioned in 'best endeavour' terms or subject to domestic legislation, include: the exchange of information on investment opportunities, the dissemination of law and regulation affecting investment, consultation mechanisms, the granting of work permits to key and technical personnel.

With the exception of the United States and Canada, BITs typically do not deal with the issue of liberalization of the entry regime for foreign investment. Such treaties leave liberalization matters entirely up to the autonomous decisions of host countries as set out in their domestic legislation. On the contrary, the US and Canadian approach allows for the reciprocal exchange of liberalization commitments through the granting of national and MFN treatment, subject to negotiated exceptions.[29]

Standards of treatment In addition to any admission standards, BITs provide for a series of standards of treatment once an investment has been established. In current practice various formulations are used. Many BITs explicitly require the host country to afford investments covered by the treaty treatment no less favourable than that required by international law. Many BITs also refer to 'fair and equitable treatment', 'full protection and security', 'prohibition of arbitrary and discriminatory measures' and the like. All these are minimum standards of treatment provided under international law. While their content is generally not defined, they may be used in conjunction with other standards and their meaning may need to be determined in the light of the specific circumstances of application. The notion of fair and equitable treatment aims at ensuring the prudent and just application of legal rules (even in the absence of discrimination) and can also provide an auxiliary element for

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[29] See, for instance, the 1999 Agreement between the Government of Canada and the Government of the Republic of El Salvador for the Promotion and Protection of Investments at Art. III (Establishment of Investments): 'Each Contracting Party shall permit establishment of a new business enterprise or acquisition of an existing business enterprise or a share of such enterprise by investors or prospective investors of the other Contracting Party on a basis no less favourable than that which, in like circumstances, it permits such acquisition or establishment by: investors or prospective investors of any third state; its own investors or prospective investors. . . .'.

the interpretation of other treaty provisions and for filling gaps in the treaty.[30] The full protection and security standard, or any of the various variations thereto (e.g. 'the most constant protection and security'), already widely used in FCN treaties, aims at ensuring that – in line with due diligence – host countries exercise reasonable care to protect investments against injury caused by private parties as well as a result of public action.[31]

The prohibition of arbitrary and discriminatory measures refers to the prohibition of actions against foreign investors in general or specific groups of foreign investors.[32] Some BITs include only general language to this effect, while others specify commitments with regard to both most-favoured nation treatment (MFN) and national treatment (NT). Such standards were commonly found in FCN treaties.

MFN treatment provides that investors and investment of one party will not be treated less favourably in the other party than any third party investor or

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[30] See P. Juillard (1999), 'Les Conventions Bilaterales d'Investissement Conclues par la France', *Journal de Droit International*, 106, 274–321; F.A. Mann, (1981) 'British Treaties for the Promotion and Protection of Investment', *British Yearbook of International Law* 52, 241–64; Mahmoud Salem, (1986) 'Le Développement de la Protection Conventionelle des Investissements Étrangers', *Journal de Droit International*, 113, 579–626; Jean-Pierre Laviec (1985) *Protection et Promotion des Investissements* Paris: Presse Universitaires de France.

[31] Since 2001 there has been an attempt to circumscribe the concepts in order to avoid expansive constructions in the course of arbitration proceedings. Fears of this kind had arisen as a result of several NAFTA dispute settlement cases. The 2004 US model BIT, in a way similar to the most recent investment chapters in US FTAs, reads: 'Article 5: Minimum Standard of Treatment 1. Each Party shall accord to covered investments treatment in accordance with customary international law, including fair and equitable treatment and full protection and security. 2. For greater certainty, paragraph 1 prescribes the customary international law minimum standard of treatment of aliens as the minimum standard of treatment to be afforded to covered investments. The concepts of 'fair and equitable treatment' and 'full protection and security' do not require treatment in addition to or beyond that which is required by that standard, and do not create additional substantive rights. The obligation in paragraph 1 to provide: (a) 'fair and equitable treatment' includes the obligation not to deny justice in criminal, civil, or administrative adjudicatory proceedings in accordance with the principle of due process embodied in the principal legal systems of the world; and (b) 'full protection and security' requires each Party to provide the level of police protection required under customary international law. 3. A determination that there has been a breach of another provision of this Treaty, or of a separate international agreement, does not establish that there has been a breach of this Article. . . .'

[32] For instance, the 1992 BIT between the Netherlands and Argentina states at Art. 3: 'Each Contracting Party shall ensure fair and equitable treatment of the investments of investors of the other Contracting Party and shall not impair, by unreasonable or discriminatory measures, the operation, management, maintenance, use, enjoyment or disposal thereof by those investors. . . .'

investment. Thus with regard to post-establishment treatment (once admission has been granted), the MFN provision links the existing BITs concluded by any one country in a network and has the effect of ratcheting up the treatment of all treaty partners' investors and investments to the highest agreed denominator. National treatment ensures that investors and investment of one party will receive from the host party treatment no less favourable than the treatment given to investors and investment of the host party. Current BITs' practice is mixed with countries either granting MFN only or both standards of treatment.

The coverage of the MFN and NT obligations may also vary depending on whether both investment and investors (or similar terms) are covered. Some qualifications are also added in a number of cases to limit the applications of MFN and NT to investment 'in similar circumstances' or 'in like situations'. General exceptions relating to public order and national security frequently apply. Current BITs' practice also often excludes from the operation of the MFN clause special privileges granted as a result of regional integration agreements, such as the establishment of customs unions and free trade areas, and of other bilateral agreements, such as double taxation treaties.[33] Specific sectoral exemptions may also be recorded in BITs on a sectoral basis, as recalled above in connection with the US and Canadian practice of extending the better of MFN and NT also to the establishment phase.

Many host countries, particularly in the developing world, use a wide array of performance requirements either as mandatory conditions for admission or operation of an investment or as voluntary conditions linked to the granting of incentives. These may take the form of domestic content requirements and domestic purchase preferences, the 'balancing' of imports or sales in relation to exports or foreign exchange earnings, requirements to export products or services, technology transfer requirements, and requirements relating to the conduct of research and development in the host country.

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[33] See, for example, the 1994 Agreement between the Government of Jamaica and the Government of the Argentine Republic on the Promotion and Reciprocal Protection of Investments, Article 3 (Protection of Investments): '. . . 2. Each Contracting Party, once it has admitted investments in its territory by investors of the other Contracting Party shall grant full legal protection to such investments and shall accord them treatment which is no less favourable than that accorded to investments by its own investors or by investors of third States. 3. Notwithstanding the provisions of Paragraph 2), of this Article, the treatment of the most favoured nation shall not apply to privileges which either Contracting Party accords to investors of a third State because of its membership in, or association with a free trade area, customs union, common market or regional agreement. 4. The provisions of Paragraph 2) of this Article shall not be construed so as to oblige one Contracting Party to extend to investors of the other contracting Party the benefit of any treatment, preference or privilege resulting from an international agreement relating wholly or mainly to taxation. . . .'

Most BITs do not explicitly restrict the use of performance requirements.[34] However, if the performance requirements are imposed following the admission of an investment, they may give rise to a violation of national treatment. To the extent that they are imposed as a condition of the admission of an investment, they are generally not covered by the national treatment obligation because in the majority of BITs, as already mentioned, the right to national treatment applies to investment only after it has been admitted.

Current US and Canadian practice, with a few other examples, departs from this approach and includes a prohibition on performance requirements as a condition of establishing, expanding or maintaining an investment project.[35] The prohibition of performance requirements does not preclude the granting of incentives as an inducement to agree to abide by performance requirements. Any such incentives, however, may be subject to the MFN obligation and thus would have to be offered to all investors covered by BITs featuring an MFN clause. This would also apply to incentives granted by other BIT partners, unless specifically exempted.[36] However, if the incentive was offered prior to

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34 Among the rare examples of BITs including provisions on performance requirements are the ones between El Salvador and Peru (1996) and Malaysia and the United Arab Republic (1991).

35 For instance, the 1995 Treaty between the Government of the United States of America and the Government of the Republic of Honduras concerning the Encouragement and Reciprocal Protection of Investment provides at Art. VI: 'Neither Party shall mandate or enforce, as a condition for the establishment, acquisition, expansion, management, conduct or operation of a covered investment, any requirement (including any commitment or undertaking in connection with the receipt of a governmental permission or authorization): (a) to achieve a particular level or percentage of local content, or to purchase, use or otherwise give a preference to products or services of domestic origin or from any domestic source; (b) to limit imports by the investment of products or services in relation to a particular volume or value of production, exports or foreign exchange earnings; (c) to export a particular type, level or percentage of products or services, either generally or to a specific market region; (d) to limit sales by the investment of products or services in the Party's territory in relation to a particular volume or value of production, exports or foreign exchange earnings; (e) to transfer technology, a production process or other proprietary knowledge to a national or company in the Party's territory, except pursuant to an order, commitment or undertaking that is enforced by a court, administrative tribunal or competition authority to remedy an alleged or adjudicated violation of competition laws; or (f) to carry out a particular type, level or percentage of research and development in the Party's territory. Such requirements do not include conditions for the receipt or continued receipt of an advantage.'

36 See, for example, the 1987 BIT between Jamaica and the United Kingdom, Article 3: '. . . (3) Special incentives granted by one Contracting Party only to its nationals and companies in order to stimulate the creation of local industries are considered compatible with this Article [providing for NT] provided they do not significantly affect the investment and activities of nationals and companies of the other Contracting Party in connection with an investment.'

establishment (e.g. a so-called locational incentive), what is mentioned above with regard to the non-application of NT would also seem to apply.

Expropriation In the 1960s many developed countries initiated BITs as a way to protect their investments abroad against the growing risks of expropriation and nationalization. Such risks have greatly abated in recent years. In current practice, the terms 'expropriation' or 'nationalization' are generally left undefined in BITs. Provisions on expropriation typically apply to actions by a country that substantially impair the value of an investment, regardless of whether they amount to an isolated event or whether they are part of a major structural reform in the economy. Many BITs include broad language, covering measures 'tantamount' or 'equivalent' to expropriation. Hence, most BITs also apply the expropriation provisions to 'indirect expropriations', namely, when the host country takes an action that substantially impairs the value of an investment without necessarily assuming ownership of the investment.

Furthermore, most BITs are also understood to apply expropriation provisions to 'creeping expropriations', which refer to expropriations carried out by a series of legitimate regulatory acts over a period of time whose ultimate effect is to substantially reduce the value of an investment. However, the demarcation between actions that would qualify as illegitimate expropriation as opposed to legitimate policy and regulatory decisions is obviously difficult to establish and open to dispute.

BITs impose certain conditions on expropriation if it is to be considered lawful. This follows general international law, where there is no rule that would bar expropriation of alien property provided that such action is undertaken for a public purpose, in a non-discriminatory manner, in accordance with due process of law and upon payment of compensation. All these conditions are generally stipulated in typical BITs. Thus if a direct or indirect expropriation takes place, compensation is due. Many disputes have revolved around the amount and modalities of such compensation.

The large majority of BITs use the traditional rule that such compensation must be 'prompt, adequate and effective' or some variation thereof.[37]

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[37] For the purpose of the 1995 Agreement on encouragement and reciprocal protection of investments between the Republic of South Africa and the Kingdom of the Netherlands, Art. 6(c), 'just compensation . . . shall represent the genuine value of the investments affected, shall include interest at a normal commercial rate until the date of payment and shall, in order to be effective for the claimants, be paid and made transferable, without delay, to the country designated by the claimants concerned and in the currency of the country of which the claimants are nationals or in any freely convertible currency accepted by the claimants'. Art. 3 of the 1995 Honduras–US BIT states: '2. Compensation shall be paid without delay; be equivalent to the fair market

Adequacy generally refers to the investment's 'market value', 'fair market value' or 'genuine value' before the expropriation took place and not considering any decrease in value because of the expropriation's plans. Unless the value can be determined making recourse to stock exchange valuations, for specific investment projects, for example, in mining or manufacturing, the present value of expected future earning or the actual funds invested in the enterprise may need to be considered. The requirement of prompt compensation does not mean immediate payment but indicates, as often explicitly set out in many BITs, that interests accrue from the date of expropriation. Finally, effective refers to a compensation made in freely usable and transferable currency (or some other financial instruments).

In case of other breaches of obligations, such as NT, MFN or other minimum standards of treatment, no comparable criteria for compensation are generally set out in BITs. With regard to cases of destruction of property due to war and civil disturbances, if some form of compensation is required, for instance in case of negligence, some BITs require that MFN (and sometimes also NT) is applied.

Transfer of funds The provisions on the transfer of payments are quite important as they concern a key aspect on which the interests of the host country and the foreign investor may differ. Host countries often prefer that profit be reinvested or otherwise used in the domestic economy. Furthermore, developing countries often incur balance-of-payments difficulties that the sudden repatriation of large profits or the proceeds from sale or liquidation can worsen. As a result they generally seek some form of flexibility. However, foreign investors regard the timely transfer of income, capital and other payments as an indispensable requirement to operate and benefit from their investment projects, and to meet their obligations *vis-à-vis* shareholders, contractors, creditors or licensors.

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value of the expropriated investment immediately before the expropriatory action was taken ('the date of expropriation'); and be fully realizable and freely transferable. The fair market value shall not reflect any change in value occurring because the expropriatory action had become known before the date of expropriation. 3. If the fair market value is denominated in a freely usable currency, the compensation paid shall be no less than the fair market value on the date of expropriation, plus interest at a commercially reasonable rate for that currency, accrued from the date of expropriation until the date of payment. 4. If the fair market value is denominated in a currency that is not freely usable, the compensation paid – converted into the currency of payment at the market rate of exchange prevailing on the date of payment – shall be no less than: (a) the fair market value on the date of expropriation, converted into a freely usable currency at the market rate of exchange prevailing on that date, plus (b) interest, at a commercially reasonable rate for that freely usable currency, accrued from the date of expropriation until the date of payment.'

Virtually every BIT has a provision on the transfer of payments, but there are important differences among them in terms of specific wording. With regard to the categories of transfers covered, BITs generally address the repatriation of the capital invested, the transfer of returns generated by an investment and dividends to the investor's shareholders, current payments made in relation to an investment (i.e. amounts that may be needed to pay current expenses, the interest and principal on loans, or other obligations incurred by the investor, such as royalties), and proceeds from the sale of all or part of the investment.

Two main approaches are common practice. The first is to guarantee the free transfer of all payments related to, or in connection with, an investment, accompanied by an illustrative list of covered payments. The second approach is simply to include an exhaustive list of the types of payments covered by the transfer provisions. BITs, with a variety of solutions, guarantee to investors the possibility of transferring payments in a freely convertible currency, without delay and at a specified exchange rate (the official rate, the market rate or some other rate). Exceptions generally allow for a limited delay in cases of emergencies, such as in instances of insufficient foreign currency reserves. However, exceptions are to be administered on a non-discriminatory basis. In some instances, transfer guarantees are limited by the explicit application of the exchange control laws of the host country.

Dispute resolution Investment disputes under BITs may involve disputes between one State and investors of the other State, or between the two States parties to the treaty. They are addressed in different provisions. Disputes between purely private parties are normally resolved through recourse to the courts of the State that has jurisdiction, or to commercial arbitration. With regard to disputes between one party, generally the host country, and investors of the other party, current BITs' practice provides for recourse to agreed third-party dispute-settlement mechanisms: consultation and negotiation but above all arbitration. This allows investors to avoid submitting the disputes to the courts of the host State (which could be biased or perceived as such) or to ask for the diplomatic protection of its home State.

Only a few BITs require that the investor exhaust local remedies before resorting to arbitration. The advantage of arbitration is that the dispute is handled in an international legal forum, generally removed from political interference and able to deliver a speedy resolution. The methods for resolving disputes between States parties to BITs involving the application or interpretation of the treaty are also typically spelled out in a number of provisions in BITs.

While the provisions regarding State-to-State disputes are generally rather short, calling for *ad hoc* arbitration in case consultations fail, most BITs

contain rather elaborate provisions on the settlement of disputes between an investor and the host country (so-called investor–State disputes), regarding the composition of the arbitration panel, timeframes, the scope of arbitrable disputes, and procedural rules.[38]

While current practice features several variations, the general trend is to give investors a choice of arbitral mechanisms through institutions such as the World Bank's International Centre for the Settlement of Investment Disputes (ICSID) and its affiliated Additional Facility for host countries which are not party to the Washington Convention, the International Chamber of Commerce or the various regional arbitration centres,[39] or through reference to other arbi-

[38] Dispute settlement rules are particularly articulated in US practice. For an example of a more concise provision, see, for example, the 1994 Argentina-Jamaica BIT, Article 9 (Settlement of Disputes Between an Investor and the Host Contracting Party): '1. Any dispute which arises within the terms of this Agreement concerning an investment between an investor of one Contracting Party and the other Contracting Party shall, if possible, be settled amicably. 2. If the dispute cannot thus be settled within six months following the date on which the dispute has been raised by either party, it may be submitted to: a. the competent, tribunal of the Contracting Party in whose territory the investment was made, or b. international arbitration according to the provisions of Paragraph 3). 3. Where a dispute has been raised by the investor and the Parties disagree as to the choice of (a) or (b), the opinion of the investor shall prevail. 4. Pursuant to Paragraphs 2) and 3), where an investor or a Contracting Party has submitted a dispute to the aforementioned competent tribunal of the Contracting Party where the investment has been made or to international arbitration, this choice shall be final. 5. In case of international arbitration, the dispute shall be submitted either to: a. the International Centre for the Settlement of Investment Disputes (ICSID) created by the 'Convention on the Settlement of Investment Disputes between States and Nationals of other States' opened for signature in Washington D.C. on 18th March, 1965, once both Contracting Parties herein become members thereof. As far as this provision is not compiled with, each Contracting Party consents that the dispute be submitted to arbitration under the regulations of the ICSID Additional Facility for the Administration of Conciliation, Arbitration and Fact-Finding Proceedings, or b. an arbitration tribunal set up from case to case in accordance with the Arbitration Rules of the United Nations Commission on International Trade Law (UNCITRAL). 6. If after a period of three months following written notification of the submission of the dispute to arbitration there is not agreement on the selection of a forum under Section 5 (a) or Section 5 (b), the parties to the dispute shall be bound to submit it to the International Centre for the Settlement of Investment Disputes. 7. The arbitration tribunal shall decide in accordance with the provisions of this Agreement, the laws of the Contracting Party involved in the dispute, including its rules on conflict of law, the terms of any specific agreement concluded in relation to such an investment and the relevant principles of international law. 8. The arbitral decisions shall be final and binding for the Parties in the dispute. Each Contracting Party shall execute them in accordance with its laws.'

[39] See further A. Asouzu (2001), *International Commercial Arbitration and African States*, Cambridge: Cambridge University Press.

tral rules, such as those established by the United Nations Commission on International Trade Law (UNCITRAL).[40]

The inclusion in BITs of various institutional options to conduct arbitration is generally regarded as an expression of consent to arbitration on the side of the host state. Such consent is expressly stated in some cases, such as in the US practice. Investors have to provide their own written consent to arbitration. Arbitration awards are then binding on the parties. Arbitration proceedings are generally confidential, and awards are sometimes published.[41] Participation of *amici curiae* is normally not allowed.[42] Enforcement is usually carried out on the basis of the provisions of the New York Convention.[43]

Regional rules

The universe of regional instruments on investment or including investment rules does not attain the proportions of the BIT phenomenon,[44] but is still vast, diverse and growing.[45] Such instruments are today creating an intricate web of

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[40] See M. Sornarajah *The Settlement of Foreign Investment Disputes*, op. cit.; Margrete Stevens (2001), '*Experience in Arbitrations under ICSID Rules Pursuant to Bilateral Investment Treaties*', *International Business Lawyer*, 29(8) (September, 377–80; George M. von Mehren, Claudia T. Salomon and Aspasia A. Paroutsas (2004), 'Navigating through Investor-State Arbitrations – An Overview of Bilateral Investment Treaty Claims', *Dispute Resolution Journal* (February–April), 69–77.

[41] Under several arbitration systems, existence of disputes and final awards are never made public. Even under the ICSID arbitration system, which maintains a public registry of claims, not all decisions have been made public.

[42] On the other hand the most recent US practice based on the new Model BIT allows for the tribunal to accept third-party amicus curiae submissions, see, for example, the 2004 US-Uruguay BIT, Article 28 (Conduct of the Arbitration) '. . . 3. The tribunal shall have the authority to accept and consider amicus curiae submissions from a person or entity that is not a disputing party. . . .'

[43] UN Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958.

[44] The majority of the reviewed instruments, some of which are not yet in force, are reproduced in the UNCTAD Compendium, op. cit. Titles of instruments are sometimes abridged for ease of reading.

[45] Not all regional instruments are binding. For instance, in the context of the Asia-Pacific Economic Cooperation (APEC), norms of a legally non-binding nature relating to the admission, treatment and protection of foreign investment have been adopted in the 1994 APEC Non-Binding Investment Principles. These state that Member economies will ensure transparency with respect to laws, regulations and policies affecting foreign investment; extend MFN treatment to investors from any economy with respect to the establishment, expansion and operation of their investments; and accord national treatment to foreign investors in relation to the establishment, expansion, operation and protection of foreign investment, with exceptions as provided for in domestic laws, regulations and policies. More specifically the APEC Principles also provide that Member economies will not relax health, safety and environmental

overlapping commitments. While BITs have a distinct focus on matters of investment protection, regional integration agreements (RIAs) are often geared towards liberalization even though an important (and increasing) number of them also address investment protection issues. According to notifications made to the WTO, over 190 regional trade agreements are currently in force and several dozens are reportedly planned or already under negotiation.[46] A large number of them feature investment provisions and so do several other trade agreements that do not aim specifically at regional integration.[47] Several agreements of this latter type have been concluded in recent years and many more are under negotiation. However, some recent instruments do not cover investment issues in light of the fact that a BIT already existed between signatories. This is the case notably of the US-Jordan FTA of 2000[48] and of the Canada-Costa Rica FTA of 2001.

Various recent agreements linking the European Union with third countries also refer to the possible conclusion of BITs between Member States of the European Union and the third countries in question.[49] On the other hand, there are agreements such as the 1998 FTA between the Caribbean Community and

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regulations as an incentive to encourage foreign investment; minimise the use of performance requirements that distort or limit expansion of trade and investment; and permit the temporary entry and sojourn of key personnel for the purpose of engaging in activities connected with foreign investment, subject to relevant laws and regulations.

[46] See J.-A. Crawford and R. Fiorentino (2005), 'The Changing Landscape of Regional Trade Agreements', WTO Discussion Paper No. 8, Geneva.

[47] These bilateral trade agreements have also been considered in the present note and are covered when general reference to RIAs is made.

[48] Agreement between the United States of America and the Hashemite Kingdom of Jordan on the Establishment of a Free Trade Area of 24 October 2000.

[49] References to the future conclusion of bilateral investment treaties appear in, for example, Europe Agreements and the Partnership and Cooperation Agreements; the 1995 Cooperation Agreement between the European Community and the Kingdom of Nepal, Art. 10; the 1995 Interregional Framework Cooperation Agreement between the European Community and its Member States, of the one part, and the Southern Common Market and its Party States, of the other part, Art. 12, and the 1996 Framework Cooperation Agreement leading ultimately to the establishment of a political and economic association between the European Community and its Member States, of the one part, and the Republic of Chile, of the other part, Art. 15; the 1999 Agreement on Trade, Development and Cooperation between the European Community and its Member States, of the one part, and the Republic of South Africa, of the other part, Art. 52; the 2000 Partnership Agreement between the Members of the African, Caribbean and Pacific Group of States of the one Part, and the European Community and its Member States, of the other part, commonly referred to as the Cotonou Agreement, Art. 78; Decision No 2/2001 of the European Union and Mexico Joint Council of 27 February 2001, Art. 33.

the Dominican Republic or the 2000 US-Vietnam Agreement on Trade Relations that basically contain BIT-like provisions within the agreement.

At a regional level, only a few instruments are entirely devoted to investment, such as the Framework Agreement on the ASEAN Investment Area and the Andean Community's Decision 291 (adopted in 1991). However, a growing number of regional agreements have included in the last few years a comprehensive set of investment disciplines. The North American Free Trade Agreement (NAFTA), the MERCOSUR[50] Protocols and the Treaty Establishing the Common Market for Eastern and Southern Africa (COMESA)[51] are all examples. The general aim of these agreements is to create a more favourable investment climate through a combination of investment liberalization and protection measures, with a view to increasing the flow of investment within or between regions. The great diversity of regional instruments and the country configurations they bring together have generally meant that the degree of commonality in terms of agreed rules is much less marked in such agreements than in the case of BITs.

A review of current practice

Scope and definition The manner in which regional instruments deal with the definition of terms such as 'investment', 'investor', 'control', or 'foreign investment' depends primarily on the scope and purpose of each instrument. Instruments geared towards investment protection objectives tend to espouse broad and inclusive definitions.[52] Instruments oriented towards liberalization at times use relatively narrower definitions of investment, more focused on FDI (and at the exclusion of portfolio investment). For instance, the 1996

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[50] See the Treaty Establishing a Common Market between the Argentine Republic, the Federal Republic of Brazil, the Republic of Paraguay and the Eastern Republic of Uruguay signed in 1991 in Asuncion and establishing a 'common market of the southern cone' (MERCOSUR).

[51] The signatories of the 1993 COMESA Treaty are Angola, Burundi, Democratic Republic of Congo, Comoros, Eritrea, Ethiopia, Kenya, Lesotho, Malawi, Mauritius, Rwanda, Sudan, Swaziland, Tanzania, Uganda and Zimbabwe. The COMESA Treaty has superseded the Treaty for the Establishment of the Preferential Trade Area for Eastern and Southern Africa concluded in 1982. It entered into force in December 1994.

[52] A typically broad (asset-based) definition of investment includes movable and immovable property and property rights, companies (as assets) and interests in companies (e.g. shares), intellectual property rights, non-equity forms of investment and long-term contractual rights, such as those created by administrative concessions. An important question is the extent to which portfolio investment is covered under this type of broad asset-based definition.

ASEAN Agreement for the Protection and Promotion of Investments (as amended) includes a very broad definition of investment covering 'every kind of asset'. Conversely, the 1998 Framework Agreement on the ASEAN Investment Area explicitly excludes portfolio investment. Decision 291 of the Commission of the Cartagena Agreement also covers FDI only. The 2000 FTA between EFTA States and Mexico explicitly considers investment to mean 'direct investment, which is defined as investment for the purpose of establishing lasting economic relations with an undertaking such as, in particular, investments which give the possibility of exercising an effective influence on the management thereof'.[53]

For its part, the 1994 NAFTA, which aims at both investment protection and liberalization, contains a definition of 'Investment' in Article 1139 based on a broad list of assets along with a negative list of certain claims which are not considered to be investments. A similar approach is to be found in the many agreements that followed the NAFTA approach to liberalization (see below under pre-establishment). A very broad definition is also included in the 2002 Agreement between Singapore and Japan for a New-Age Economic Partnership[54] and the 2004 Japan-Mexico Economic Partnership Agreement.[55]

The agreements concluded by the EC usually define the terms 'company' or 'legal person' to mean corporations set up according to the laws of the parties and having their registered office or central administration or principal place of business within the parties and 'establishment' to mean the taking up of economic activities and the setting up of undertakings, in particular companies.[56] Comparable is the approach followed by the 1973 Treaty Establishing

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[53] The Agreement is available at http://secretariat.efta.int/library/legal/fta/mexico/

[54] The Agreement is available at http://www.mti.gov.sg/public/PDF/CMT/FTA_JSEPA_Agreement.pdf

[55] The Agreement is available at http://www.sice.oas.org/Trade/JPN_MEXDraftEPA_e/JPN_MEXind_e.asp

[56] See, for instance, the 2002 Association Agreement between the EU and Chile, Art. 131(Definitions): 'For the purposes of this Chapter, (a) 'legal person' means any legal entity duly constituted or otherwise organised under applicable law, whether for profit or otherwise, and whether privately-owned or governmentally-owned, including any corporation, trust, partnership, joint venture, sole proprietorship or association; (b) 'legal person of a Party' means a legal person constituted or otherwise organised under the law of the Community or its Member States or of Chile. Should such a legal person have only its registered office or central administration in the territory of the Community or of Chile, it shall not be considered as a Community or a Chilean legal person respectively, unless it is engaged in substantive business operations in the territory of the Community or of Chile respectively. (c) 'natural person' means a national of one of the Member States or of Chile according to their respective legislation. (d) 'establishment' means: (i) the constitution, acquisition or maintenance of a legal

the Caribbean Community (CARICOM), as amended by a Protocol adopted in July 1997. [57]

Transparency The 1998 FTA between the Caribbean Community and the Dominican Republic contains a very limited transparency obligation relating to the commitment to publish all laws, judgments, administrative practices and procedures regarding investment. This approach is followed in a number of regional agreements. The 1996 ASEAN Agreement for the Protection and Promotion of Investments includes a slightly stronger transparency commitment calling on the parties to provide up-to-date information on all laws and regulations pertaining to foreign investment and 'to ensure that such information be made as transparent, timely and publicly accessible as possible'.

The 1998 Framework Agreement on the ASEAN Investment Area extends the publication requirements to international agreements affecting investment to which Member States are signatories. It also mandates prompt notification of any change to existing laws, regulation and administrative guidelines affecting investment. In a similar vein is the transparency article in the investment chapter of the 2000 Agreement between the US and Vietnam on Trade Relations. However, the Agreement also includes further and more detailed provisions in a specific chapter on transparency.[58] The 2002 Agreement between Singapore and

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person, or (ii) the creation or maintenance of a branch or a representative office, within the territory of a Party for the purpose of performing an economic activity.'

[57] See Protocol II: Establishment, Services, Capital. CARICOM Member States are Antigua and Barbuda, Barbados, Belize, Dominica, Grenada, Guyana, Jamaica, Montserrat, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines and Trinidad and Tobago. The Bahamas, a member of the Caribbean Community, is not a party to this Protocol. The original Treaty establishing the CARICOM was revised in 2001. The Revised Treaty of Chaguaramas incorporates the provisions of Protocol II.

[58] See Chapter VI (Transparency-Related Provisions and Right to Appeal): 'Article 1: Each Party shall publish on a regular and prompt basis all laws, regulations and administrative procedures of general application pertaining to any matter covered by this Agreement. Publication of such information and measures will be in a manner which enables governmental agencies, enterprises and persons engaged in commercial activity to become acquainted with them before they come into effect and to apply them in accordance with their terms. Each such publication shall include the effective date of the measure, the products (by tariff line) or services affected by the measure, and all authorities that must approve or be consulted in the implementation of the measure, and provide a contact point within each authority from which relevant information can be obtained. Article 2: Each Party shall provide nationals and companies of the other Party with access to data on the national economy and individual sectors, including information on foreign trade. . . . Article 3: Each Party shall allow, to the extent possible, the other Party and its nationals the opportunity to comment on the formulation of laws, regulations and administrative procedures of general application that may affect the conduct of business activities covered by this Agreement. Article 4:

Japan for a New-Age Economic Partnership and 2004 Mexico-Japan Economic Partnership Agreement include broad publication requirements as well as an obligation for each Party to 'promptly respond to specific questions from, and provide information to, the other Party . . .' (Arts. 2 and 160 respectively). The 2002 Association Agreement between the EU and Chile provides for the creation of contact points to facilitate communication between the parties (Art. 190). Furthermore, 'each Party shall provide information and reply to any question from the other Party relating to an actual or proposed measure that might substantially affect the operation of . . . the Agreement'.

Non-discrimination The treatment of foreign investment refers to two phases. The first phase relates to treatment accorded to a potential investor before the investment has taken place. This is generally referred to as the 'pre-establishment' or admission phase. Commitments in this area generally entail a liberalization of the investment regime and may create rights of establishment for persons and companies covered by the agreement. A growing number of recent regional agreements indeed focus on liberalizing the admission phase, often subject to sectoral and other exceptions. The second phase relates to standards of treatment after entry has been approved: the stage of operation of the investment. The different standards used, namely national treatment, most-favoured nation treatment, fair and equitable treatment and international minimum standard of treatment were all already elaborated in FCN and BITs practice. Regional agreements that address the admission phase generally grant non-discrimination standards also for the operation phase.

Many RIAs now provide both for MFN and national treatment but only post-entry.[59] These include the 1997 Canada-Chile Free Trade Agreement, the 2000 Mexico-Singapore Free Trade Agreement, the 2000 FTA between Mexico and El Salvador, Guatemala and Honduras, the 1995 Mexico-Costa Rica FTA, the 1997 Mexico-Nicaragua FTA, the 1994 Treaty on Free Trade

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All laws, regulations and administrative procedures of general application referred to in paragraph 1 of this Article that are not published and readily available to other governments and persons engaged in commercial activities as of the date of signature of this Agreement will be made public and readily and quickly available. Only laws, regulations and administrative procedures of general application that are published and readily available to other governments and persons engaged in commercial activity will be enforced and enforceable. Article 5: The Parties shall have or designate an official journal or journals and all measures of general application shall be published in such journals. The Parties will publish such journals on a regular basis and make copies of them readily available to the public. . . .'

[59] There are regional agreements mainly geared towards investment protection, such as the 1981 Agreement on Promotion, Protection and Guarantee of Investments among Member States of the Organization of the Islamic Conference, that only provide for MFN treatment.

between Colombia, Venezuela and Mexico, the 1998 Chile-Mexico FTA, the 1998 FTA between Central America (Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua) and the Dominican Republic.

An important issue in the context of the application of national treatment is the existence in host country domestic regulation of performance requirements, which may specifically affect foreign investment. Some regional agreements, such as the NAFTA, address them in detail.[60] Similar provisions are also included in the 1997 Canada-Chile Free Trade Agreement (Art. G-06), the 1997 Mexico-Nicaragua FTA (Art. 16-05), and the 2000 FTA between Mexico and El Salvador, Guatemala and Honduras (Art. 14-07), the 2003 US-Chile FTA and the 2004 Central American Free Trade Agreement (CAFTA). Article 13 of the 1985 US-Israel FTA forbids the use of local content and export performance requirements. A prohibition of a wide range of performance requirements is also contained in the 2002 Agreement between Singapore and Japan for a New-Age Economic Partnership and in the 2004 Mexico-Japan Economic Partnership Agreement. On the other hand, the 1994 Treaty on Free Trade between Colombia, Venezuela and Mexico explicitly allows the imposition of requirements to locate production, generate jobs, train workers, or carry out research and development (Art. 17-04).

Pre-establishment commitments If we leave aside the European experience,[61] the NAFTA is probably the first regional agreement that has included

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[60] Article 1102(4) forbids local equity requirements. Article 1106(1) proscribes the imposition or enforcement of mandatory requirements and the enforcement of any undertakings or commitments: (1) to export a given level or percentage of goods or services; (2) to achieve a given level or percentage of domestic content; (3) to purchase, use or accord a preference to goods produced or services provided in the territory of a Party or to purchase goods or services from persons in its territory; (4) to relate the volume or value of imports to the volume or value of exports or to the amount of foreign exchange inflows associated with investment; (5) to restrict sales of goods or services produced or provided by an investment in a Party's territory by relating such sales to the volume or value of exports or foreign exchange earnings of the investment; (6) to transfer technology, a production process or other proprietary knowledge; and (7) to act as the exclusive supplier of the goods produced or services provided by an investment to a specific region or world market. Furthermore, requirements (2), (3) only with reference to goods, (4) and (5) above are also prohibited if applied as conditions for the receipt of an advantage (Article 1106(3)). However, Parties are free to condition the receipt of an advantage on compliance with requirements, in connection with an investment, to locate production, provide a service, train or employ workers, construct or expand particular facilities, or carry out research and development in their territories (Art. 1106(4)).

[61] Closely following the EC model, the 1992 Agreement on the European Area which now binds the EC and its Member States and Iceland, Norway and Liechtenstein also provides for a full right of establishment (Art. 31).

deep and detailed commitments in the area of pre-establishment rights with important liberalization effects on the investment regimes of the Parties. In the NAFTA, each Party is required to accord the better of national treatment and MFN treatment to investors of another Party, and to investments of investors of another Party, with respect to the establishment, acquisition, expansion, management, conduct, operation, and sale or other disposition of investments (Arts. 1102–1104). The NAFTA adopts a negative list approach such that the actual coverage of the Agreement's investment provisions is determined by the reservations provided for under Article 1108 and detailed in a number of annexes to the Agreement. Furthermore, the Agreement provides that nothing in the Investment Chapter shall be construed to prevent a Party from adopting, maintaining or enforcing any measure, otherwise consistent with the chapter, 'that it considers appropriate to ensure that investment activity in its territory is undertaken in a manner sensitive to environmental concerns' (Art. 1114). The NAFTA also provides for a general national security exception (Art. 2102).

A number of more recent regional agreements, especially those involving NAFTA signatories, have broadly followed the NAFTA model. This is the case, for example, with the 1997 Canada-Chile Free Trade Agreement, the 2000 Mexico-Singapore FTA, the 2000 FTA between Mexico and El Salvador, Guatemala and Honduras, the 2000 Agreement between the US and Vietnam on Trade Relations and the 2004 CAFTA. Such an approach can also be found in the draft text for the Free Trade Area of the Americas, albeit subject to many brackets reflecting sharply divergent views among FTAA participants.

A very similar approach was also followed by the 2000 Agreement between New Zealand and Singapore on Closer Economic Partnership. The 2002 Agreement between Singapore and Japan for a New-Age Economic Partnership[62] (and quite similarly the 2004 Mexico-Japan Economic Partnership Agreement) also provides for national treatment with very broad language.[63] The NT commitment is subject to exceptions, both horizontal and

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[62] See Article 73 (National Treatment under Chapter 8) 'Each Party shall within its territory accord to investors of the other Party and to their investments in relation to the establishment, acquisition, expansion, management, operation, maintenance, use, possession, liquidation, sale, or other disposition of investments, treatment no less favourable than the treatment which it accords in like circumstances to its own investors and investments (hereinafter referred to in this Chapter as 'national treatment').'

[63] Interestingly, the Agreement does not contain a firm MFN commitment. See Article 89 (Application of Chapter 8): '. . . If a Party has entered into an international agreement on investment with a non-Party, or enters into such an agreement after this

sectoral, listed in annexes to the Agreement, which each Party endeavours to reduce or eliminate. A Joint Committee on Investment is entrusted, *inter alia*, with the task of reviewing such exceptions 'for the purpose of [their] reduction or elimination' (Art. 88). A series of general exceptions are also set out, including with a view to protecting public morals, human, animal and plant life or health, privacy (Art. 83). The Agreement also specifically accords national treatment 'with respect to access to its courts of justice and administrative tribunals and agencies in all degrees of jurisdiction' (Art. 74). In 1994, Member States of the MERCOSUR adopted the Colonia Protocol on Reciprocal Promotion and Protection of Investments within MERCOSUR. This Protocol also provides for MFN and national treatment to investors of the Parties at the admission phase, subject to exceptions in sectors identified in an Annex to the Protocol.

The Treaty Establishing the Caribbean Community, as amended in 1997, prohibits the introduction by Member States of any new restrictions relating to the right of establishment of nationals of other Member States (Art. 35b of the 1997 Protocol). Member States are also required over time to remove restrictions on the right of establishment of nationals of other Member States, including restrictions on the setting up of agencies, branches or subsidiaries by nationals of a Member State in the territory of another Member State (Art. 35c). The right of establishment is defined as the right to engage in any non-wage earning activities and to create and manage economic enterprises (Art. 35b). Any discrimination on the basis of nationality is also prohibited (Art. 38). Member States can apply for a waiver to the requirement to grant the right of establishment (Art. 38b). General (including the protection of human, animal and plant life and health) and security exceptions also apply (Arts. 38b (bis) and 38b (ter)).

RIAs concluded by the EC include provisions aimed at liberalizing the admission phase through the setting out of the right of establishment. A number of the Europe Agreements, Association Agreements and Partnership and Cooperation Agreements concluded in the early and mid-1990s between the EC and virtually all Central and Eastern European countries focus primarily on establishment issues by providing for national treatment with regard to the establishment and operation of companies and nationals.[64] Some of the

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Agreement comes into force, it shall favourably consider according to investors of the other Party and to their investments, treatment, in relation to the establishment, acquisition, expansion, management, operation, maintenance, use, possession, liquidation, sale, or other disposition of investments, no less favourable than the treatment that it accords in like circumstances to investors of that non-Party and their investments pursuant to such an agreement.'

[64] Some of the Euro-Mediterranean Agreements, such as the 2001 with Egypt, consider the right of establishment of companies as an objective to pursue and mandate the Association council to make the necessary recommendations.

agreements include lists of reservations to the establishment and national treatment obligations and generally feature transition periods. The term 'establishment' is defined in each of these Agreements and generally refers to the right to take up and pursue economic activities by means of the setting up and management of subsidiaries, branches and agencies. Some Partnership and Cooperation Agreements, such as the one with the Russian Federation, only provide for MFN treatment in the pre-establishment phase, although the importance of moving towards the granting of national treatment is recognized.[65]

With the 2001 Vaduz Convention, the revised Convention establishing the European Free Trade Association, the EFTA States have drawn up comprehensive chapters aiming at a general liberalization of investment and trade in services among themselves. The Convention is also based on the right of establishment of companies or firms, formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business in the territory of the Member States. The right of establishment is subject to a negative list of specific provisions and exceptions to be eliminated over time as well as to general (on grounds of public policy, public security, public health or the environment) and security exceptions.[66]

The OECD Code of Liberalization of Capital Movements and the Code of Liberalization of Current Invisible Operations constitute legally binding rules, stipulating progressive, non-discriminatory liberalization of capital movements, the right of establishment and current invisible transactions (mostly services). All non-conforming measures must be listed in country reservations against the Codes. The Codes are implemented through policy reviews and country examinations, relying on 'peer pressure' to encourage unilateral rather than negotiated liberalization. The Codes were initially adopted in 1961 but have since been revised and expanded in scope. Recent additions dealt with the right of establishment (1984) and cross-border financial services (1992). For most member countries, remaining reservations against the Code obligations relate to FDI, the purchase of real estate by non-residents and the prohibitions of certain types of securities operations.

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[65] See Agreement on partnership and cooperation establishing a partnership between the European Communities and their Member States, of one part, and the Russian Federation, of the other part, Article 28: '1. The Community and its Member States of the one part and Russia of the other part, shall grant to each other treatment no less favourable than that accorded to any third country, with regard to conditions affecting the establishment of companies in their territories and this in conformity with the legislation and regulations applicable in each Party. . . .', in *Official Journal of the European Communities*, L 327, of 28 November 1997, pp. 3–69, also available at http://europa.eu.int/eur-lex/en/lif/dat/1997/en_297A1128_01.html

[66] The original EFTA Convention was signed in 1960 in Stockholm. The text is available at: http://secretariat.efta.int/library/legal/vaduz/

The 1998 Framework Agreement on the ASEAN Investment Area provides for MFN and national treatment for ASEAN investors at the admission and establishment phase. These obligations are subject to the possibility of waivers. General (including the protection of human, animal and plant life and health) exceptions also apply. The overall objective of the area is to ensure liberalization of all industries and national treatment for the benefit of all ASEAN investors by 2010 and, moreover, to be extended to all investors by 2020.

A number of African regional agreements also include the right of establishment and the removal of obstacles to the free movement of capital among their objectives. These include the 1993 COMESA Treaty, the 1993 Revised Treaty of the Economic Community of West African States (ECOWAS),[67] 1994 Treaty Establishing the Economic and Monetary Union of West Africa[68] and the 1999 Treaty for the Establishment of the East African Community.[69]

Development provisions Like the vast majority of international agreements, RIAs also contain various exceptions, safeguards and transition periods meant to address the objectives and needs of parties at differing levels of development. These qualifications may apply to all substantive provisions and may assume particular importance with regard to the standard of treatment, both pre- and post-entry. A special category of exceptions also affects the repatriation of funds and will be considered in the following section.

Another set of development-related provisions refers to the notions of investment promotion and facilitation. The CARICOM Treaty (as amended in 1997) provides for the adoption of measures in a large number of areas, ranging from market intelligence to the harmonization of company laws.[70] A

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[67] ECOWAS Member States are Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Mauritania, Niger, Nigeria, Senegal, Sierra Leone and Togo.

[68] The text of the agreement is available at: www.uemoa.int/actes/traité/TraiteUEMOA.doc. Member States are Benin, Burkina Faso, Côte d'Ivoire, Mali, Niger, Senegal and Togo.

[69] The Treaty establishing the East African Community was signed by Kenya, Uganda and Tanzania 1999. The East African Community was formally launched in 2001.

[70] Article 38 (bis) (Measures to Facilitate Establishment, Provision of Services and Movement of Capital) provides for the adoption of appropriate measures for:

'(a) the establishment of market intelligence and information systems in the Community;

(b) harmonised legal and administrative requirements for the operation of partnerships, companies, or other entities;

(c) abolition of exchange controls in the Community, and free convertibility of the currencies of Member States;

number of regional agreements contain significant provisions for the exchange of information with regard to investment and strategic alliance opportunities. These include the 1995 Mexico-Costa Rica FTA, the 1997 Mexico-Nicaragua FTA, the 1998 FTA between Central America (Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua) and the Dominican Republic, the 2000 FTA between Mexico and El Salvador, Guatemala and Honduras. Some agreements, such as the 1993 Framework Cooperation Agreement between the EEC and the Republics of Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and Panama, specifies (Art. 8) that 'measures shall include: a) seminars, exhibitions and business missions; b) training businessmen with a view to setting up investment projects; c) technical assistance for joint investment . . .'.[71] The Chile-EU Association Agreement goes into even more details.[72] However, some of the most extensive provisions on investment promotion are included in the 2000 Cotonou Agreement, which builds upon the provisions of the previous Lomé Conventions.[73]

(d) the establishment of an integrated capital market in the Community;
(e) convergence of macro-economic performance and policies through the co-ordination or harmonisation of monetary and fiscal policies, including, in particular, policies relating to interest rates, exchange rates, tax structures and national budgetary deficits;
(f) the establishment of economical and efficient land, sea and air transport services throughout the Community, and
(g) the establishment of efficient communication services. . . .'

[71] A similar provision is included in the 1993 Framework Agreement for Cooperation between the EEC and the Cartagena Agreement and its Member Countries, namely, the Republic of Bolivia, the Republic of Colombia, the Republic of Ecuador, the Republic of Peru and the Republic of Venezuela. Less detailed provisions are also contained in the majority of partnership and Association agreement to which the EC is party.

[72] Article 21 (promoting investment) reads: '. . . Cooperation will cover in particular the following: (a) establishing mechanisms for providing information, identifying and disseminating investment rules and opportunities; (b) developing a legal framework for the Parties that favours investment, by conclusion, where appropriate, of bilateral agreements between the Member States and Chile to promote and protect investment and avoid dual taxation; (c) incorporating technical assistance activities for training initiatives between the Parties' government agencies dealing with the matter; and (d) developing uniform and simplified administrative procedures.'

[73] Article 75 provides that Parties shall:
'a. implement measures to encourage participation in their development efforts by private investors who comply with the objectives and priorities of ACP-EC development cooperation and with the appropriate laws and regulations of their respective States;
b. take measures and actions which help to create and maintain a predictable and secure investment climate as well as enter into negotiations on agreements which will improve such climate;

Finally, the 2000 Agreement between New Zealand and Singapore on Closer Economic Partnership explicitly includes among its objectives the establishment of 'a co-operative framework for further strengthening the economic relations between the Parties through such means as: . . . (v) promoting trade and investment activities of private enterprises of the Parties through facilitating their exchanges and collaboration; (vi) promoting, particularly, trade and investment activities of small and medium enterprises of the Parties through facilitating their close co-operation . . .'.[74] The 2004 Mexico-Japan Economic Partnership Agreement includes a full chapter dedicated to the improvement of the business environment and a specific article to the cooperation in the field of trade and investment promotion. Specific committees are also provided for (Arts. 136–9).

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c. encourage the EU private sector to invest and to provide specific assistance to its counterparts in the ACP countries under mutual business cooperation and partnerships;
d. facilitate partnerships and joint ventures by encouraging co-financing;
e. sponsor sectoral investment fora to promote partnerships and external investment;
f. support efforts of the ACP States to attract financing, with particular emphasis on private financing, for infrastructure investments and revenue generating infrastructure critical for the private sector;
g. support capacity building for domestic investment promotion agencies and institutions involved in promoting and facilitating foreign investment;
h. disseminate information on investment opportunities and business operating conditions in the ACP States; and
i. promote national, regional and ACP-EU private sector business dialogue, cooperation and partnerships, in particular through an ACP-EU private sector business forum. Support for operations of an ACP-EU private sector business forum shall be provided in pursuit of the following objectives:
   i. to facilitate dialogue within the ACP/EU private sector and between the ACP/EU private sector and the bodies established under the Agreement;
   ii. to analyse and periodically provide the relevant bodies with information on the whole range of issues concerning relations between the ACP and EU private sectors in the context of the Agreement or, more generally, of economic relations between the Community and the ACP countries; and
   iii. to analyse and provide the relevant bodies with information on specific problems of a sectoral nature relating to, inter alia, branches of production or types of products at regional or sub-regional level.'

[74] For this purpose the Agreement provides for the establishment of a Joint Committee on Trade and Investment Promotion entrusted with the tasks of: '(a) exchanging views and information on trade and investment promotion; (b) reviewing and discussing issues concerning the effective implementation of this Chapter; (c) identifying and recommending ways of further co-operation between the Parties; and (d) discussing other issues relating to co-operation in trade and investment promotion' (Art. 128). A similar mandate is given to a Joint Committee on small and medium-sized enterprises (see Art. 132).

Exceptions and balance-of-payments safeguards A majority of RIAs include provisions on free transfers of funds related to covered investments. One example is the 1991 Decision 291 of the Commission of the Cartagena Agreement. This Decision removes restrictions contained in the previous rules on the transfer of funds by obligating member countries to permit foreign investors and sub-regional investors to remit abroad in convertible currency the verified net profits derived from foreign direct investment and the proceeds from the sale or liquidation of such investment. However, it does not tackle the issue of balance of payments difficulties, which is addressed in a growing number of RIAs.

In the context of the EU-Mexico Economic Partnership Agreement, the Parties agreed that in the case of serious balance of payment difficulties, restrictive measures with regard to payments, including the transfer of proceeds from the total or partial liquidation of direct investment, can be adopted in a non-discriminatory and time-bound fashion.[75] Similar provisions are included, for instance, in some of the Euro-Mediterranean Agreements.[76] The NAFTA provides for the possibility of adopting measures that restrict transfers in case of serious balance of payment difficulties, subject to a series of conditions (such as avoiding unnecessary damage to commercial, economic and financial interest of another Party, not being more burdensome than necessary to deal with the difficulties, as well as being temporary and non-discriminatory). The 1994 Treaty on Free Trade between Colombia, Venezuela and Mexico also provides for the possibility of temporarily limiting transfers on a non-discriminatory basis in case of balance of payments difficulties. Similarly, the 2000 FTA between the EFTA States and Mexico provides for the possibility to adopt restrictive measures, that 'shall be equitable, non-discriminatory, in good faith, of limited duration and may not go beyond what is necessary to remedy the balance of payments situation' (Art. 50).

The 2002 Agreement between Singapore and Japan for a New-Age Economic Partnership also provides for temporary safeguards both in case of serious balance-of-payments difficulties and 'where, in exceptional circumstances, movements of capital result in serious economic and financial disturbance in the Party concerned' (Art. 84).

The 2000 FTA between Mexico and El Salvador, Guatemala and Honduras provides for the possibility of introducing temporary exchange controls in the

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[75] Decision No. 2/2001 of the European Union and Mexico Joint Council of 27 February 2001 Implementing Articles 6, 9, 12(2)(b) and 50 of the Economic Partnership, Political Coordination and Cooperation Agreement (2001), Art. 31.

[76] See, for instance, the 1995 Euro-Mediterranean Agreement Establishing an Association between the European Communities and Their Member States, of the One Part, and the Republic of Tunisia, of the Other Part, at Art. 35.

event of a serious balance of payments disequilibrium. Measures have to be compatible with internationally accepted criteria. Similar provisions are included in the 1998 FTA between Central America (Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua) and the Dominican Republic.

The Treaty Establishing the Caribbean Community, as amended in 1997, provides for rather elaborate rules on restrictions in the event of balance of payments difficulties. Envisaged restrictions extend not only to movement of capital, payments and transfer but also to the right of establishment. They have to be non-discriminatory, subject to periodic consultation, temporary (not exceeding 18 months) and progressively phased out.

In a similar way, the 1998 Framework Agreement on the ASEAN Investment Area provides that in case of serious balance of payments and external financial difficulties Member States may adopt or maintain restrictions on investments, including on payments or transfers. Such restrictions shall be non-discriminatory, temporary, progressively phased-out and subject to consultations. The ASEAN Investment Area Agreement also provides for the possibility of introducing emergency safeguard measures, 'if, as a result of the implementation of the liberalisation programme under this Agreement, a Member State suffers or is threatened with any serious injury . . .'. Emergency measures have to be non-discriminatory and provisional. The ASEAN Investment Area Council is mandated to define 'serious injury' and the procedures for instituting emergency measures.

Consultation and the settlement of disputes Some regional agreements provide for the possibility of settling dispute by means of consultation and negotiation, including for instance the 2002 Agreement between Singapore and Japan for a New-Age Economic Partnership, the 2004 Mexico-Japan Economic Partnership Agreement, the 2000 FTA between Mexico and El Salvador, Guatemala and Honduras, the 1994 Colonia Protocol on Reciprocal Promotion and Protection of Investments within MERCOSUR and the 1997 EU-Mexico Partnership Agreement. Many of the Europe Agreements, Association Agreements and Partnership and Cooperation Agreements recently concluded by the EU provide for consultation through the body (e.g. cooperation or association councils) entrusted with the monitoring and implementation of a specific agreement.

There are also some bilateral agreements, such as the Trade and Economic Cooperation Arrangements between Canada and respectively Australia (1995), Switzerland (1997), Norway (1997), Iceland (1998), MERCOSUR (1998), South Africa (1998), the Andean Community (1999),[77] as well as the

[77] Available at http://www.dfait-maeci.gc.ca/

Agreements Concerning the Development of Trade and Investment Relations between the United States and respectively Ghana, Egypt, South Africa and Turkey (all concluded in 1999) and with Nigeria (concluded in 2000), which have as one of their main purposes the provision of a consultation mechanism in the form of a bilateral body.

Some RIAs contain provisions only for the settlement of disputes arising between the Parties, thus not covering disputes between a Party and an investor of another Party. This is for instance the case for the 1997 EU-Mexico Partnership Agreement, as well as for many of the Europe Agreements, Association Agreements and Partnership and Cooperation Agreements recently concluded by the EU and for the 1998 Framework Agreement on the ASEAN Investment Area.

Articles 1115 to 1138 of the NAFTA contain detailed rules providing for the international arbitration of disputes between a Party and an investor of another Party.[78] An investor may submit to international arbitration a claim that another Party has breached an obligation under Chapter 11 (Investment) or under certain provisions of the chapter on monopolies and state enterprises and that the investor has incurred loss or damage by reason of, or arising out of, that breach. Article 1122 contains the unconditional consent of the Parties to the submission of a claim to arbitration. The investor can elect to proceed under the International Centre for Settlement of Investment Disputes (ICSID) Convention, the Additional Facility Rules of ICSID or the United Nations Commission on International Trade Law (UNCITRAL) Arbitration Rules. Detailed rules are contained in these provisions on matters such as the constitution of arbitral tribunals, consolidation of claims, applicable law, nature of remedies, and finality and enforcement of arbitral awards.[79]

The investment provisions of the NAFTA have proved to be both innovative and controversial. While heralded by some as an essential tool of economic governance for the 21st century, others have charged that Chapter

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[78] For an overview of the dispute settlement provisions, see NAFTA Secretariat, *Overview*, 2003: www.nafta-sec-alena.org. See also Todd Weiler, (2002), 'NAFTA Investment Arbitration and the Growth of International Economic Law', 2.0 *International Bar Association*, 2.0, 158; Guillermo Aguilar Alvarez (2003), 'The New Face of Investment Arbitration: NAFTA Chapter 11', *Yale Journal of International Law*, 28, 365.

[79] Each party to the dispute appoints one of the arbitrators, and the parties agree on a third, presiding arbitrator. If the tribunal finds that the claim is founded, it can order that monetary compensation be made to the investor. NAFTA does not provide for the appeal of awards, rather, each jurisdiction contains its own domestic rules which apply to the appeal of arbitral awards. In general, an appeal will be limited to *judicial review* of a decision, that is, a domestic court will not be entitled to review a decision on its merits, but rather, it may only rule on the much narrower legal question of whether the tribunal exceeded its jurisdiction in any way.

11 puts the rights of foreign investors ahead of the rights of States to govern in the public interest.[80] As the number of cases of corporations making claims against the American, Canadian and Mexican governments mounted over the course of the 1990s (a trend that the post-NAFTA rise in BIT-related investor–state disputes has mirrored), a growing body of literature, particularly from non-governmental organizations, has drawn attention to the impact of investor rights provisions on economic development, public services, government procurement policies, cultural identity and even human rights.[81]

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[80] The concerns surrounding Chapter 11 of NAFTA and similar provisions found in other bilateral or regional investment instruments must be seen as part of a broader set of concerns about the costs of globalization, that is, increased global economic integration, and increased environmental concern and activism on the part of non-governmental organizations (NGOs). The pace at which economic integration has taken place, facilitated in part by trade and investment liberalization agreements, has led to growing anxiety among citizens who fear the loss of control over the factors that govern their lives. This fear, which has focused on both the legal and procedural provisions of Chapter 11, would also prove instrumental in the post-NAFTA demise of the proposed Multilateral Agreement on Investment (see following section).

[81] Much of the scholarship on Chapter 11 is to be found in the area of law: for example, Chris Tollefson (2002), 'Games without Frontiers: Investor Claims and Citizen Submissions under the NAFTA Regime', *Yale Journal of International Law*, 27; Todd Weiler (2000), 'Arbitral and Judicial Decision: The Ethyl Arbitration – First of its Kind and a Harbinger of Things to Come', *American Review of International Arbitration*, 11; David Gantz (1999), 'Dispute Settlement under the NAFTA and the WTO: Choice of Forum Opportunities and Risks for the NAFTA Parties', *American University International Law Review*, 14; José E. Alvarez (1997), 'Critical Theory and the North American Free Trade Agreement's Chapter Eleven', *University of Miami Inter-American Law Review*, 28. For non-legal perspectives, see, for example, Sanford E. Gaines, 'The Masked Ball of NAFTA Chapter 11: Foreign Investors, Local Environmentalists, Government Officials, and Disguised Motives', and Julie Soloway, 'Expropriation under NAFTA Chapter 11: The Phantom Menace', both in John Kirton and Virginia Maclaren (eds) (2002), *Linking Trade, Environment, and Social Cohesion: NAFTA Experiences, Global Challenges*, Aldershot: Ashgate; Laura Ritchie Dawson (ed.) (2004), *Whose Rights? The NAFTA Chapter 11 Debate*, Ottawa: Centre for Trade Policy and Law, Carleton University. For a politcal account of the making of NAFTA's Chapter 11, see Maxwell A. Cameron and Brian W. Tomlin (2000), *The Making of NAFTA: How the Deal Was Done*, Ithaca, NY: Cornell University Press, 100–102, 112–114. For a closer look at the key elememts of the NGO critique of NAFTA's investemnt provisions, see, for example, Council of Canadians (2003), *NAFTA's Big Brother: The Free Trade Area of the Americas and the Threat of NAFTA-style 'Investor State' Rules*, Ottawa: www.canadians.org/; Public Citizen (2001), *NAFTA Chapter 11 Investor-to-State Cases. Bankrupting Democracy: Lessons for Fast Track and the Free Trade Area of the America*, September, pp. ix–x. www.citizen.org/trade/NAFTA/ CH_11/; International Institute for Sustainable Development (2001), *Private Rights, Public Problems: A Guide to NAFTA's Controversial Chapter on Investor Rights*, Winnipeg, esp. chapter 7; www.iisd.org.

A number of recent regional agreements have followed the NAFTA approach, albeit at times with a number of modifications and with varying degree of detail. These include the 1994 Mexico-Costa Rica FTA, the 1994 Treaty on Free Trade between Colombia, Venezuela and Mexico (the so-called G3), the 1997 Canada-Chile FTA, the 1997 Mexico-Nicaragua FTA, the 1998 Chile-Mexico FTA, the 1998 FTA between Central America (Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua) and the Dominican Republic, the 2000 FTA between Mexico and El Salvador, Guatemala and Honduras, the 2000 Agreement between the US and Vietnam on Trade Relations, the 2004 CAFTA, as well as the 2002 Agreement between Singapore and Japan for a New-Age Economic Partnership and the 2004 Mexico-Japan Economic Partnership Agreement.

Other regional agreements, such as the 2000 Agreement between New Zealand and Singapore on Closer Economic Partnership and the 1994 Colonia Protocol on Reciprocal Promotion and Protection of Investments within MERCOSUR, also provide for international arbitration of disputes between a Party and an investor of another Party under the ICSID Convention but do not include such detailed rules as those found in the NAFTA. Interestingly, the Australia-United States FTA of 2004 contains no provisions on investor–state arbitration. Rather, and uniquely among bilateral or regional treaties to which the US is a party, disputes potentially arising under the proposed FTA's investment chapter are to be handled solely on a State-to-State, basis.[82]

The rising number of investor–State disputes in recent years and the public policy controversy such litigation has ignited have led to a number of important developments. For instance, in July 2001, the NAFTA Commission, made up of the three signatory governments, issued an interpretive statement[83] as part of an ongoing clarification exercise, designed to 'give future tribunals clearer and more specific understanding of Chapter 11's obligations, as originally intended by the drafters'.[84] This was meant to rein in particularly expan-

[82] For an analysis of the political forces that may have shaped such an outcome, see Ann Capling and Kim Richard Nossall (2004), 'The Rise and Fall of Chapter 11: Investor-State Dispute Mechanisms in the North American Free Trade Agreement and the Australia-United States Free Trade Agreement', Paper prepared for the Oceanic Conference on International Studies, Australian National University Canberra (14–16 July).

[83] Interpretative statements have a particular bearing also in dispute settlement procedures as in accordance with Art. 1131.2: An interpretation by the Commission of a provision of this Agreement shall be binding on a Tribunal established under this Section.

[84] The interpretive statement provided (i) that each Party shall make available to the public in a timely manner all Chapter 11 documents (subject to certain exceptions); and (ii) a clarification of what minimum standard of international law governs foreign investments under NAFTA.

sive constructions of the NAFTA standard of treatments. In particular, the 2001 Commission's interpretation stated that in the NAFTA 'the concepts of "fair and equitable" and "full protection and security" do not require treatment in addition to or beyond that which is required by the customary standard of treatment of aliens'.[85]

Recent FTAs involving the United States, notably those with Singapore and Chile, as well as the CAFTA of 2004, all embed clarifying provisions spelling out the Parties' understanding of what is meant by way of public interest regulation and indirect expropriation. The CAFTA text specifies, for example, that non-discriminatory regulatory actions designed and applied to protect public welfare do not constitute indirect expropriation 'except in rare circumstances'. Both the CAFTA and the US-Chile FTA also encourage the development of an appeals procedure for investor–State abritral decisions. Such provisions attest both to the efficacy of the NGO critique of investor–State rules and, more fundamentally, to the widely acknowledged need for greater precision in legal drafting in an environment characterized by significantly heightened judicial activism. Furthermore, and again as a result of pressure from civil society the arbitration process under the CAFTA is more transparent as hearings and documents are now public and *amicus curiae* submissions are expressly authorized.

Assessing bilateral and regional advances in investment rule-making

Prior to the 1990s, relatively few investment-related provisions appeared in RIAs. Most such provisions were intended to protect property and were found in BITs. Since the 1990s the number of RIAs with investment-related provisions has increased dramatically and now these commonly appear in RIAs in every region of the world. Prior to the 1990s, such agreements were negotiated principally among states within the same region and among states at similar stages of economic development. RIAs now commonly link states in different regions of the world and frequently seek to integrate economies at very different stages of development.

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[85] See *Loewen v the United States*, Award, ICSID Case No. ARB(AF)/98/3, para. 125, 26 June 2003. The arbitral tribunal in Loewen (an ICSID arbitration brought under the NAFTA by Canadian parties), also said that, as a result of the Commission's interpretation, ' "fair and equitable treatment" and "full protection and security" are not free-standing obligations. Rather, they constitute obligations of the host State only to the extent that they are recognized by customary international law' (para 128). The Loewen tribunal explained that to the extent NAFTA tribunals in other cases (e.g., *Metaklad Corp. v United Mexican States*, *S.D. Myers v Government of Canada*, and *Pope and Talbot v Government of Canada*) 'may have expressed contrary views, those views must be disregarded'.

Many investment-related provisions in RIAs address the same issues as their counterpart provisions in BITs and relate to compensation for expropriation and guaranteeing a free right of transfers. Although investment protection provisions in RIAs are often similar to those found in BITs, there is greater variation in the content of these provisions across RIAs than in BITs. One explanation may be that many countries use a model negotiating text for their BITs, which tends to create uniformity across bilateral treaties. On the other hand, the participation of many states in the negotiation of RIAs has tended to require more flexibility and thus more creativity in the drafting of legal provisions.

The commonly found provisions in RIAs that go beyond traditional BITs are those that prohibit anti-competitive business practices, protect intellectual property rights, liberalize admission procedures and liberalize trade in services, including in the form of commercial presence. RIAs in the Americas have been heavily influenced by the NAFTA, which contains an investment chapter modelled after the provisions of the US BITs, though more elaborate in some respects. The same can also be said of the 2004 Mexico-Japan Economic Partnership Agreement. The European RIAs are principally concerned with liberalization, limiting anti-competitive practices, and protecting intellectual property. The European approach appears to leave investment protection to BITs. Accordingly, RIAs involving the EU do not feature provisions on investor–State dispute settlement.

The fact that RIAs tend to contain greater variation in legal provisions than is the case with BITs does not mean that RIAs are necessarily weaker agreements. Indeed, many RIAs contain high standards of investment protection and liberalization. Furthermore, RIAs also tend to feature a larger number of provisions that take account of the special circumstances of developing countries than is the case under BITs. Finally, whether limited to developing countries or including countries at different stages of economic development, RIAs appear to offer greater scope than BITs for experimenting with different approaches to promoting and regulating international investment flows.

Multilateral rules

To this very day, as can be seen from the fact that investment has failed to stay on the agenda of the World Trade Organization's ongoing Doha Development Agenda negotiations, the history of multilateral rule-making on investment remains a troubled one. The investment chapter of the 1948 Havana Charter was one of the main reasons for the failure of the proposed International Trade Organization (ITO) project. In the General Agreement on Tariffs and Trade (GATT), no further investment-related negotiations would take place, up until the Uruguay Round negotiations launched in the mid-1980s. In the United Nations, immediately after decolonization, developing countries clubbed

together and pushed through many (non-binding) resolutions, including the Charter of Economic Rights and Duties. Under this charter, investment protection was dependent on the goodwill of the host State and the principle of national sovereignty was reaffirmed. The US and other developed countries opposed this approach and sought stronger rules to protect investors and their investments. Developing countries were generally hostile towards stringent investment rules for fear of losing their new-found sovereignty to foreign investors. The attempt to negotiate a UN Code of Conduct on Transnational Corporations was abandoned in the early 1990s after many years of deliberations. Yet throughout this entire period, both the bilateral and, more recently, the regional routes to investment rule-making have been actively pursued, resulting in generally high standards of investment protection and liberalization.

Several other attempts at crafting a global investment regime would prove stillborn, including the proposed Multilateral Agreement on Investment (MAI) initiative in the OECD in the late 1990s (see below), which represented a major attempt at crafting a multilateral (if far from universal) regime for investment. Finally, and most recently, efforts to include investment negotiations proper within the WTO negotiating purview have proven deeply contentious, contributing significantly to the derailment of the WTO's December 2003 ministerial meeting in Cancún. As part of the price to pay for imparting renewed momentum to the stalled Doha Development Agenda, WTO Members agreed in July 2004 that foreign investment would (alongside two other so-called 'Singapore Issues' – trade and competition and transparency in government procurement)[86] be taken off the WTO negotiating table for the duration of the current negotiating round.

Accordingly, in terms of binding multilateral rules, what survives from the multiple initiatives of the past half century are the rules that were agreed in the Uruguay Round of trade negotiations, concluded in 1994. Of these, by far the most important elements are the Agreeement on Trade-Related Investment Measures (TRIMs) and the General Agreement on Trade in Services (GATS), followed by the Agreement on Subsidies and Countervailing Measures (ASCM), the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs), and the Understanding on the Settlement of Disputes (DSU), the latter three having a less direct impact on rule-making in the investment field.

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[86] The four policy areas in which WTO Working Groups were established at the December 1996 Ministerial Conference in Singapore were: (i) trade and investment; (ii) trade and competition; (iii) transparency in government procurement; and (iv) trade facilitation.

Arrested development: the draft Multilateral Agreement on Investment

At the beginning of the 1990s, the United States government proposed the negotiation of a 'Wider Investment Instrument' at the OECD, with high standards of liberalization, investor protection and availability of dispute settlement mechanisms along the lines of the many BITs that most developed countries had concluded by that time. Negotiations on what subsequently became known as the Multilateral Agreement on Investment (MAI) were launched in May 1995. They were abandoned in late 1998, following three years of intensive negotiating efforts.

A major reason for the MAI débâcle lies in the sheer complexity of and high (and most likely excessive) level of ambition for the proposed treaty, which was compounded by the legally binding and (especially) enforceable character of the proposed Agreement, a significant departure from past OECD practice. Among the differences that remained unresolved during the negotiations, several were central issues of foreign investment treatment: the extension of protection to investors at the pre-entry stage and attendant conditions and exceptions; the scope of the definition of 'investor' and 'investment'; the character and content of the non-discrimination standards, both national and most-favoured-nation treatment; the scope of the prohibition of performance requirements; applicable rules on expropriation; and the proposed dispute-settlement provisions, which would have involved giving investors direct rights to bring claims against governments in a variety of contexts.[87]

A number of broader political and systemic factors contributed to derailing the MAI negotiations, precipitating its ultimate demise. The Agreement was being negotiated within the framework of the OECD, an international organization comprised solely of developed country members and in which only a handful of developing countries enjoy observer status.[88] This meant that the majority of developing countries were excluded from a negotiation that was meant to – and undoubtedly would – create important legal precedents at the multilateral level. The process was thus seen by many developing countries and civil society organizations as unbalanced and non-representative of a crucial set of interests.

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[87] For a detailed examination of these issues, see for instance P. Muchlinski (2000), 'The Rise and Fall of the Multilateral Agreement on Investment: Where Now?' *The International Lawyer* (Fall), 34, 1033 ff. and UNCTAD, *Lessons from the MAI, 1999*, UNCTAD Series on Issues in International Investment Agreements, UN Doc. TD/UNCTAD/ITE/IIT/MISC.22. See also Edward M. Graham (2000), *Fighting the Wrong Enemy: Antiglobal Activists and Multinational Enterprises*, Washington, DC: Institute for International Economics.

[88] Argentina, Brazil, Chile, Hong Kong and Singapore enjoyed observer status in the MAI negotiations.

The Agreement's intended application among developed countries, rather than solely or principally between developed and developing ones (as had hitherto largely been the case with BITs), raised new concerns: there was no widespread perception of a compelling need for increased investment protection within the OECD area to begin with; and the ability of private investors to initiate lawsuits against host country governments before arbitration tribunals concerning such matters as regulatory takings came to be seen (particularly against the backdrop of the first investor–State cases arising under the NAFTA) by a number of developed country governments as a potentially undue interference with their sovereign right to regulate their economies in the public interest. Furthermore, the initial strong support of the business community waned at a critical time in the negotiations when it became clear that the agreement would not lead to any significant liberalization[89] and that the key issues of taxation, locational incentives and intellectual property rights would largely be excluded from the draft agreement's coverage.

Another important factor that significantly influenced the MAI negotiations in its later stages and which precipitated their demise was the vocal opposition mounted by NGOs to the entire project, both in terms of the procedures used, which were seen as secretive and unaccountable, and in terms of the draft treaty's substantive provisions, which were seen as constitutionalizing the rights of multinational corporations, by emphasizing investor rights and neglecting investor responsibilities, without imposing any concomitant obligations on such central actors of the globalization process. As noted earlier, this stage of the negotiations coincided with the emergence of – and incipient public policy controversies generated by – the first NAFTA-related investment disputes involving investor–State arbitration. Such a coincidence fuelled a heightened sense of concern about the impact of international trade and investment agreements on the sovereign rights of host country states to regulate their economies. Finally, external factors, notably the end of the Cold War as well as the election of centre-left governments in a large number of OECD countries, ushered in new political priorities and policy sensitivities that weakened the earlier resolve to pursue the negotiations.

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[89] Concerns arose in part because of the late realization both by the business community and by the negotiators themselves (many of whom hailed from the world of BITs rather than that of trade policy) that any new (WTO+) liberalization commitment made under the MAI, notably in services where the bulk of investment restrictions are found, would need to be extended automatically to all WTO Members who remained non-MAI signatories by virtue of the MFN principle found under the WTO's GATT and GATS. Such free-riding on the part of important emerging countries was seen as potentially inhibiting the negotiating positions of major OECD players in future WTO negotiations.

Investment-related rules in the WTO[90]

As the discussion below shows, the WTO already features a rich harvest of investment-related provisions. This may come as a surprise in light of the determined attempt of many GATT members to eschew a meaningful discussion of investment matters at the outset of the Uruguay Round. That the Marrakesh Agreeement establishing the WTO contains as many investment-related provisions – most notably in the TRIMs Agreement and, particularly in the GATS – must be ascribed to the rapidly changing policy environment within which the Uruguay Round took place.

This fertile environment, characterized by a number of far-reaching changes in policy and rule-making approaches which gained currency in a growing number of developed and developing countries, was one the multilateral trading system was able to internalize (albeit partially) by the time the Uruguay Round was completed. Among such changes were: (i) the growing recognition of the increasingly complementary relationship between trade and investment in a globalizing world economy; (ii) heightened awareness, particularly among developing countries, of the policy signalling benefits to be derived from credible commitments in the areas of trade, investment, and intellectual property protection; (iii) a greater appreciation of the key contribution of services in promoting economy-wide efficiency gains and the central role played by investment as the principal means of securing market access and enhancing the contestability of service markets; and (iv) a significant worldwide push towards investment regime liberalization, often pursued on a unilateral basis and closely tied to efforts aimed at regulatory reform in key sectors, many of them key service sectors such as energy, telecommunications, finance and transportation services. In what follows, we briefly review the salient features of the Uruguay Round's harvest of investment-related disciplines.

Agreement on Trade-Related Investment Measures The stated objectives of the Agreement on Trade-Related Investment Measures (the TRIMs Agreement) include not only the promotion of the expansion and progressive liberalization of world trade but also the facilitation of investment across international frontiers.[91] The TRIMs Agreement prohibits the application of certain investment measures related to trade in goods to enterprises operating within the territory of a Member. It should be noted that the TRIMs Agreement is

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[90] The following discussion draws on Pierre Sauvé (1994), 'A First Look at Investment in the Final Act of the Uruguay Round', *Journal of World Trade*, 28, 5 (October), 5–16.

[91] See TRIMs Agreement Preamble.

concerned with the discriminatory treatment of imported and exported goods and is not specifically concerned with the treatment of foreign legal or natural persons. Thus, the basic substantive provision in Article 2 of the TRIMs Agreement prohibits the application of any trade-related investment measure that is inconsistent with the GATT's provisions on national treatment or the elimination of quantitative restrictions. In particular, an Illustrative List annexed to the Agreement identifies certain measures that are inconsistent with Article III:4 or Article XI:1 of GATT 1994.

These cover essentially the following types of measures: local content requirements, trade-balancing requirements, foreign exchange balancing requirements and restrictions on exportation. The Agreement bans not only TRIMs that are obligatory in nature, but also those whose compliance is necessary in order to obtain an advantage. It applies only to investment measures related to trade in goods. It does not cover trade in services. Measures concerning service industries are addressed by the GATS, which does not contain explicit rules dealing with TRIMs, although these may be subject to specific negotiated commitments.

Article 5 of the TRIMs Agreement contains provisions for the notification of, and for according transitional periods for the elimination of, trade-related investment measures inconsistent with the Agreement existing at least 180 days prior to entry into force of the WTO. Under Article 5.1 States that were members of WTO on 1 January 1995 were required to notify to the Council for Trade in Goods, within 90 days after the date of entry into force of the WTO Agreement, any TRIMs that were not in conformity with the Agreement. With regard to transition periods, developed, developing and least-developed countries were given, respectively, two, five and seven years from the date of entry into force of the WTO Agreement to eliminate notified TRIMs (Art. 5.2). Furthermore, upon request, the transition period could be extended for developing and least-developed countries that demonstrate particular difficulties in implementing the provisions of the Agreement (Art. 5.3). After protracted negotiations, such an extension was granted to Argentina, Colombia, Malaysia, Mexico, Pakistan, the Philippines, Romania and Thailand until the end of 2003, subject to certain criteria, such as the submission of a phase-out plan for the TRIMs measures.

Export performance requirements are another type of performance requirement often imposed on foreign investors. For various domestic economic policy reasons, these force foreign affiliates to export a larger share of the local output than might otherwise be the case. They increase the cost of local sales by an amount that equals the cross-subsidy needed to keep the share between export and local sales above the stipulated limit. Neither the TRIMs Agreement nor any other WTO rules forbid the imposition on foreign investors of requirements to export a minimum amount of domestic production. An important

GATT dispute settlement panel ruling clarified this point in 1984.[92] The panel considered a complaint by the United States regarding certain types of undertaking which were required from foreign investors by Canada as conditions for the approval of investment projects. These undertakings pertained to the purchase of certain products from domestic sources (local content requirements) and to the export of a certain amount or percentage of output (export performance requirements). The Panel concluded that the local content requirements were inconsistent with the national treatment obligation of Article III:4 of the GATT but that the export performance requirements were not inconsistent with GATT obligations.[93] The Panel emphasized that at issue in the dispute before it was the consistency with the GATT of specific trade-related measures taken by Canada under its foreign investment legislation and not Canada's right to regulate foreign investment *per se*.

This panel decision confirmed that existing obligations under the GATT were applicable to performance requirements imposed by governments in an investment context in so far as such requirements involve trade-distorting measures. At the same time, the Panel's conclusion that export performance requirements were not covered by the GATT also underscored the limited scope of existing GATT disciplines with respect to such trade-related performance requirements. The subsequent Uruguay Round negotiations would not change this situation. The coverage of WTO rules on performance requirements is thus basically limited to the measures included in the TRIMs Illustrative List and does not extend to export performance requirements.

The General Agreement on Trade in Services The General Agreement on Trade in Services (GATS) subjected one of the most important and fastest growing components of world trade to multilateral disciplines for the first time. Acknowledging one of the defining characteristics of trade in services, namely the frequent need for proximity between suppliers and consumers, hence for commercial presence, the GATS contains the single largest number of investment-related provisions now found in WTO law. Such provisions relate to matters of both investment liberalization and investment protection, albeit with differing degrees of' comprehensiveness.

The GATS defines trade in services as consisting of four modes of supply, one of which (Mode 3) is the 'supply of a service by a service supplier of one member through *commercial presence* in the territory of another Member'.

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[92] See *Canada – Administration of the Foreign Investment Review Act ('FIRA')* (BISD 30S/140, 1984).

[93] In particular the panel stated 'there is no provision in the General Agreement which forbids requirements to sell goods in foreign markets in preference to the domestic market' (BISD 30S/164).

Commercial presence is defined as consisting of any type of business or professional establishment, including through the constitution, acquisition or maintenance of an enterprise or the creation or maintenance of a branch or representative office. While the definition of commercial presence used in the GATS covers matters relating to both pre- and post-establishment and applies to both existing and *de novo* investments, its scope remains significantly narrower than the asset-based definition of investment often encountered in bilateral investment treaties and in the newer generation of regional trade agreements featuring comprehensive investment disciplines.

Determining the ultimate scope of the GATS, including with regard to commercial presence, involves the interplay of a number of parameters. While coverage of the GATS is universal in scope (all services are covered except those supplied in the exercise of governmental authority and the bulk of air transport services), specific commitments on market access and national treatment as well as a number of framework disciplines – for instance those pertaining to payments and transfers, apply only to sectors and to modes of supply on terms inscribed in Members' schedules. The scope of the Agreement is further circumscribed by the (one-off and theoretically time-bound) ability of Members to lodge exemptions against the most-favoured treatment obligation.

The mode of supply against which the largest number of specific commitments has been undertaken under the GATS, including by developing countries, is that relating to commercial presence. Of relevance from an investment liberalization point of view is the fact that the commercial presence commitments scheduled by Members are linked to complementary commitments under the movement of supplier mode which provides temporary entry privileges to intra-company transferees that are essential to the establishment/operation of a commercial presence (i.e. managers, executives and specialists). That the GATS has generated a positive liberalization dynamic for investment is perhaps less than fully surprising when one considers the establishment-related nature of much 'trade' in services.[94] It also most likely reflects the greater comfort that host countries may have in being able to subject established foreign enterprises to greater regulatory oversight and compliance with domestic laws and regulations than if the latter were supplying the market on a remote, cross-border, basis.

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[94] The decision to schedule commitments by mode of supply may, however, have resulted in fewer commitments on the cross-border movement of services and service supplier by providing Member Countries with what could be called an 'architectural' incentive to impose on foreign service suppliers TRIM-like requirements to establish a commercial presence as a prerequisite for supplying services in their territories.

The GATS does not enshrine an investor's right to establish a commercial presence. Such a presence, instead, is conditioned by the terms inscribed in national schedules. The core *investment-liberalizing provisions* of the GATS comprise Articles II (*Most-Favoured-Nation Treatment*), XVI (*Market Access*) and XVII (*National Treatment*). Of the three, Article II is the only obligation applicable to all Members and to all service sectors. *Market Access* is not defined under Article XVI. Rather, agreement was reached on six categories of measures, which unless specified in national schedules, are prohibited in principle. These six categories define in effect what is meant by market access under the GATS. Two such categories relate more specifically to commercial presence: (i) those that limit the type of legal entities through which a foreign service supplier may supply a service (e.g. branches vs. subsidiaries) and (ii) those that impose limitations on the level or value of foreign capital participation (e.g. equity limitations). A footnote to Article XVI specifies that where a Member schedules a commitment under the commercial presence mode of supply, it commits itself as well to allowing related transfers of capital into its territory. The article is, however, silent as regards the treatment of capital outflows (such as liquidation proceeds) related to a commercial presence.

Unlike the TRIMs or TRIPs Agreements, the GATS allows Members to maintain *existing* non-confirming measures. In sectors where specific commitments are undertaken, such measures must be inscribed in Members' national schedules. Members retain the freedom to adopt new discriminatory measures in sectors that are either not inscribed in their schedules (though on an MFN basis) or in sectors subject to MFN exemptions. The GATS also provides that a foreign service supplier established in a party to an economic integration agreement may benefit from preferential treatment.

The GATS contains both general exceptions (including measures relating to direct taxation and double taxation agreements) and security exceptions similar to those applicable to trade in goods under the GATT. The Agreement foresees future discussions aimed at assessing the need for disciplines on safeguards for services as well as future negotiations on trade-distorting subsidies in the services area.[95] The GATS does not contain provisions dealing directly with matters of investment screening and performance requirements, both of which may be subject to terms and conditions inscribed in national schedules.

The Agreement calls for Members to ensure that monopoly suppliers in their territories behave consistently with their MFN obligations and specific

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[95] Pending the completion of such negotiations, subsidy measures are deemed to apply on an MFN and, in scheduled sectors, on a national treatment basis unless specifically reserved under the GATS.

commitments and do not abuse their dominant positions when competing outside their statutory scope. The GATS applies a 'substantial business operation' test in determining who qualifies for the Agreement's benefits and, in the case of commercial presence, focuses as well on ownership (defined as involving more than 50 per cent equity interest) and control (defined as the power to name a majority of directors or to legally direct the actions of an enterprise).

The GATS contains fewer and generally weaker provisions relating to matters of investment protection. Disciplines on payments and transfers contained in Article XI are not a general obligation. Under Article XI, Members are normally obliged not to restrict international transfers and payments for current transactions in sectors subject to specific commitments, though there are provisions allowing limited restrictions in the event of serious balance-of-payments and external financial difficulties. Where such restrictions are imposed, they would be subject to multilateral surveillance aimed at ensuring that they be applied in a non-discriminatory fashion, be least trade-restrictive in their effects and temporary in nature. Provided a Member does not impose restrictions on capital transactions inconsistently with its specific commitments, the GATS does not affect the rights and obligations of members of the International Monetary Fund under the Articles of Agreement of the Fund.

The GATS contains no provisions relating directly to issues of expropriation and compensation as commonly addressed in BITs and in many RIAs (e.g. provisions dealing with the treatment of foreign investors in cases of expropriation or nationalization, fair-market value compensation, freedom to transfer compensation payments). Nevertheless, compensation through recourse to arbitration aimed at determining compensatory adjustments of equal commercial effect is foreseen in instances where Members may choose to modify or withdraw a concession under the GATS.

As with the TRIMs Agreement, consultations and the settlement of disputes under the GATS are to be governed by the WTO's integrated dispute settlement system. Both Agreements provide Members with the right to compensatory adjustments if their benefits are deemed by the WTO's Dispute Settlement Body to have been nullified or impaired.

Agreement on Subsidies and Countervailing Measures The provision of investment incentives, widespread in both developed and developing countries, is a particularly important element of the legal framework for foreign investment. Investment incentives could be defined as measurable economic advantages afforded to specific enterprises or categories of enterprises by (or at the direction of) governments, in order to encourage them to behave in a certain manner. This would include the decision to invest in the host country

rather than elsewhere. Incentives take many different forms and can be classified in various ways. One useful classification can be to distinguish between: (i) financial incentives; (ii) fiscal incentives; (iii) subsidized services; and (iv) market privileges. Financial incentives involve the provision of funds directly to firms to finance new foreign investment or certain operations. That is, the host government pays for some of the investment cost through a grant or subsidized credit without demanding a commensurate equity stake. Fiscal incentives are provisions designed to reduce the tax burden for foreign investors, for example tax holidays (sometimes exceeding 10 years), reduction in the standard corporate income tax rate, accelerated depreciation, and duty drawbacks and exemptions from import duties on raw materials, intermediate inputs and capital goods.[96] Subsidized services include the provision of land, designated infrastructure and government services at less-than-commercial prices. Market privileges include different measures designed to enhance the profitability of FDI by biasing market competition in favour of the investing firm. For example, investors may receive preferential access to government contracts; guarantees against further entry, for example in services sectors requiring government licences (telecommunications, banking, etc.); special regulatory treatment; guarantees of protection against import competition or preferential treatment with regard to the import of certain products.[97]

The Agreement on Subsidies and Countervailing Measures (ASCM) defines the concept of 'subsidy' and establishes disciplines on the provision of subsidies. This is of particular relevance for FDI policy, as certain investment incentives granted by governments are subsidies as defined by the ASCM. The definition contains three basic elements: (i) a financial contribution (ii) by a government or any public body within the territory of a Member (iii) which confers a benefit.[98] All three of these elements must be satisfied in order for a subsidy to exist.

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[96] In an action brought in WTO by the European Communities against the United States on the tax treatment of export income through foreign sales corporations, the Dispute Settlement Body made it clear that the prerogative of taxation rests with the sovereign Government – what to tax or not to tax; how much to tax etc. However, having set up a system of tax rules, exemption given in support of export sales that amounts to export subsidy is what runs foul of WTO obligations (United States – Tax Treatment for 'Foreign Sales Corporations': Report of the Appellate Body, WT/DS108/AB/R, p. 31).

[97] For example, in some countries manufacturers of cars with assembly operations that meet local content requirements are entitled to import cars produced elsewhere at preferential rates.

[98] Besides clear-cut cases such as cash grants, the issue of benefit will be more complex in other instances including the granting of loans, equity infusions or the purchase by a government of a good. Although the ASCM does not provide complete

At least some types of measures in each of the categories referred to above are subsidies as defined in Article 1 of the ASCM. That is, they can involve a financial contribution by a government or public body and would confer a benefit. Fiscal incentives, for example, would generally fall within the ASCM definition of 'government revenue . . . otherwise due [that] is foregone or not collected (e.g. fiscal incentives such as tax credits)'. Financial incentives, such as the direct provision of funds through grants and subsidized credits, would generally meet the ASCM definition of a 'government practice [that] involves a direct transfer of funds (e.g. grants, loans and equity infusion . . .)'. Finally, the provision of subsidised services would appear to be a subsidy as defined by the ASCM. In particular the provision of such items as land and infrastructure at less than market prices would appear to fall within the definition of 'a government provid[ing] goods or services other than general infrastructure, or purchas[ing] goods'.

To the extent that such incentives are provided on a 'specific' basis, as defined in Article 2 of the ASCM, they would also be subject to the ASCM's provisions. The basic principle is that only subsidies that distort the allocation of resources within an economy should be subject to the Agreement's disciplines. Where a subsidy is widely available within an economy, such a distortion in the allocation of resources is presumed not to occur. Thus, only 'specific' subsidies are subject to the ASCM disciplines. There are four types of 'specificity' within the meaning of the ASCM: enterprise-specificity: a government targets a particular company or companies for subsidization; industry-specificity: a government targets a particular sector or sectors for subsidization; regional specificity: a government targets producers in specified parts of its territory for subsidization; and prohibited subsidies: a government targets export goods or goods using domestic inputs for subsidization. Thus, the two categories of prohibited subsidies are: export subsidies and import substitution subsidies.

Investment incentives meeting the definition of a subsidy, and granted contingent upon exportation of goods produced (or to be produced) by an investor are prohibited under the ASCM. A detailed list of export subsidies is annexed to the ASCM. The Illustrative List of Export Subsidies, provided in Annex I to the ASCM, includes direct and indirect subsidies linked to exports, such as services in their production, transport and marketing as well as associated export credit and insurance schemes. Also prohibited is the full or

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guidance on these issues, the Appellate Body has ruled that the existence of a benefit is to be determined by comparison with the market-place (i.e., on the basis of what the recipient could have received in the market). See WTO panel on *Canada – Measures Affecting the Export of Civilian Aircraft*, WT/DS70/R, para. 9.112; the WTO Appellate Body endorsed this ruling (WT/DS70/AB/R, paras 149–61).

partial remission of direct taxes and social welfare charges or special direct tax deductions that are not also available to production for domestic consumption.

A number of other 'specific' investment incentives other than those meeting the definition of prohibited subsidies can also be geared towards enhancing export competitiveness and are subject to the disciplines of the ASCM. That is, even if not prohibited, incentives that meet the definition of a specific subsidy and that cause 'adverse effects' as defined by the ASCM potentially are subject to compensatory action (i.e. they are 'actionable').[99]

It is interesting to note that the underlying concepts of the ASCM are oriented towards trade in goods and may not in all cases be easily applied to investment incentives, in particular locational incentives. The ASCM is concerned with the flow of traded goods, which by definition occurs only after the investment has been made. Two areas, 'adverse effects' and remedies, illustrate this point. Under the ASCM, the adverse effects of subsidization are defined in terms of distortions to trade flows of subsidized goods: that is, the extent to which subsidies increase the level of exports from, or reduce the level of imports into, the subsidizing country, and thereby harm producers of like goods in another country. In the context of investment, because the granting of an incentive generally predates production, often by a considerable period, such an after-the-fact measurement of adverse effects is unlikely to exercise discipline over the provision of investment incentives.

A similar issue arises in the context of remedies. By the time production and exportation have commenced, incentives aimed at attracting investment will often have ended. In this situation, neither a recommendation to withdraw or modify a subsidy, nor the application of a countervailing duty to the exported goods, would be likely to 'undo' or to change an investment that has already been made.

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[99] Most subsidies, especially production subsidies, may fall into the 'actionable' category. Actionable subsidies are not prohibited, but are subject to challenge, either through multilateral dispute settlement or through countervailing action, in the event that they cause adverse effects to the interests of another Member. There are three types of adverse effects. First, there is injury to a domestic industry caused by subsidized imports in the territory of the complaining Member. This is the sole basis for countervailing action. Second, there is serious prejudice. Serious prejudice usually arises as a result of adverse effects (e.g., export displacement) in the market of the subsidizing Member or in a third country market. Thus, unlike injury, it can serve as the basis for a complaint related to harm to a Member's export interests. Third, there is nullification or impairment of benefits accruing under the GATT 1994. Nullification or impairment arises most typically where the improved market access presumed to flow from a bound tariff reduction is undercut by subsidization.

The Agreement on Trade-Related Aspects of Intellectual Property Rights A consideration of the treatment of intellectual property rights (IPRs) in the Final Act of the Uruguay Round is relevant in assessing the Round's outcome for investment-related matters because provisions aimed at securing and enforcing the protection of IPRs are often embodied in BITs. While the Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPs Agreement) contains no provisions addressing directly the treatment of investment, it is widely regarded as a strong, rules-based, agreement likely to generate positive investment protection externalities. The Agreement, indeed, significantly enhances the protection (including through coverage under the WTO dispute settlement system) afforded to firms investing in, producing and trading research and intellectual property goods and services.

The Agreement recognizes that widely varying standards in the protection and enforcement of intellectual property rights and the lack of a multilateral framework of principles, rules and disciplines dealing with trade in counterfeit goods have been a growing source of tension in international economic relations. The Agreement may also be viewed as a recognition of the fact that the strength or weakness of a country's system of intellectual property protection may have a substantial effect on the kinds of technology likely to be transferred by internationally active firms, and hence may be a potentially important determinant of the composition and extent of FDI.

The Dispute Settlement Understanding As with the TRIPs Agreement, the provisions contained in the Understanding on Rules and procedures Governing the Settlement of Disputes (DSU) are generic and do not focus specifically on investment-related matters. The DSU has strengthened the previous (GATT) dispute settlement mechanism significantly. Among the central innovations made to the WTO's integrated system for consultations and dispute settlement are: (i) the automatic adoption of panel reports (unless there is a consensus to do so, Members cannot block findings against them (negative consensus)); (ii) the possibility of requesting the review of a panel report by an Appellate Review Body (whose findings are final and binding on Members unless there is a negative consensus); (iii) the possibility of cross-sectoral retaliation (e.g. a Member can take action in the goods area for a violation of the GATS); and (iv) the requirement for Members to establish what the 'reasonable time for implementation' will be, which should result in the prompter implementation of panel recommendations.[100]

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[100] The stages of dispute settlement foreseen under the DSU are: (i) *consultations between Members* (i.e. State-to-State arbitration): (ii) *establishment of a panel;* (iii) *first and second panel hearings* based on the exchange of written submissions, (iv)

While the Uruguay Round has introduced important investment disciplines, the limitations of existing provisions must be borne in mind. For one, the TRIMs Agreement remains extremely limited in scope and does not address distortive practices arising in services trade. WTO rules on investment remain unbalanced given the asymmetry of disciplines applying to performance requirements, the incidence of which tends to fall primarily on developing countries, as opposed to weak disciplines governing the distortive practice of investment incentives, the incidence of which tends to be greater among developed countries. Moreover, while the GATS negotiations have brought out quite vividly the central importance of investment to trade in services and generated far more by way of commercial presence commitments than had been expected, their treatment of investment-related matters is embodied in provisions that display a number of shortcomings: they are generally weaker than those found in BITs or in many more recent RIAs, do not generate adequate transparency, produce limited pressures for liberalization, and do not address many important development-related issues.

Much, therefore, remains to be done if the multilateral trading system is to be equipped with a comprehensive set of investment disciplines. Yet, despite the continued improvements in host country investment climates and policy regimes, attempts at crafting a multilateral investment regime have met with very limited success.

Developments after the Uruguay Round: still a bumpy road

Alongside the failed attempt at agreeing on an OECD-anchored MAI, the period since the establishment of the World Trade Organization in 1994 has witnessed a concerted attempt by a number of WTO Members to place investment more comprehensively within the multilateral trading system's negotiating purview. Such a process, which was initiated in the midst of the MAI negotiations, was launched at the WTO's first Ministerial Conference, held in Singapore in December 1996, leading to the establishment of a WTO Working Group on the Relationship between Trade and Investment (WGTI).

At the fourth Session of the WTO's Ministerial Conference, held in Doha, Qatar, in November 2001, WTO Members agreed to launch negotiations on foreign investment after the Fifth Session of the Ministerial Conference 'on

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circulation and adoption of the panel report; and (v) on request, *review by the Appellate Body.* Each stage of the procedure for settling disputes is subject to strict time limits. Such a procedure is not to exceed six to nine months (or twelve months in case of appeal). Failure to comply with panel recommendations provides aggrieved Members with the right to request the imposition of commensurate (i.e. commercially 'equivalent') trade sanctions. The DSU contains no provisions allowing for private party (e.g. investor–State) recourse to multilateral dispute settlement.

the basis of a decision to be taken, by explicit consensus, at that Session on modalities of negotiations'. In adopting this decision, Ministers recognized 'the case for a multilateral framework to secure transparent, stable and predictable conditions for long-term cross-border investment, particularly foreign direct investment, that will contribute to the expansion of trade, and the need for enhanced technical assistance and capacity-building in this area'.[101] The decision identified certain subjects that would be the focus of further work in the WGTI until the following Ministerial Conference to be held in Cancun, Mexico in September 2004[102] and defined certain basic considerations that had to be taken into account in negotiations on the envisaged multilateral framework.[103] As preparations intensified ahead of the WTO's Cancun meeting investment discussion remained particularly contentious. Of the four so-called 'Singapore Issues' discussed by WTO Members since 1996, investment was indeed the subject matter most centrally involved in the derailing of the Cancun meeting.[104]

The impasse surrounding investment and its treatment in the WTO system was ultimately resolved in the WTO General Council's July 2004 decision to confine negotiations among the Singapore Issues solely to the subject of trade facilitation. Hence, for the time being, any further discussion, if any, on investment at the WTO will be limited to work that does not relate to negotiations. The most immediate fallout from the failed WTO initiative may well be to

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[101] Ministerial Declaration, adopted on 14 November 2001, doc. WT/MIN(01)/DEC/1, 20 November 2001, para. 20.

[102] These subjects were: (i) scope and definition; (ii) transparency; (iii) non-discrimination; (iv) modalities for pre-establishment commitments based on a GATS-type, positive list approach; (v) development provisions; (vi) exceptions and balance-of-payments safeguards; (vii) consultation and the settlement of disputes between Members. See para. 22.

[103] Paragraph 22 of the Doha Ministerial Declaration states in relevant part: 'Any framework should reflect in a balanced manner the interests of home and host countries, and take due account of the development policies and objectives of host governments as well as their right to regulate in the public interest. The special development, trade and financial needs of developing and least-developed countries should be taken into account as an integral part of any framework, which should enable Members to undertake obligations and commitments commensurate with their individual needs and circumstances. Due regard should be paid to other relevant WTO provisions. Account should be taken, as appropriate, of existing bilateral and regional arrangements on investment'.

[104] See David Hartridge (2003), 'The Cancun Failure: Why and Where Next?', in *WTO Insight*, No. 5, Paris: International Chmaber of Commerce (29 September); see also Pierre Sauvé (2004), 'Decrypting Cancun', in United Nations, *Perspectives from the ESCAP Region After the Fifth WTO Ministerial Meeting: Ideas and Actions Following Cancun*, Studies in Trade and Investment No. 51, Bangkok: United Nations Economic and Social Commission for Asia and the Pacific, 16–39.

increase the focus of rule-making initiatives on investment at the bilateral and regional levels.

Reaching agreement on investment issues may well be more feasible at the bilateral and regional levels for at least two important reasons. First, because such negotiations are typically characterized by significant asymmetries of economic and political power between capital-exporting and capital-importing countries. And second, because BITs and RIAs typically start from a blank page and do not confront the delicate task of reopening existing rules, commitments and the balance of concessions that inherently complicate attempts at fitting new investment rules alongside existing ones in the WTO context.

Discussions on investment at the WTO have highlighted a strange paradox: offering the sight of fierce resistance at the multilateral level by a number of developing countries on a subject matter towards which their unilateral, bilateral or regional policy stances have been starkly different and considerably more open and accommodating. The burgeoning network of treaties, principally at the bilateral level, cannot but be seen as reflecting a growing willingness and ability on the part of developing countries (in part because of the strongly unilateral character of recent liberalization decisions) to codify existing legal frameworks for international investment at the country level. Such behaviour naturally raises questions as to the 'value-added' that could be expected from a framework for investment at the multilateral level, particularly from the perspective of investment protection.

International investment issues are complex and feature an important 'horizontal' dimension, in that they can affect industries in a variety of sectors across the economic spectrum, increasingly spanning manufacturing and services in a seamless manner. Such changes point to growing complementarities between investment and trade, including with respect to proliferating global supply chains. A multilateral framework that does not reflect this reality by providing the proper institutional underpinnings for the way in which international commerce unfolds in a globalizing world economy is itself sub-optimal. Over time this risks calling into question the benefits and continued relevance of the existing multilateral framework which has thus far proven integral to the growth of a postwar trading system built on the core principles of transparency and non-discrimination.

The failure of WTO Members to reach agreement on negotiating modalities for investment must be assessed against the backdrop of the value-added, coherence and negotiating incentives implicit in the proposals of its WTO advocates. On all grounds, the investment agenda as delineated in the Doha Declaration, failed to garner widespread support among WTO Members.[105]

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[105] From the perspective of developing countries only a significantly different,

Such failure can be explained by examining the agenda through the prism of the four core components of investment rule-making: protection, liberalization, distortions and good governance.

The increasing salience of BITs and of RIAs in the area of investment protection is largely reflective of the negotiating asymmetries that distinguish capital exporting and importing nations. Such asymmetries go some way towards explaining the far-reaching nature of disciplines that host countries have been increasingly willing to accept in such institutional settings. Seen from a capital exporting perspective, the WTO is arguably not the optimal setting in which to tackle matters of investment protection. This is so because one of the distinguishing features of BITs or RIAs featuring comprehensive investment disciplines – recourse to investor–State dispute settlement procedures, to which investors naturally attach considerable importance – is to all intents and purposes not conceivable in a WTO setting. The precedents – both legal and, perhaps more importantly, political – that such an instrument would create would likely fuel strong demands for private party recourse to dispute settlement in areas outside investment, notably in matters of environmental concerns, labour and human rights, which the diverse WTO membership appears most unlikely to support.

Similarly, of the various issues linked to what one might call the 'good governance' agenda, transparency is arguably the only one that could easily be anchored within a WTO investment agreement. However, questions remain on the efficacy and development implications of relying on dispute settlement and the attendant threat of trade sanctions as a means of enforcing such disciplines. For all other issues arising under this sub-agenda, which span subjects as diverse as the fight against bribery corruption, the promotion of home country measures, the advancement of corporate social responsibility, or the adoption of best practices in investment promotion, legally binding and enforceable hard law responses, *a fortiori* in the WTO, still remain difficult.[106]

As regards the core investment liberalization agenda, the WTO is on decidedly firmer ground. However, here again one needs to consider two important facts to which proponents of a WTO agreement have to date paid insufficient attention. First is the fact that some two-thirds of aggregate annual FDI flows are today directed towards service industries.[107] And second, and perhaps

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broader and more development-oriented agenda could possibly have mustered such support, see A. Beviglia Zampetti and T. Fredriksson (2003) 'The Development Dimension of Investment Negotiations in the WTO: Challenges and Opportunities', *The Journal of World Investment*, June, 399–450.

[106] See World Bank (2002), *Global Economic Prospects 2003 – Investing to Unlock Global Opportunities*, Washington, DC: The World Bank.

[107] See UNCTAD (2004), *World Investment Report 2004: The Shift to Services*, Geneva: United Nations.

more important from the perspective of the value-added of any new WTO investment rule-making initiative, is that some four-fifths of impediments to cross-border FDI are also found in services.[108] Furthermore, the bulk of barriers to investment relating to goods sectors involve FDI in primary activities, such as agriculture, fishing, mining and oil and gas extraction, where entry obstacles tend to be more deeply entrenched politically (sometimes even written into countries' constitutions) than those relating to FDI in manufacturing.

This situation also underscores the extent to which the GATS already affords WTO Members an important vector of investment liberalization.[109] For this reason, negotiating efforts could usefully be deployed in attempting to make the GATS a more potent vehicle of investment regime liberalization, notably by modifying the agreement's scheduling approach with a view to securing commitments that lock in the regulatory *status quo* rather than allowing Members to maintain a wedge between applied and bound regulatory measures in services trade and investment.

Finally, as regards a collective action response to investment distorting measures, the incidence of which tends to affect FDI in manufacturing more than in services, it is important to distinguish three sub-categories of policy measures. A first category consists of performance requirements already banned under the WTO's TRIMs Agreement. An important rule-making challenge would thus be to revisit the TRIMs Agreement also to consider in more detail its development implications and to consider its possible extension in the realm of services trade. Given the salience of the TRIMs Agreement in the WTO's contentious debate over the Uruguay Round's implementation burden, such expanded scope cannot be taken for granted even as recent research has begun to document the prevalence of TRIM-like measures in services.

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[108] See Pierre Sauvé, Martin Molinuevo and Elisabeth Tuerk (2006) *Preserving Flexibility in IIAs: The Use and Scope of Reservation Lists*, UNCTAD Series on International Investment Policies for Development, New York and Geneva: United Nations. The study maps the distribution of non-conforming measures reserved by various country groupings under a sample of negative list agreements. The predominance of services as the principal locus of investment restrictions – and thus of investment regime liberalization – stands out vividly, with the share of non-conforming measures in services ranging from 76.9 per cent in the case of Canada and the United States, 81.6 percent in the study's Latin American sample countries (Argentina, Brazil, Colombia, Chile, Mexico and Venezuela) and a high of 94.1 per cent in the case of transition economies (e.g. Czech Republic, Hungary, Poland).

[109] For a fuller discussion of how to enhance the investment liberalization properties of the GATS, see Pierre Sauvé and Christopher Wilkie (2000), 'Investment Liberalization in GATS', in Pierre Sauvé and Robert M. Stern (eds), *GATS 2000: New Directions in Services Trade Liberalization*, Washington, DC: Brookings Institution Press, 331–63.

A second core element of the distortion agenda relates to investment incentives, an area where a growing list of 'users' has emerged in recent years in all regions of the world and which today encompasses a growing number of developing countries. However desirable, not least on efficiency, equity and policy coherence[110] grounds, the coverage of investment incentives – the granting of which is often closely related to the imposition of performance requirements – would likely prove daunting in a WTO context if one is to judge by past failures and the revealed policy preference of host countries for inaction in this area.

What's more, the question arises of the most appropriate level at which to tackle such a source of distortion, i.e. regional or multilateral agreements, given the likely greater regional incidence of locational competition between host countries. There has indeed been intense competition within (but significantly less so between) developed and developing countries in trying to attract FDI by using investment incentives. Central and sub-national governments in federal countries make great use of these instruments, particularly in developed countries.

There is little doubt that investment incentives – be they fiscal, financial or regulatory in nature – can play a decisive role in influencing the ultimate location decisions of some specific investors. Countries, including those that can ill-afford them, can be led to embark on expensive 'races to the top', resulting in discrimination and distortions in the allocation of productive resources, and costly rent-seeking behaviour on the part of investors. Countries with fewer resources may find it difficult to compete on a level playing field with other states using such instruments. Host countries have traditionally been very hesitant about tackling this issue in international negotiations.[111]

Still, in an optimal scenario, prospective multilateral disciplines on investment incentives could usefully address a range of issues related to their scope and codification by degree of distortiveness. Consideration could also be given to the prohibition of (or the hortatory, best endeavours, encouragement to refrain from) the most distortive types of incentives. The principles of transparency and non-discrimination (MFN treatment and ideally national treatment as under the GATS in scheduled sectors) could also be made to apply to such practices, though progress is likely to prove difficult for obvious political reasons in important host countries.

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[110] So as to redress the current imbalance between the treatment of performance requirements, where disciplines under the TRIMs Agreement primarily affect developing countries, and that of investment incentives, where existing multilateral disciplines under the ASCM only weakly constrain distortive practices which developed countries are in a better position to offer.

[111] Host countries with federal structures of government have been particularly reluctant, as they consider they cannot or should not bind their sub-national entities.

A final cluster of distortion-related challenges relates not so much to investment measures but to trade policy measures, and involves a range of practices that distort investment decisions away from the equilibrium that would otherwise prevail in their absence. Perhaps the best example of such investment-related trade measures are the discriminatory, sector-specific, rules of origin found in many free trade agreements. Many such rules have targeted foreign investors in the past, notably Japanese investors in the automobile sector under the NAFTA, with significant trade- and investment-distorting consequences. Such measures are also prevalent in the textiles and clothing sector, and indeed in many sectors subject to host country fears of delocalization and structural competitive weaknesses in domestic industries.

Other significant investment-related trade measures include tariff peaks and tariff escalation, as well as the anti-competitive practices made possible under national anti-dumping regimes. An important policy- and rule-making insight arising from the above practices is that all are already subject to multilateral negotiations under various chapters of the ongoing Doha Round, so that their negative incidence in cross-border investment activity could be reduced and/or progressively eliminated without the need for an explicit negotiating mandate on investment at the WTO.

As the above discussion illustrates, the reasons for the current impasse on investment at the WTO are numerous. They involve a complex interplay of procedural, tactical and substantive concerns. Such an impasse provides WTO Members with a good opportunity for a thorough and much-needed rethinking of the objectives that a possible multilateral negotiation on investment should pursue, the value-added it can hope to achieve, and the parameters within which it should be conducted if it is to balance the interests of home and host countries among the broadly diverse WTO membership.

5. Concluding remarks

The advantages and disadvantages of international investment agreements differ depending on whether these are bilateral, regional or multilateral in scope. Advantages and disadvantages can be viewed from different perspectives, such as those of host versus home countries, and also specifically with regard to the issues covered, the inclusion of development-related provisions, the impact on induced FDI flows and the bargaining power configuration in negotiations.

One of the main reasons for the popularity of BITs is the fact that they provide flexibility to host countries, affording them the possibility to screen and channel FDI (as admission is generally subject to the respect of domestic laws of the host country), while at the same time extending the necessary protection to foreign investors. However, BITs generally involve countries at different levels of development, with asymmetrical bargaining power and

negotiating capabilities. Furthermore, available empirical evidence does not suggest a significant impact of BITs on investment flows. Finally, investor-to-State dispute settlement mechanisms which complement investment protection provisions may give rise to high costs and liabilities for developing countries, in addition to raising potentially controversial issues relating to the right to regulate in the public interest.

At the regional level, while investment protection issues are often addressed, international investment agreements tend to have a broader focus, which includes the liberalization of restrictions to entry and establishment of FDI, followed by the reduction of discriminatory operational (post-entry) restrictions. These elements are generally part of wide-ranging agreements addressing various other areas, from trade liberalization for both goods and services to intellectual property protection. As such, regional integration agreements may provide signatories with more space for trade-offs. However, the broader focus of these agreements, coupled with recourse to investor-to-State dispute settlement mechanisms, means that, like BITs, they are hardly immune from potential public policy controversy, as experience under the NAFTA has shown, notably in respect of litigation relating to the alleged confiscatory effects (e.g. indirect expropriation) of environmental or health regulations.

Regional instruments use, even to a larger extent than BITs, all the panoply of traditional international law tools, such as exceptions, reservations, transition periods and the like, to ensure flexibility in obligations so as to cater to the needs and capacities of parties at different levels of development. From the perspective of developing countries, this, together with the growing recognition of the links between trade and investment flows, may explain why investment rules are increasingly found in RIAs that were hitherto primarily concerned with trade issues. The combination of investment liberalization and improved trade (market) access at the regional level has, in some cases, proved very beneficial to developing country parties to regional integration agreements.

As both RIAs addressing investment issues and BITs have multiplied in number, they have also created an intricate web of overlapping commitments. This is one of the main arguments cited in favour of creating a common, multilaterally agreed, framework for investment that, in the words of the WTO Doha Ministerial declaration, would ‘secure transparent, stable and predictable conditions for long-term cross-border investment, particularly foreign direct investment’. Proponents of a unified WTO compact on investment have argued that a new multilateral framework of rules could ‘lock in’ autonomous as well as bilaterally and regionally negotiated liberalization and extend the benefits of such openness on an MFN basis, thus preventing possible policy reversals where liberalization measures have yet to be consolidated.

The counter-argument that has been voiced recalls that a multi-layered set of investment rules already exists across BITs, regional instruments and also at the multilateral level, especially under the WTO's TRIMs Agreement and the GATS, alongside a host of soft law instruments and recommendations on issues such as bribery and corruption, corporate social responsibility, etc.

Existing rules may be far from perfect and coherent, but it has generally proved difficult for the advocates of investment negotiations at the WTO to advance proposals suggesting that a clearly superior set of rules could be agreed upon in a multilateral setting. Furthermore, the complexity of overlapping investment rules and regulations would likely persist, unless BITs and investment rules in regional instruments were superseded by a multilateral agreement. At the same time, it remains the case that in the current WTO system an imbalance exists between the treatment enjoyed by investors in service sectors, which are already covered by GATS rules, and the treatment enjoyed by all other investors.

From a development perspective, the question of the appropriate rule-making 'level' – bilateral, regional or multilateral – cannot be separated from an examination of the actual or potential content of investment rules and commitments. All international investment agreements are instruments of cooperation between countries that are entered into voluntarily. Like all treaties, international investment agreements are neutral instruments: what counts in determining their impact on the development prospects of developing countries is their content and so far the development-specific content of such agreements has been rather modest. There is, accordingly, considerable scope for increasing the attention paid to development issues in international rule-making on investment. This is especially true in light of existing power and negotiating capacity asymmetries, particularly in the context of multi-issue negotiations where a single undertaking logic prevails at the end and where great care needs to be exercised in ensuring that the interests of developing countries are properly addressed.

7. International commercial law

Robert K. Rasmussen

Commercial law regulates commercial transactions. The various rules and institutions that commercial law offers enhance the ability of parties to enter into exchanges and provide a framework for resolving any subsequent disputes. Of course, the two are related in that the procedures that will be available to adjudicate future disputes will affect the incentives to enter into agreements in the first instance. The parties' expectations of what will happen should things go awry color their willingness to transact as well as the structure of any deal that they reach.

Commercial law encompasses a number of different areas of law. The rules provided by contract law interpret and complete contracts; the available payment systems provide alternative mechanisms for allocating the risks of nonperformance between the parties; laws facilitating the pledging of collateral and resolving financial distress sort out rights among competing creditors when a party cannot satisfy all of its obligations.

International commercial law does not differ much from domestic commercial law in the problems that it attends to. The salient differences are the sources of the applicable rules and the mechanisms that parties adopt to resolve future disputes. Economic analysis generally posits that the goal of any commercial law is to facilitate voluntary exchanges that increase social welfare. The rules that maximize the contracting surplus in a domestic transaction should, at first approximation, be the same rules that maximize the contracting surplus in an international transaction. The efficient rule on damages for a contract between a New York buyer and a California seller should be the efficient rule for a contract between a New Zealand buyer and a Colombian seller.

The crucial difference between these two transactions is that the transnational players are more likely to agree to resolve their dispute via arbitration rather than through litigation.[1] Parties arranging international transactions

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[1] As a practitioner handbook put out by the ABA states, '[A] provision that specifies applicable law is essential. . . . [A] provision that specifies the forum for dispute resolution is imperative'. Jay M. Vogelson (2003), 'Dispute Resolution in Transnational Business Transactions', in Mark R. Sandstrom and David N. Goldsweig (eds) *Negotiating and Structuring International Commercial Transactions*, American Bar Association, 111.

select private adjudication over that which is supplied by the various countries in the world. The accepted wisdom is that 90 percent of cross-border deals specify that any subsequent dispute will be resolved by arbitration. Indeed, there are dozens of arbitration organizations spread across the globe that compete for business. One would be hard pressed to locate a major commercial city that was not home to at least one arbitration association.

The prevalence of arbitration impacts the economic analysis of international commercial law. Arbitration provides the contracting parties with unrivaled freedom in selecting applicable law. Western courts generally enforce contract provisions specifying which law will apply to future disputes. Yet there are constraints. Usually, the parties have to select the law of a jurisdiction that has some relationship to the transaction at hand. Also, courts retain the power to override choice of law if they conclude that applying the law selected would violate public policy. In the arbitral context, however, parties can select any law they desire, regardless of whether the jurisdiction whose law is selected has any relationship to the transaction at issue. Arbitrators will apply the law that the parties have chosen. Also, while there are some constraints on the ability of parties to opt out of mandatory law via arbitration, it is generally the case that nations will enforce arbitral awards without re-examining the basis on which the award is based.[2]

When it comes to specifying which law will apply to future disputes, contract drafters select from a full menu. Obvious choices include the domestic law of any nation. Yet such national laws do not exhaust the choice set. Organizations other than nations compete to provide rules of decision that the parties may select. The International Chamber of Commerce ('ICC'), a private organization dedicated to advancing business interests worldwide, UNIDROIT, an intergovernmental agency with a mission of harmonizing private law across the globe, and UNCITRAL, an organ of the United Nations, have all produced texts designed to regulate various aspects of international transactions. To be sure, there are domestic organizations that also produce commercial texts, most notably the American Law Institute (ALI) and the National Conference of Commissioners on Uniform Laws (NCCUSL). However, legislatures and courts are the primary consumers of their work. For the international players, however, private parties who opt for arbitration can directly adopt the product of any producer of commercial texts.

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[2] The United States Supreme Court's main pronouncement on the extent to which courts should defer to arbitration where such arbitration may fail to respect antitrust rules is somewhat ambiguous. See *Mitsubishi Motors Corp. v Soler Chrysler-Plymouth, Inc.*, 473 US 614 (1985). For an economic defense of this position, see Eric A. Posner (1999), 'Arbitration and the Harmonization of International Commercial Law: A Defense of *Mitsubishi*', *Virginia Journal of International Law*, 39, 647.

The domineering presence of arbitration also has the effect of rendering the actual operation of international commercial law opaque. Most arbitration decisions are not published, nor are contracts between parties generally available. Hence, it is difficult to ascertain what law parties tend to choose and how arbitrators apply that law with any degree of precision. To be sure, there are intuitions on these matters, and more data are becoming available. Still, it remains the case that much of the folk wisdom that surrounds international commercial law has yet to be verified.

The general lack of sustained empirical work in international commercial law is emblematic of a larger phenomenon; there simply is little extant scholarship analyzing international commercial law from an economic perspective. To be sure, one can find extensive scholarship that describes the major developments in this field over the last 20 or so years, at least if one's gaze is limited to the 'law on the books' as opposed to the actual behavior of contracting parties. As yet, however, there is little work that provides an economic analysis of the variety of issues raised by the growth of commercial transactions that cross country borders.[3]

This lack of sustained economic analysis of international commercial law stands in marked contrast to two other areas that are in some ways related to international commercial law. When one looks at either the economic analysis of commercial law or the economic analysis of public international law, one can locate a substantial body of important work relatively easily. For commercial law, economic analysis extends back at least three decades, and there are helpful surveys of the extant law and economics literature.[4]

The economic analysis of public international law does not have a similarly long pedigree. The last decade or so, however, has seen a growing body of work that applies economic insights to such law, most prominently the notion of rational choice to state action. Numerous articles attempt to understand the interactions of nation-states from this perspective. Perhaps most closely

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3 There are, of course, exceptions, many of which are discussed in the chapter.

4 See the relevant entries in *The New Palgrave Dictionary of Economics and the Law* (Peter Newman, ed., 1998) and the *Encyclopedia of Law and Economics* (Boudewijn Bouckaert and Gerrit De Geest, eds, 1998). For an argument that much of the recent economic scholarship has failed to improve our understanding of contract law from either a normative or a descriptive perspective, see Eric A. Posner, (2003), 'Economic Analysis of Contract Law after Three Decades: Success or Failure?', 112, *Yale Journal of Law Journal*, 829. Recent economic scholarship has attempted to use option theory to provide fresh insights into contracting law and contracting behavior. See, for instance, Avery Wiener Katz (2004), 'The Option Element in Contracting', *Virginia Law Review*, 90, 2187; Robert E. Scott and George G. Triantis (2004), 'Embedded Options and the Case Against Compensation in Contract Law', *Columbia Law Review*, 104, 1428.

related to commercial law is that part of the literature that analyzes trade disputes between nations. In the case of international commercial law, however, there is relatively little normative analysis of this increasingly prominent area of economic activity.

One can posit two competing reasons for this lack of sustained economic inquiry. The deficit of work in this area may stem from scholars' failure to pay sufficient heed to this growing area of economic practice. The interest in public international law has increased dramatically in recent years. Ten years ago, the economic analysis of public international law would have occupied a relatively small place; today, it is growing at a rapid rate. Perhaps the same will be true of the commercial law counterpart. One could explain a lag between the growth of international commercial transactions and analysis of how these transactions are regulated by the higher barriers to entry in international commercial law as compared with public international law. Whereas many of the materials defining public international law are readily available – treaties are public documents, decisions by international tribunals can be tracked down on the internet, 'customary international law' has been the study of academics for decades – the source materials necessary to understand the operation of international commercial law are at times more obscure. While there are treaties that impact on this area, to the extent that one wants to analyze actual contracting behavior and the ways that arbitrators dispose of commercial disputes, there is no ready source to which to turn. It is much easier to explore the dynamics of, say, international criminal liability, than it is to discover the commercial practices of companies that routinely engage in transnational exchanges. This opacity is increased by the common practice of settling international commercial law disputes via arbitration rather than either domestic or international tribunals.

If this explains the extant scarcity of scholarship in this area, we would expect to see a dramatic increase in the economic analysis of international commercial law in the coming years. By all accounts, cross-border transactions are increasing. These transactions will undoubtedly bring more disputes. Moreover, a variety of institutions are working at producing statutory texts focused on international transactions. Also, legal scholars are becoming more adept at locating information about actual contracting practices. The greater visibility will attract the attention of scholars, and as more scholars turn their attention to this area, the amount of scholarship should increase. To the extent that this story is correct, this is an auspicious time to approach the topic of international commercial law from an economic perspective.

One could tell a less sanguine story, however. The paucity of work in this area may reflect that there is little that is distinctive about international commercial law. At least from an economic perspective, the interesting issues of commercial law may be the same regardless of whether a transaction is

domestic or international in character. In other words, the fact that parties reside in different jurisdictions may increase transaction costs, but it does not alter the basic analysis of the problems in this area. Much of the economic analysis of commercial law searches for the legal rules that would maximize the surplus between the contracting parties.[5] At least as an initial matter, one can question the extent to which placing the transacting parties in different countries alters this analysis. Businesses seek to maximize with equal vigor regardless of the jurisdictional setting. Put differently, to have an interesting body of international commercial law scholarship, one has to articulate how the problems of international commercial law deviate systematically from the problems of domestic commercial law.

On this view, the substantial body of scholarship looking at commercial law and commercial practices may translate with relative ease, but little novelty, to the international arena. Questions involving the appropriate scope of party autonomy, the optimal method of setting default rules, the most efficient method of contract interpretation, the proper measure for damages upon breach, facilitating the taking of collateral, establishing dependable payment mechanisms and solving the problems posed by financial distress would yield the same answers in both domestic and international settings.

Viewed from this vantage point, the most interesting questions of international commercial law are the institutional dynamics that generate rules that parties are free to adopt. There is a growing literature on how so-called 'private legislatures' perform when creating American commercial law. Whereas American commercial law is dominated by the NCCUSL/ALI alliance, there is more heterogeneity in the international arena. Those drafting rules under the auspices of the ICC may differ systematically from those involved in a project sponsored by UNCITRAL or UNIDROIT. In other words, we may see the development of positive theories as to why international commercial law as written differs from domestic commercial law that is on the books.[6]

Even if there is nothing distinctive about international commercial law, the fact that it provides parties with extreme latitude in selecting governing law naturally raises questions of regulatory competition and the demand for law.

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5 See Alan Schwartz and Robert E. Scott (2003), 'Contract Theory and the Limits of Contract Law', *Yale Law Journal*, 113, 541, 550–56.

6 An important recent piece that examines the political economy of the CISG is Clayton P. Gillette and Robert E. Scott (2005), 'The Political Economy of International Sales Law', April 22. For an earlier effort advocating increased attention to the political economy of groups that produce international law, see Paul B. Stephan (1999), 'The Futility of Unification and Harmonization in International Commercial Law', *Virginia International Law Review*, 39, 743.

Scholars have debated the merits of competition among entities in corporate law, securities law, domestic commercial law, and bankruptcy. What is unique about international commercial law is that parties have unfettered choice as to the products of a variety of institutions. Future research may uncover what preferences parties reveal through their actions – do they choose the domestic law of one of the contracting parties, or do they choose a body of law from a 'neutral' source? Do they prefer domestic law or law that aspires to be international in character? By looking at the choices that are made, we may be able to ascertain what increases the value of any given body of law to the parties.

Thus, even if the commercial realities facing contracting parties are similar in the domestic and international settings, there will be substantial room for important work in the area of international commercial law. But in terms of normative analysis, an analysis that attempts to specify what legal doctrines increase social welfare, one would not expect to see a robust law and economics literature on the substance of international commercial law develop any time soon.

It would be hazardous to choose between the more optimistic view or the more constrained view of the future of research in this area.[7] The determinative factor is the extent to which the economic issues facing contracting parties differ systematically between the domestic and transnational settings. Further work in the area may well shed light on this question.

1. Extant international commercial law

International commercial law is comprised of at least four distinct areas of law. The first, and perhaps foremost, is the law of contracts. As with American law, international contract law consists of general contract principles as well as rules that apply only to the sale of goods. Contract law provides the rules for interpreting the provisions that the parties have agreed to and fills in any gaps that the parties may have left in their agreement. The second area of law contained within international commercial law is the law of payment systems. By providing alternative payment mechanisms, the law in this area gives parties choices as to how they can allocate the risk of nonperformance. The third area is the law of secured transactions. This law allows a party to pledge assets and assure the recipient that it will have an enforceable priority against the other creditors of the debtor. The final segment of international commercial law is bankruptcy law. The law here sorts out the conflicting rights of vari-

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[7] As discussed below, there is at least one example where the economic analysis of domestic commercial law may differ from that of international commercial law. Both Clayton Gillette and Avery Katz have concluded that the case for turning to commercial norms to interpret a contract is stronger in the international setting than in the domestic one.

ous investors in an enterprise when the enterprise is in financial distress, and determines the future deployment of the assets of the enterprise.

1.1 Contract law

Voluntary agreements form the foundation of international commerce. It is thus not surprising that the law that regulates such agreements – contract law – occupies the central place in any discussion of international commercial law. Indeed, for some, international commercial law and international contract law are coextensive.

Ultimately, international commercial law rests on the power of individual sovereigns. Most countries have acquiesced in allowing their nationals extreme latitude when it comes to which set of rules will resolve any subsequent dispute. The New York Convention provides for the enforceability of arbitral awards. Countries that have signed the treaty pledge to honor arbitral decisions rendered in other jurisdictions. Indeed, those who study arbitration conclude that the second most important reason as to why contracting parties select arbitration is that it provides for the easy enforcement of any judgment. (The most important reason is to keep away from the home court of either party.)

By so endorsing arbitration, each country has in essence provided contracting parties with a menu of contractual regimes from which to choose. One choice available is the domestic law of any state, regardless of whether that state has any connection to the transaction. If a French buyer and a German seller believe that the state of New York provides the best contract law, they are free to select it. Indeed, while the empirical evidence is scant, that which is available suggests that in the large majority of cases parties select the domestic law of a particular country to govern their contract.[8] Unfortunately, the data collected to date do not specify whether the law selected is that of one of the parties to the transaction or from a nation that has no relation to the exchange.

Despite the apparent overwhelming preference of those doing transnational deals to select some state's domestic law, much academic attention is focused elsewhere. Two variants of transactional law tend to garner the lion's share of the press: the *lex mercatoria,* or law merchant, and the recent efforts by international organizations to promulgate the Convention on Contracts for the International Sale of Goods (CISG) and the UNIDROIT Principles. Indeed,

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[8] See Christopher R. Drahozal (2005), 'Competing and Complementary Rule Systems: Civil Procedure and ADR: Contracting Out of National Law: An Empirical Look at the New Law Merchant', *Notre Dame Law Review*, 80, 523, 538–9 (reporting that in a sample of contracts calling for arbitration, only 1 to 2 per cent called for application of international, as opposed to domestic, law).

some view the recent efforts to promulgate international law as a continuation of the tradition of the law merchant.

One cannot read far in the literature on international commercial law without encountering references to the fabled *lex mercatoria,* or law merchant.[9] Unfortunately, there is no single agreed-upon definition in the literature as to what is meant by the law merchant. In short, the law merchant means different things to different people. In its strong form, the law merchant is taken to be that set of norms and principles by which merchants conduct and settle their affairs without resort to sources and institutions of domestic law. The law merchant on this view allows merchants to avoid the uncertainties of competing domestic law and conduct their affairs according to practices that they have established.[10] It is usually touted as superior to state-provided law in that the rules that emerge come from a relatively close-knit community involved in repeated interactions. It is truly international in that it is not bound to any set of domestic institutions. It is law in the sense that it is a set of rules that the parties live by.

One can identify a second distinct version of the law merchant as that term is often used. Under this version, norms of conduct develop among merchants, and these norms should be used to inform legal disputes.[11] This seems to be the version that inspired Llewellyn.[12] The practices here differ from the rules promulgated by nongovernmental, intergovernmental or trade organizations in that the governing 'law' is found not in a formally issued set of instructions, but rather in the mores of the relevant business community. Precisely how these commercial practices should be used by tribunals is itself a matter of debate.[13] American law in the sales of goods areas expressly allows for the use

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[9] The history of the law merchant remains a lively subject of debate. See, for instance, Charles Donahue, Jr. (2004), 'Medieval and Early Modern *Lex mercatoria*: An Attempt at the *probation diabolica*', *Chicago Journal of International Law 21*, 5; Emily Kadens (2004), 'Order within Law, Variety within Custom: The Character of the Medieval Merchant Law', *Chicago Journal of International Law*, 5, 39.

[10] See Paul R. Milgrom, Douglass C. North and Barry R. Weingast (1990), 'The Role of Institutions in the Revival of Trade: The Law Merchant, Private Judges, and the Champagne Fairs', *Economics & Politics*, 2, 5.

[11] On the divergence between the rights granted under the contract and actual practices, see Stewart Macaulay (1963), 'Non-contractual Relations in Business: A Preliminary Study', *American Sociology Review*, 28, 55.

[12] See Alan Schwartz (2000), 'Karl Llewellyn and the Origins of Contract Theory', in *The Jurisprudential Foundations of Corporate and Commercial Law*, Cambridge: Cambridge University Press, 12, 15; Lisa Bernstein (1996), 'Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms', *University of Pennsylvania Law Review*, 144, 1765.

[13] The extent to which domestic commercial law should embrace and incorporate commercial norms remains a topic of ongoing debate. See Lisa Bernstein (1999),

of such norms when interpreting contracts. American common law, at least historically, was not as willing to supplement the written contract with lessons drawn from commercial practices.

Regardless of which definition one subscribes to, the evidence we have suggests that the law merchant does not loom large in actual practice. While the data on this score are scanty, what we do have suggests that substantially fewer than 5 per cent of contracts, indeed perhaps fewer than 2 per cent, specify that they should be resolved by the law merchant. Indeed, by and large, most contracts select domestic law of some nation as the governing law. Norms may govern how parties resolve disputes between themselves before they repair to formal dispute resolution; once such a mechanism is invoked, it will usually resolve the dispute according to the domestic law that the parties chose in their original contract.

The second international source of contract law is that produced by international organizations. Two efforts along these lines stand out: the CISG and the UNIDROIT Principles.[14] The CISG applies to sales of goods, while the UNIDROIT Principles apply to international contracts generally.

The CISG differs from the UNIDROIT Principles in that it can apply directly to transnational contracts. The CISG is a treaty, and it has been adopted by over 60 countries. These countries include most of the world's major trading nations, with the notable exceptions of England and Japan. When the parties to a transnational sales agreement both reside in countries that have adopted the CISG, the CISG covers the transaction. The parties, however, are free to contract out of the CISG. Moreover, even if parties are not bound by the CISG, they are free to contract for arbitration, and point the arbitrator toward the CISG as the law governing the dispute.

The UNIDROIT Principles, in contrast to the CISG, are not directly binding on any party. Rather, they attempt to set forth the principles that the drafters thought applied generally to international contracts. The drafters hoped that they would be a source that adjudicators could turn to when resolving disputes.

'The Questionable Empirical Basis of Article 2's Incorporation Strategy: A Preliminary Study', *University of Chicago Law Review*, 66, 710; Richard Craswell (2000), 'Do Trade Customs Exist?', in Jody S. Kraus and Steven D. Walt (eds), *The Jurisprudential Foundations of Corporate and Commercial Law*, Cambridge: Cambridge University Press, 118, 118–21.

[14] One could merge the law merchant with these more recent efforts by asserting that the new texts embody the teachings of the law merchant. See, for instance, Klaus Peter Berger (1999), *The Creeping Codification of the Lex Mercatoria*, Kluwer, 1999. Such a linkage, however, seems problematic. Those who drafted the CISG and the UNIDROIT Principles consisted primarily of academics and government officials. There seems to be little reason to posit that this pool of individuals has any great insight into the contracting behavior of actual parties, which is supposed to form the basis of the law merchant.

Thus, whereas the American domestic counterpart of the CISG is Article 2 of the Uniform Commercial Code, the comparative analogy for the UNIDROIT Principles is the Restatement of Contracts.

The analogy, however, is not perfect. No one doubts that there exists a common law of contracts, and the effort of the Restatement is to tease out the general principles that exist in the law as it has developed in 50 separate jurisdictions. In the case of international contract law, however, it is far from clear that such a law exists. Most international contracts are adjudicated by the domestic law of some country. Thus, the UNIDROIT Principles are in some sense an effort to create an international contract law rather then restating one.

1.2 Payment systems

The miasma of text that surrounds contract law is not replicated in the area of payment. The law here is well settled, and is by and large the same in all trading nations. Parties to transnational deals have at least four ways that they can structure the payment terms of the transaction. The buyer can pay in advance, the seller can ship the goods but the buyer can collect them only after it pays, the parties can use a letter of credit or the seller can send the goods and await payment from the buyer.

Of these four mechanism, letters of credit merit special mention in terms of being international in character. They arose in international commerce, tracing their origins to medieval Europe, and remain more closely allied with international transactions rather than domestic ones. The basic structure of the letter of credit transaction is that the buyer procures a letter of credit from her bank in favor of the seller. The credit is an undertaking of the bank to pay the seller when the seller has met the conditions set forth in the letter. These conditions are the supplying of documents specified in the letter. Banks deal in documents; they do not assess actual performance. In a typical sales transaction, the letter may allow the seller to draw upon the credit when the seller presents a bill of lading that reflects the shipment of the specified goods. Since the seller can only procure the bill of lading by shipping the goods, the seller does not receive payment until it has performed. Because the buyer's bank has issued the letter – and presumably made arrangements to ensure that it will be able to recover from her – the seller knows that once he procures the required documents, he can receive payment.[15] The buyer has no opportunity to renege on payment once the letter of credit has been issued.

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[15] On the way in which letters of credit provide bilateral assurances, see Avery Wiener Katz (2000), 'Informality as a Bilateral Assurance Mechanism', *Michigan Law Review*, 98, 2554. On the high rate of providing documents that do not comply strictly with the requirements of the credit and the argument that the procurement of the credit provides information to the seller about the quality of the buyer, see Mann, *infra*, note 42.

To be sure, the seller may not have easy access to the buyer's bank. In this situation, the buyer's bank will enlist the aid of the seller's bank. The buyer's bank will transmit the letter to the seller's bank, and the seller can present the documents at his bank.

The law governing letter of credit transactions is set by the ICC. Unlike UNCITRAL and UNIDROIT, the ICC is a purely private organization. In the case of its text on letters of credit, it was drafted almost exclusively by representatives of large, international banks. Virtually all letter of credit transactions are governed by the ICC rules, which are contained in the Uniform Customs and Practice for Documentary Credits ('UCP'). The letters of credit themselves routinely specify that they are governed by the UCP, and jurisdictions honor such specifications. American banks have exerted tremendous effort to ensure that the letters of credit that they issue are governed by the UCP rather than Article 5 of the UCC. In one well-known example, the state of New York, prior to the recent revision of Article 5 which moved it closer to the UCP, enacted a non-uniform amendment to its version of Article 5 that provided that, in case of a conflict between the UCP and Article 5, the UCP was to control.

1.3 Secured transactions

Contract law and payment mechanisms have had international aspects for some time, with the law merchant and letters of credit dating back centuries. Up until recently, however, the law of secured transactions was wholly domestic in character. Each country would enact its own system of secured credit. For goods that remained in one country, this did not create a problem. However, as technologies have advanced and cross-border interactions increased, so has the amount of personal property that moves freely across jurisdictions. To the extent that this personal property can serve as collateral in a financing arrangement, there is a need to ensure that a creditor who has a security interest in a good in one country can retain that security interest when the good enters a new jurisdiction.

Most problematic in this area are those goods that routinely cross national borders. To address this problem, UNIDROIT has created a convention on mobile goods.[16] The convention contains a protocol on the handling of security interests in airlines – a common type of collateral – and efforts are under way to draft protocols covering other types of mobile collateral. A number of states have signed the convention and the protocol. Neither, however, is yet in

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[16] See Roy Goode (2003), 'The Cape Town Convention on International Interests in Mobile Equipment: A Driving Force for International Asset-Based Financing', *UCC Law Journal*, 36.

force. The convention has received sufficient ratifications to enter into force, but only to the extent that a protocol is in force. As to the only existing protocol, the United States has ratified it, but it currently falls three ratifications short of coming into force.

Along the same lines, but to date even less successful, UNCITRAL has sent out to its member states a convention on receivables. The proponents of the convention assert that its adoption would facilitate securitization transactions. This convention has yet to garner sufficient adoptions to enter into force. The United States has signed, but not ratified, the convention.

1.4 Bankruptcy law

The bankruptcy of a company can have two distinct international aspects. The first is that the enterprise may have creditors that reside in other countries. A company may have borrowed from foreign sources, or committed torts on foreign soil. Regardless of how such debt arose, the foreign creditor would seek compensation in the domestic bankruptcy proceedings. Historically, foreign creditors faced prejudice in domestic bankruptcy proceedings. Today, however, the norm is that most countries accord foreign creditors equal status with domestic ones. While every country has its own priority scheme, they tend to focus on the nature of the debt rather than the citizenship of the creditor.

The more active international problem involving a company's financial distress arises when the enterprise itself has assets in more than one country. Traditionally, the bankruptcy law of each country tended to administer the assets found within that country's borders. This so-called territorial approach has been criticized for over 100 years. Recent international efforts have focused on drafting a text that would allow the bankruptcy courts of all countries that find some of the debtor's assets within their borders to cooperate with each other when a multinational business becomes financially distressed. In particular, UNCITRAL has proposed a model insolvency law, the primary purpose of which is that it affords primacy to the debtor's 'home country'. The United States, in 2005, added Chapter 15 to its bankruptcy law, which is based on the UNCITRAL proposal.

2. The economic analysis of international commercial law

2.1. Contract law

The basic terms of commercial transactions are regulated by contract law. Contract law, both in its domestic and international incarnations, is not a unified whole in that one set of rules governs all contracts. Transactions involving the sales of goods have been singled out for special treatment. In the United States, sales are governed by Article 2 of the Uniform Commercial

Code.[17] Internationally, the United Nations, through UNCITRAL, has promulgated the United Nations Convention on Contracts for the International Sales of Goods (CISG). By its terms, the CISG applies whenever the contracting parties have places of business in countries that have adopted the CISG, or when the contracting parties have businesses in different countries and international choice of law rules point to a country that has signed the CISG.[18]

The parties, however, have the ability to contract out of the CISG by specifying that the law of another jurisdiction should apply. To this extent, the CISG is similar to the domestic contract law of most nations, which allow parties to specify which law will resolve subsequent disputes. Thus, when the CISG is applicable, it provides an additional choice to the menu that the parties can choose from, in addition to the various domestic laws. To date, 63 countries have adopted the CISG. Parties from these countries are involved in a significant portion of, but by no means all, cross-border transactions.

Despite the fact that the CISG is not universally adopted, it is universally available. Even countries that have not adopted the CISG can still take advantage of its provisions. All they have to do is agree that any future disputes will be resolved via arbitration and provide that the arbitrator shall use the CISG as the governing law.

The CISG is not the only source that contract drafters can repair to in addition to domestic law. International commercial transactions not involving goods will tend to involve services. For example, an American corporation may contract with an Indian corporation to provide customer support. (The other major category of contract law – contracts for the sale of real estate – is, for obvious reasons – governed by local law). These contracts are governed by the common law in the United States. Much of this common law can be found in the Restatement of Contracts 2d, which is promulgated by a nongovernmental organization, the American Law Institute.

Internationally, such contracts are potentially governed by the UNIDROIT Principles.[19] According to the drafters, 'the objective of the UNIDROIT

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[17] For a history of the drafting of the UCC, see Allen R. Kamp (1998), 'Uptown Act: A History of the Uniform Commercial Code: 1940–49', *SMU Law Reivew*, 51, 275; Allen R. Kamp (2001), 'Downtown Code: A History of the Uniform Commercial Code 1949–54', *Buffalo Law Review*, 49, 359. On the recent attempts to update Art. 2, see Robert E. Scott (2001), 'Is Article 2 the Best We Can Do?', *Hastings Law Journal*, 52, 677.

[18] Countries, when adopting the CISG, have the ability to opt out of this second basis for applying the CISG. See Art. 95. While only a small number of countries have exercised this option, they include the United States and China (Gillette and Walt, *infra*, note 28).

[19] For a copy of these principles, their drafting history, and their reception, see Michael Joachim Bonell (1997), *An International Restatement of Contract Law: The*

Principles is to establish a neutral and balanced set of rules designed for use throughout the world irrespective of the legal traditions and the economic and political conditions of the countries in which they are to be applied'. Much like the American Restatements of Law, the UNIDROIT Principles are not the direct product of a government. Rather, UNIDROIT is the International Institute for the Unification of Private Law. It is an international organization, originally organized under the League of Nations, which consists of representatives sent by member countries. The Principles themselves were crafted by academics from a variety of countries.[20] Unlike domestic contract law, however, the UNIDROIT Principles are not self-executing. They do not apply to any transaction unless the parties or the adjudicator affirmatively reach out and select them.

There is one final potential source of contract law. When parties within a given industry contract with each other, they may agree to have their disputes adjudicated by rules put forth by a trade association. For example, Bernstein reports that most international sales of cotton are governed by the rules that the Liverpool Cotton Association has established.[21] The extent to which other industries have also provided private rules of conduct is an open empirical question.

We thus have two major efforts – one treaty based and hence binding on all covered parties, one more of an attempt to spur the development of a new law merchant – to create international contract law that stands apart from any domestic law. It is far from obvious that such efforts are welfare enhancing. These efforts obviously entail a cost. Resources have been spent over the years producing the CISG and the UNIDROIT Principles. Resources have also been consumed in encouraging states to adopt the CISG, in informing parties as to the existence of the two texts and in encouraging parties to adopt the UNIDROIT Principles as the grounds for decisions. Lawyers have had to spend time learning the provisions of these new instruments. Indeed, in American law schools more and more contracts classes include the CISG within their ambit.

Also, there may be some gravitational pull toward the use of the CISG and the UNIDROIT Principles. The CISG is the default rule for many transactions; the UNIDROIT Principles could also achieve such a status. Empirical research

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UNIDROIT Principles of International Commercial Contracts, New York: Transnational Publishers, 1997.

[20] See E. Allan Farnsworth (1997), 'An International Restatement: The UNIDROIT Principles of International Commercial Contracts', *University of Baltimore Law Review*, 26, 1, 2.

[21] See Lisa Bernstein (2001), 'Private Commercial Law in the Cotton Industry: Creating Cooperation through Rules, Norms, and Institutions', *Michigan Law Review*, 99, 1724, 1724–5.

suggests that there tends to be some stickiness to default rules. Some parties may choose the economizing strategy of just sticking with the default rules.[22]

Finally, at least in the case of the CISG, there is the cost of confusion. It may well be the case that parties in two countries that have signed the CISG have contracted with each other, oblivious of the fact that their subsequent dispute would be adjudicated under the terms of the CISG. As transaction costs decrease, one would expect that smaller and smaller companies will engage in transnational sales with each other. As the size of a transaction decreases, one would also expect that there would be less investment in legal advice surrounding the sale. Thus, one would expect the number of parties that unwittingly end up having their dispute adjudicated under the provisions of the CISG to increase. Adding choices to the extant menu of legal regimes is not free.

Of course, one must not overstate the matter. The cost of contracting caps the cost of any legal rule. Parties that do not wish to bother themselves with the details of the CISG can easily avoid its application through the adroit use of choice of law clauses.[23] The opportunity costs of the drafters of the CISG – by and large academics and government officials – may be quite low. The market may produce standard forms that ensure that even the smallest transactions are governed by a law that, on an *ex ante* basis, increases the value of the transaction.

Still, even if the costs imposed by adding the CISG and the UNIDROIT Principles are relatively slight, it is far from clear that these costs are outweighed by compensating benefits. Parties to international commercial transactions already have a variety of existing domestic laws from which to select. Under standard conflict of laws principles, parties are free to choose the law of any jurisdiction that has some relationship to the transaction. Moreover, there is some trend toward allowing parties to choose any law they see fit, regardless of whether the transaction at issue touches the state whose law is selected.[24] Such is certainly the case when the parties agree to resolve future disputes via arbitration. It is thus the case that parties, even absent the CISG

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[22] See Russell Korobkin (1998), 'The Status Quo Bias and Contract Default Rules', *Cornell Law Review*, 83, 608. See also Clayton and Scott, *supra*, note 6, at 60 (noting possible stickiness of CISG).

[23] If the transaction is entered into with the buyer and the seller sending competing forms, however, a party may not be able to ensure that it will not find itself subject to the CISG. As noted, the CISG is the default rule for some transactions, and under the CISG it is not the case that a party can always ensure that its form, and hence its choice of law clause, will control.

[24] For example, the European Community Convention on the Law Applicable to Contractual Obligations allows the parties to select 'any law' to govern their contract.

and the UNIDROIT Principles, will have a menu of laws to choose from, with a minimum of two choices and the possibility of many more.

The potential benefit of adding another choice to the menu is even smaller once one remembers that the contract law of most countries allows parties to tailor their provisions to suit their own needs. Thus, for a new choice to add value to contracting parites, it must be the case that it reduces the costs of tailoring a contract in a significant number of cases. To do this, one of two things has to be true. First, the new law would add value if it had better default rules. If there were some reason to believe that the new international efforts produced terms that were the optimal terms for more parties than were the terms of the available domestic law, fewer resources would be spent on contracting out of the defaults.

A second way in which the CISG or the UNIDROIT Principles could increase social welfare is by making it easier to contract out of the defaults and into the decision rule that the parties desire. Efficiency increases when parties have to spend less on ensuring that adjudicators understand that they have provided for something other than the default rule.

It is an open question as to whether either of these two benefits exists with respect to the CISG and the UNIDROIT Principles. Indeed, Gillette and Scott argue vigorously that the CISG does not meet these criteria. As to the substance of the CISG, Gillette and Scott find it replete with vague standards that offer no improvement over other law. The reason for this lack of specificity stems from the process by which the CISG was drafted. It was drafted by a working committee of academics and government officials from countries with disparate contracting regimes. Moreover, the drafting committee worked by consensus. Both the expected and actual result of this process, according to Gillette and Scott, is that differences among the committee members would be papered over by vague language rather than resolved definitively. Moreover, Gillette and Scott conclude that there may be some difficulty in contracting out of the CISG's provisions.

The drafting process for the UNIDROIT Principles is similar to that of the CISG. They were drafted by a working group of academics from different countries who strove for consensus. It is thus not surprising that the Principles operate at a high level of abstraction, thus allowing representatives for each country to view the Principles as consistent with their own legal traditions.

In short, the products produced by the international efforts to date do not improve the content of the various domestic laws from which contracting parties can choose. Indeed, it is likely that, over time, the quality of both the CISG and the UNIDROIT Principles will, to the extent that they are used, decrease.

The domestic contract law of each country has a longer pedigree than do either the CISG or the UNIDROIT Principles. There have been numerous cases interpreting their provisions. In short, it has an installed interpretative

base. Contrast this with the CISG. First, there is not even a single definitive text; the CISG has official versions in six languages; the UNIDROIT Principles can be found in even more languages. Second, the case law interpreting the CISG and the UNIDROIT Principles will be sparse when compared with domestic law. There are many more domestic transactions than there are transnational ones. Moreover, few transnational deals are resolved by either the CISG or the UNIDROIT Principles. It is thus easier for contracting parties to predict how an adjudicator would apply domestic law as compared with its international competitors. To the extent that the newness of the CISG creates uncertainty, the parties may opt for some domestic law and tailor it as necessary.

Of course, the fact that there is an incentive to select a body of law with a deep interpretive base does not mean that that law is efficient. The problem is one of network externalities. The value of the law turns in part on the existing number of users. While it can be the case that parties gravitate to the most efficient terms, it can also be true that there is a 'lock-in' to a set of rules that is less than optimal. Yet, as suggested above, neither the CISG nor the UNIDROIT Principles seem to provide an efficient set of contract doctrine.

Another cost that attends contract law that is set forth in an international document is that, over the long run, it is unclear whether that law can remain uniform. To the extent that parties litigate disputes under either the CISG or the UNIDROIT Principles, these disputes will be heard by a variety of institutions. Most cases will be decided by arbitration, others by the domestic courts of various countries. Some arbitration decisions will be published; most will not be. These disparate decision makers will inevitably speak different languages and come from different domestic law traditions. They will undoubtedly reach different results. This is especially true given the high level of abstraction that both the CISG and the UNIDROIT Principles contain. Domestic legal systems have mechanisms that are designed to keep interpretive divergences to a minimum. Each jurisdiction that issues contract law has a highest body whose rulings are determinative. Moreover, in the case of Article 2 of the UCC, the Permanent Editorial Board offers commentaries designed to retain the uniform character of Article 2 across the 50 American states. There is no such mechanism for either the CISG or the UNIDROIT Principles. Thus, one would expect that over time there will, in essence, be multiple versions of these documents.

Defenders of the project of creating international contract law have touted as a benefit that it would provide a 'neutral' law for the parties to agree upon. This benefit, however, is suspect. The assumption is that the domestic law of either of the parties would somehow provide an advantage to the home party. It is difficult to see why this would be the case. To be sure, one may conclude that a domestic forum would be tilted in favor of its citizens. The decision

maker – be it a judge or a jury – may more readily sympathize with the plight of its fellow citizen. Such concerns, however, can be ameliorated by providing that any subsequent dispute will be settled by arbitration. Indeed, the arbitration literature reports that the most important factor as to why parties opt for arbitration is to ensure that the dispute will be resolved by a neutral third party.

Once the parties have arranged for a neutral decision maker, however, it is not clear that an international contract law increases the lack of bias. When we look at the substantive content of contract law, it is difficult to see how domestic law can be systematically skewed to favor citizens over foreigners. Commercial transactions by and large consist of a buyer and seller. Even if one could draft contract law that favored one group over another – and given the ability to contract out of most default rules it is far from clear that such an attempt would be effective – a country faces two problems. First, the primary consumers of its law are going to be its domestic citizens. It is unclear why these groups would endorse a law that attempted to favor buyers over sellers or sellers over buyers. This is especially true if the law is limited in its scope to businesses – which both buy and sell – with consumer protection handled elsewhere.

Second, it is unclear that a country could identify, *ex ante*, whether in international commercial transactions its businesses are more likely to be buyers or sellers. Given that it is thus difficult if not impossible to systematically favor domestic interests via contract law, it is unlikely that commercial parties will have a preference for contract law that purports to be international over domestic contract law.

The economic case for the trend toward international contract law is thus uneasy at best. The mere existence of these efforts, however, is not evidence of their efficiency. One can easily posit reasons as to why the CISG and UNIDROIT Principles may exist even if they do not promote efficiency. Those involved in creating these instruments may get rents from their efforts. Government officials and academics may well enjoy being part of an international working group. Moreover, to the extent that one wants to be an arbitrator in future cases, something over which there is substantial competition, being part of a drafting effort may burnish one's reputation.

The empirical data we have suggest that, in fact, parties do not view either the CISG or the UNIDROIT Principles as superior to domestic law. Drahozal provides data for 2280 cases that went to arbitration under the auspices of the ICC between 2001 and 2003.[25] Of these, seven provided for application of the CISG, one directed the arbitrator to the UNIDROIT Principles, and a small number of others invoked general principles of international contract law. *In*

[25] Drahozal, *supra,* note 8, at 537–40.

toto, less than 2 per cent of the contracts called for the application of nondomestic law. More than three-fourths specified a particular domestic law to be applied, and the rest, roughly 20 per cent, did not specify which law should govern the dispute. Of 15 joint venture contracts that Drahozal located in a different database that provided for arbitration, four mandated the application of international legal practices.[26]

While the data gathered so far are suggestive, they are by no means conclusive. Still, if additional work confirms the patterns found by Drahozal, it would be strong evidence that the parties have yet to conclude that the CISG and the UNIDROIT Principles offer a value-enhancing alternative to the domestic laws from which they could select.

While the available data offer some indication that parties do not have a taste for international commercial law, they do not provide any insight into which domestic law parties tend to adopt. One can imagine a number of possibilities. The parties may tend to select the law of the home country of one of the parties. In selecting between the two, there may be a rough ordering among countries. For example, it may be the case that when one party is from England, English law is always selected.

A second possibility would be that the parties tend to eschew the law from the country of either of them. In other words, they may tend to select the law of a third country. Again, there may be patterns as to which country's law parties tend to select.

A third distinct pattern would be that parties would simply select what they view as the best law, regardless of whether any party to the transaction hales from that country. Perhaps New York supplies the best contract law, and most contracts embrace it.

A final pattern would be one where parties select a country's law based on the type of transaction involved. For example, parties involved in a sale of goods could gravitate toward one country's law, while parties to contracts that are not sales of goods gravitate toward another country's law.

A related open question is whether, as cross-border transactions increase, jurisdictions will engage in competition in order to attract users of both their forums and their laws. Competition here could take one of two forms. The first would be to create a reputation for treating all parties equally. As mentioned above, roughly 90 per cent of transnational commercial contracts call for arbitration, and the main reason for this selection is the desire to avoid a biased

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[26] See id. at 540–41. All four contracts were between American and Chinese businesses, and they only called for application of general international principles if the law of China was silent on the matter in question. Otherwise, the law of China was to control. See id. at 541.

forum. A state that created a reputation for courts that were scrupulously even-handed might be able to capture some of this business.

Jurisdictions could also compete over the quality of their contract law. In terms of promoting better forums and better law, the interest that would benefit the most, and hence have an incentive to lobby for such actions, would be the local lawyers. In terms of a demand for better law, perhaps the more a jurisdiction's law becomes used, the more work there is for its lawyers in consulting on the drafting of contracts. If so, these lawyers would have an incentive to lobby for laws that would be more favorable to contracting parties.

To be sure, there may not be much room for competition on this dimension. The contracting parties always have an easy way out. They can simply provide the terms they want in the contract. Rather than scouring the world for the best set of default rules, it may be cheaper for a business to draft a contract that provides the set of terms that will optimize the transaction rather than selecting among the various alternatives provided by the respective states. All it needs to do is to find a jurisdiction that allows it sufficient freedom in crafting contract terms. Once a party identifies such a jurisdiction, it may be the case that it will not monitor the changes in the law of other jurisdictions. The costs of search may outweigh any benefits that the party would capture from a better set of default rules. It is far from clear that, at the margin, investing in better legislation would be a profitable strategy for either business groups or business lawyers.

On the other hand, it may make sense for some states to invest in providing a better forum to resolve disputes. Whereas parties are by and large free to tailor contracts to meet their needs, they cannot alter the expertise and speed of the various forums in which any subsequent disputes will be adjudicated. Arbitration, while having its benefits, also has its costs. Moreover, local lawyers benefit from having an attractive forum. When a dispute arises, regardless of where the parties are located, they will more than likely engage local counsel. Such counsel can provide insight into the operation of the chosen forum, and they can serve as a conduit for transmitting documents and materials to the court. They thus have an incentive to increase the attractiveness of their forums. The same is true for judges. To the extent that they have a taste for international commercial disputes, they have an incentive to create a hospitable venue.[27]

Of course, one cannot relentlessly divorce forum and law. While one can

[27] For an example of this dynamic in the domestic context, see Robert K. Rasmussen and Randall S. Thomas (2000), 'Timing Matters: Promoting Forum Shopping by Insolvent Corporations', *Northwestern Law Review*, 94, 1357.

find an arbitrator to apply any given law, if lawyers want their forum to be selected, they will have some incentive to ensure that the substantive law is attractive to the parties. One would not select a New York court to resolve a dispute, but then instruct that court to apply Japanese law.

Thus, it may be the case that we will see in the future competition among jurisdictions. We in fact do see some movement in this direction. New York has enacted legislation that offers its courts and its laws to all parties, regardless of whether the deal has any connection with that state.[28]

Given the federal nature of the United States, this could be an attempt to garner use by wholly American parties residing outside of New York, or it could be an effort to become a center for resolving international commercial disputes. No research to date has reported as to whether this effort has garnered additional business for New York courts and lawyers.

Of course, even if some jurisdictions endeavored to make their forums more attractive to foreign parties, one would not expect the arbitration associations and the arbitrators to stand still. They get the lion's share of the dispute resolution business, and will, no doubt, take necessary steps to safe-guard their prerogatives. Indeed, if states view the arbitrators as more nimble in any competition than they are, if they decide that there is a lock-in effect, or if there simply is not enough money on the table, they may not get into the competition in the first instance.

Before looking at a few of the notable substantive divergences between American contract law and its international brethren, one should first pause to note the similarities. The cost of any legal rule is capped by the cost of contracting around it. By and large, all of the contenders – the domestic laws of most countries (including the United States), the CISG, the UNIDROIT Principles – embrace the tenet of party autonomy.[29] Choice of law and choice of forum clauses are almost universally respected. To the extent that no governing law provides the appropriate set of default rules, the parties can select the law of a jurisdiction that provides for easy opting-out. In other words, while there are differences between the various laws that may apply to an international commercial contract, one should be careful not to overstate either the magnitude or the importance of these differences.

A detailed comparison of Article 2 of the UCC and the CISG can be found

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[28] See NY General Obligation Laws § 5–1401 (2001).

[29] See, for example, UNIDROIT Art 1.1 ('The parties are free to enter into a contract and to determine its content.'); Art 1.5 ('The parties may exclude the application of these Principles or derogate from or vary the effect of any of their provisions, except as otherwise provided in the Principles').

in Gillette and Walt.[30] By and large, the UNIDROIT Principles follow the lead of the CISG.[31] Some of the more important differences include the following. Article 2 resolves the so-called 'battle of the forms' problem (the buyer and the seller each send a form that agrees on the basic terms but differ on other terms that the parties have not expressly bargained over) by having conflicting terms cancel out and applying the UCC terms that cover the issue in question.[32] Under the CISG, however, timing matters. If the second form contains terms that differ from the first, and the parties perform the deal, the terms of the second form control. This is basically the 'last shot' rule that applied at American common law prior to the adoption of Article 2. The UNIDROIT Principles follow the CISG on this score.[33]

This difference presents an opportunity to provide some fresh evidence on the battle of the forms debate. Keating argues that his research shows that many companies contracting under Article 2 often structure their arrangements so as to avoid the problem of battling forms.[34] Baird and Weisberg argue that parties would prefer the last-shot rule.[35] If one could locate sufficient companies that are subject to the UCC in its domestic contracts and the CISG in its international contracts, it may be possible to ascertain whether the company acts differently based on which set of rules applies. For example, if a party structures its transactions to avoid the battle of the forms problem in its domestic transactions, but is willing to live with the CISG's handling of conflicting forms, this would be some evidence that the CISG's approach is the more efficient of the two.

Another area of divergence between Article 2 and the CISG is the parole evidence rule. The parole evidence rule delineates what evidence can be introduced at trial to establish the terms of a contract. At common law, if the contract was complete on its face, no supplemental terms could be added.

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[30] See Clayton P. Gillette and Steven D. Walt (1999), *Sales Law: Domestic and International*, New York: Foundation Press 1999.

[31] Joseph M. Perillo (1994), 'UNIDROIT Principles of International Commercial Contracts: The Black Letter Text and a Review', *Fordham Law Review*, 43, 281.

[32] The literature on this provision is voluminous. For an introduction to this literature and a description of how businesses handle this problem in practice, see Daniel Keating (2000), 'Exploring the Battle of the Forms in Action', *Michigan Law Review*, 98, 2678.

[33] See Art. 2.11

[34] See Keating, *supra*, note 32, at 2696–7 (reporting that half of the businesses in his sample have adopted contracting practices designed to avoid the battle-of-the-forms problem).

[35] See Douglas G. Baird and Robert Weisberg (1982), 'Rules, Standards, and the Battle of the Forms: A Reassessment of § 2-207', *Virginia Law Review*, 68, 1217.

Article 2 contains a parole evidence rule that is less strict than the traditional common law rule.[36] For cases litigated under the UCC, the parties can always introduce course of dealing, trade usage or course of performance and, unless the written contract so forbids, evidence of additional terms that do not contradict those in the writing.[37] While the interpretation of the CISG on this matter is open to debate, most read the treaty as being even more expansive than Article 2. Under this reading, there is no limit on the evidence that can be introduced to aid the decision maker in ascertaining the terms of the deal.

The parole evidence rule is notable in that it is one substantive area of contract law where one can find economic arguments that the rule in international transactions should be different than the one that applies to domestic transactions. Domestic scholars have argued over whether, from an *ex ante* perspective, the UCC's blessing of the use of custom when interpreting contracts is efficient, with much of the economically inspired work arguing against the widespread use of custom as an interpretative tool.[38]

Both Clayton Gillette and Avery Katz have argued that there are additional reasons to allow the introduction of custom when interpreting transnational contracts as opposed to purely domestic ones. Gillette endorses the CISG's use of custom on the grounds that courts have been restrained in that they only find customs in two situations, both of which have low probability for error. The first is when the custom at issue is promulgated and publicized by an international trade organization. Such an observable and verifiable source makes it unlikely that the adjudicator would erroneously find a custom where none exists. The second is predicated on customs that are easy to verify whether or not they have been complied with. For Gillette, this selective use of custom makes it more likely that the adjudicator will invoke custom in a way that reduces the parties' contracting costs.

Katz, while agreeing with Gillette that dispute resolution under the CISG is right to invoke custom, points to four other factors: the ability of parties to select the applicable law and choice of forum in international transactions (so

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36 See Schwartz and Scott, *supra,* note 5.

37 UCC 2-202.

38 See Charles J. Goetz and Robert E. Scott (1985), 'The Limits of Expanded Choice: An Analysis of the Interactions between Express and Implied Contract Terms', California Law Review, 73, 261; Jody S. Kraus and Steven D. Walt (2000), 'In Defense of the Incorporation Strategy', in Kraus and Walt, *supra*, note 13; Lisa Bernstein (1999), 'The Questionable Empirical Basis of Article 2's Incorporation Strategy: A Preliminary Study', *University of Chicago Law Review*, 66, 710; Richard A. Epstein (1999), 'Confusion about Custom: Disentangling Informal Custom from Standard Contractual Provisions', *University of Chicago Law Review*, 66, 821; Robert E. Scott (2000), 'The Case for Formalism in Relational Contract', *Northwest University Law Review*, 94, 847.

that parties that do not want to be stuck with one regime can easily contract for another), the ability to select procedural regimes that are less costly than the domestic US regime (parties that desire the use of custom can select regimes that are more adept at discerning them than are general US courts), the extensive use of letters of credit as the payment mechanism in international transactions (it provides an alternate enforcement mechanism which is highly formalistic in nature), and the fact that international litigation has a higher fixed cost than does domestic litigation (which makes it more likely that parties will spend resources on the marginal cost of proving the nature of the governing trade usage). In sum, the benefit that Katz finds with the CISG is that it provides the contracting parties with the option to opt into a legal regime that has a parole evidence rule that may fit the needs of some cross-border transactions.

The extent to which remedies upon breach differ between American law on the one hand and the CISG on the other is another area that warrants brief mention. The debate in the law and economics literature over whether specific performance should be routinely available has been quite robust.[39] The CISG, at least on first reading, broadly embraces specific performance. There is, however, a twist. Article 28 provides that 'a court is not bound to enter a judgment for specific performance unless the court would do so under its own law in respect of similar contracts of sale not governed by this Convention'. While the conventional wisdom is that specific performance is not routinely available under the UCC, Gillette and Walt argue that in looking for 'similar' contracts, one has to take into account the often geographic distance between the parties in the international context. They assert that such distance in a domestic setting could well lead a court to order specific performance.[40] It remains to be seen whether or not courts will follow this interpretation.

2.2. *Payment mechanisms*

Ensuring the transfer of money from buyer to seller has been a distinctive part of international commercial transactions for centuries. Letters of credit, commonly used in international sales of goods transactions, trace their origins back to medieval Europe.[41] In situations where legal remedies against a breaching party are either uncertain or prohibitively expensive, the payment

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[39] For an introduction to the literature, see Thomas S. Ulen (1998), 'Specific Performance', in Peter Newman (ed), *The New Palgrave Dictionary of Economics and The Law*, Stockton Press, 481.

[40] See Gillette and Walt, *supra* note 30, at 338–42.

[41] For a brief history, see Boris Kozolchyk (1965), 'The Legal Nature of the Irrevocable Commercial Letter of Credit', *American Journal of Comparative Law*, 14, 395, 395–400.

mechanism can provide sufficient assurances to both parties to induce them to enter into the trade.

There are basically four ways parties can structure the payment aspect of a transaction. At one extreme is prepayment, where the buyer pays the seller before the seller begins its performance. At the other extreme is shipping on open account. Here, the seller completes its performance before the buyer sends payment. In these two types of payment structure, one side is protected against opportunism – it is assured of the other side's performance before it has to begin its own – but the other side exposes itself to such risks – it has tendered its obligations and needs to await performance by the other side. To the extent that performance is not forthcoming, the disappointed party is left with the unappealing remedy of bringing suit against the foreign party, often in a foreign jurisdiction.[42]

Two other types of payment structure, both commonly employed in cross-border contracts, lessen the asymmetry of the risk of opportunism. These are the collection transaction and the letter of credit transaction. In a collection transaction, the seller ships the goods prior to payment, but does not grant the buyer unfettered access to the goods. Rather, the seller at the time of shipment procures a bill of lading or a similar type of document. The bill of lading embodies the right to the goods. The seller then prepares a draft drawn on the buyer. The draft and the bill of lading are then sent through banking channels to the buyer. The buyer must pay the draft in order to procure the bill of lading.[43]

The buyer is thus assured that it will receive the goods. This reduces the risk that the buyer faces, but does not eliminate it. The buyer will receive the goods that the seller shipped, but the goods themselves may not be up to snuff. To the extent that the goods are not what the seller promised, the buyer has to seek recourse against the seller.

The collection transaction also reduces the risk to the seller. It ensures that the buyer has to tender its performance in order to obtain the goods. To be sure, the seller retains the risk that the buyer will decide to back out of the transaction.[44] The magnitude of this risk, however, turns on the nature of the

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[42] Mann reports that one banker whom he interviewed offered two sets of figures regarding the use of various payment mechanisms. One data set indicated that 72 per cent of transactions are down on open account, and 2 per cent by prepayment; a second put the figures at 52 per cent and 12 per cent respectively. See Ronald J. Mann (2000), 'The Role of Letters of Credit in Payment Transactions', *Michigan Law Review*, 98, 2494, 2518 note 78 .

[43] Mann reports that although a standardized text for enforcing documentary drafts has yet to emerge, all major trading countries enforce the basic mechanics of this transaction. See Mann, *supra* note 42, at 454.

[44] In a sample of 100 collection transactions, Mann reports a failure-to-pay rate of 12 per cent. See *id.* at 2518 note 75.

market for the goods in question. To the extent that the goods end up in a market where they can be resold quickly, the cost to the seller of the buyer's failure to pay is reduced. The seller's loss is limited to the difference between what the buyer promised to pay and what the goods are actually sold for, net of the costs of arranging the sale.

Letters of credit offer additional protections to the seller, without increasing the risk to the buyer. The basic structure of the letter of credit transaction is that the buyer procures a letter of credit from its bank in favor of the seller. The credit is an undertaking of the bank to pay the seller when the seller has met the conditions set forth in the letter. In a typical sales transaction, the letter may allow the seller to draw upon the credit when the seller presents a bill of lading that reflects the shipment of the specified goods. Since the seller can only procure the bill of lading by shipping the goods, the seller does not receive the benefit of the buyer's performance until it has performed. To this extent, the letter of credit is similar to the collection transaction. Yet there is more. Because the buyer's bank has issued the letter – and presumably made arrangements to ensure that it will be able to recover from her – the seller knows that once he procures the required documents, he can receive payment.[45] The seller thus does not risk the buyer deciding to not go through with the transaction after the goods have been shipped.

To be sure, the seller may not have easy access to the buyer's bank. In this situation, the buyer's bank will enlist the aid of the seller's bank. The buyer's bank will transmit the letter to the seller's bank, and the seller can present the documents at his bank.

The standard economic explanation for the letter of credit is that it assures the seller of payment. The seller knows that if it produces the documents required by the letter of credit, it will be paid. Once the seller ships the goods, it will not be beholden to the good will of the buyer.[46] Recent empirical work, however, has questioned this conventional account. In particular, it has focused on the assurances of payment that sellers have once they send the goods. The traditional account rests on the ability of sellers to submit documents that provide them with an iron-clad right to payment. It implies that sellers, in order to prevent buyer opportunism, routinely present documents that strictly comply with the terms of the letter of credit.

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[45] On the way in which letters of credit provide bilateral assurances, see Avery Wiener Katz (2000), 'Informality as a Bilateral Assurance Mechanism', *Michigan Law Review*, 98, 2554. On the high rate of providing documents that do not comply strictly with the requirements of the credit and the argument that the procurement of the credit provides information to the seller about the quality of the buyer, see Mann, *supra,* note 42.

[46] See Mann, *supra* note 42, at 215–24; Clayton P. Gillette *et al.*, (1996), 'Payment Systems and Credit Instruments', 560–61.

However, in fact, sellers drawing on letters of credit often submit documents that do not comply with the credit terms. When a bank receives a draw on a letter of credit that does not strictly comply with the letter's terms, it asks the applicant – the buyer – whether it will waive the defects. In practice, buyers routinely consent to the bank paying on the letter of credit. In looking at 500 letter-of-credit transactions, Mann finds a compliance rate of only 27 per cent.[47]

Responding to these empirical results, Mann offers an alternative explanation as to how letters of credit reduce the performance risks inherent in a cross-border sale of goods. He argues that the bank's decision to issue a letter of credit is itself a verification that the buyer will pay for the goods. Banks do not want to develop a reputation for not honoring letters of credit. Hence, they will tend to issue letters of credit to buyers whom they believe will not attempt to opportunistically fail to waive discrepancies.[48] In addition, in some settings, the letter of credit verifies the fact that there is a legitimate transaction.

Katz, while agreeing that the traditional account cannot be squared with the level of non-conforming documents that Mann observes, offers a different explanation.[49] Katz begins with the bilateral nature of the risks involved in the cross-border commercial transaction. The seller is worried about the buyer's willingness to pay and the buyer is worried about the seller's willingness to ship. Both parties have observable but not verifiable information that the other is likely to perform, though neither relishes the prospect of tracking down the other in a foreign jurisdiction should the need arise. When the seller prepares documents, even ones that do not strictly comply with the terms of the credit, this is observable and verifiable information that the seller has in fact performed its side of the bargain. The issuing bank in this situation makes sure that the buyer does not opportunistically insist that the bank dishonor the letter. Whereas Mann posits that the informational role of the letter takes place when the bank decides to issue the letter, for Katz the key role of the bank is monitoring its customer after the seller has attempted to draw on the letter. Indeed, the stories are compatible in that both trade-off on the ability of the issuing bank to monitor and police its customer. They only differ on whether the bank performs this function when the letter of credit is issued or after the seller has attempted to draw on it.

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[47] See Mann, *supra*, note 42, at 2502.

[48] Gillette questions Mann's account. He argues that letters of credit would serve as poor signals of the quality of the buyer, and that sellers would have no mechanism to discipline banks that allow their customers to stand on technicalities in order to prevent payment on a letter of credit. See Clayton P. Gillette (2000), 'Letters of Credit as Signals', *Michigan Law Review*, 98, 2537.

[49] Avery Wiener Katz (2000), 'Informality as a Bilateral Assurance Mechanism', *Michigan Law Review*, 98, 2554.

The law governing letters of credit is essentially private in origin. The International Chamber of Commerce has put forth the Uniform Customs and Practice for Documentary Credits. Article 5 of the UCC also governs letters of credit.[50] The most recent revision of Article 5 was undertaken with the express purpose of bringing American law into alignment with the UCP. Also, New York law expressly makes the UCC inapplicable when the letter is governed by the UCP.

As with the CISG and the UNIDROIT Principles, one area for future research would be the political economy of the ICC. The success of the ICC in the letter of credit area is extraordinary. No other international commercial law has been so widely adopted. What explains the success of the UCP?

One attribute that may explain the success is the composition of the ICC. Unlike UNCITRAL and UNIDROIT, it is not staffed with members selected by national governments. Rather, it is manned by executives of the businesses that comprise the membership of the ICC. As an initial matter, one would expect that those involved in ICC drafting projects will have more familiarity with actual commercial practices than would those who labor on the UNCITRAL and UNIDROIT projects.

The widespread adoption of the UCP may also relate to the nature of the letter of credit transaction. Large, money-center banks, a well-defined interest group capable of coordinated action, charge for their services in issuing letters of credit.[51] To minimize their costs, they may insist on playing by a single set of rules. Moreover, they may be able to capture the ICC drafting process.[52] On this story, they would use the ICC to promulgate rules that favor their interests, and then insist that the letters that they issue be governed by those rules.

Of course, even if banks dominate the process, it is far from clear that the rules that they draft could systematically transfer wealth to them from their clients. To be sure, the UCP limits the liability of banks and sets clear bound-

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[50] On the most recent redrafting of Art. 5, see James J. White (1995), 'The Impact of Internationalization of Transnational Commercial Law: The Influence of International Practice on the Revision of Article 5 of the UCC', *Northwestern Journal of International Law and Business*, 189, 190. ('The UCP had an enormous influence on the revision of Article 5. Nothing else . . . had anything like the influence the UCP had. In fact, the UCP may have had a greater influence on the redraft of Article 5 than existing Article 5 of the UCC'.)

[51] Mann reports that the typical fee for a letter of credit transaction is 0.25 per cent of the amount of the letter. Mann, *supra*, note 42, at 2499.

[52] See Stephan, *supra* note 6, at 781. While Stephan asserts that banks dominate the ICC drafting process, he offers no theory as to how they are able to do so. The ICC, after all, is composed primarily of business interests. If the rules of the banks impose costs on the companies that use letters of credit, one would think that there would be some effort to place business representatives on the ICC drafting committee.

aries on their obligations.[53] Yet the law is not the only mechanism that polices bank behavior. Anecdotal evidence suggests that reputation plays a large role in the letter of credit market. Banks cultivate a reputation of honoring the letters of credit that they issue.[54] To the extent that the need to maintain a reputation provides adequate incentives for banks to fulfill the role that they play in letter of credit transactions, one would not expect there to be extensive legal liability as well.

2.3. Secured transactions

Credit is an essential element in all commercial transactions. At times, credit will be sought in order to purchase specific goods; at other times, a debtor may borrow money to assist it in its general obligations. Regardless of the reason for the debtor's desire for credit, it will often be the case that the borrower will pledge collateral to back up the loan. The loan itself is memorialized in a contract, which is interpreted under the applicable contract law. The subject of this subheading is the law that regulates the lender's ability to ensure that it has priority to the collateral that the debtor has pledged.

At the outset, it is important to note that choice of law clauses play no role when it comes to the granting of collateral. The essential element of modern asset-pledging systems is a recordation system. Third parties can quickly ascertain where they should look to ascertain whether the debtor has already granted someone a priority interest in its assets. It is thus clear that there needs to be a mandatory law specifying which jurisdiction's law will cover the pledge of the collateral.

To the extent that the borrower pledges real estate to stand behind its repayment obligation, that pledge will be governed by local law. To be sure, while one could imagine a uniform solution, local lawyers have reasons not to see it happen. They get rents from ensuring that they have to be consulted on any transfer involving real estate. Moreover, it is far from clear that there would be significant gains should real estate law be harmonized across countries.

As to personal property, historically countries differed significantly in terms of both whether they had a functioning law of secured credit and, for those that did, how those systems operated. Recently, there have been attempts to bring some degree of harmonization to the law of secured credit. Part of the movement is simply to increase the number of countries that have a system of secured credit. UNCITRAL is currently in the process of drafting a legislative guide for states that wish to institute a system of secured credit. The World

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[53] See Stephan, *supra* note 6, at 780–83.

[54] See Mann, *supra* note 42, at 2502 note 32.

Bank, as part of its Doing Business Project, monitors the extent to which countries have enacted functioning secured credit regimes.

The efficiency of secured credit in the United States has been hotly debated for years.[55] The debate has centered on the extent to which the granting of priority to a secured credit can lower a debtor's overall cost of capital. Proponents of secured credit note that it can ensure that a single lender takes responsibility for monitoring the actions of the debtor and that it limits the debtor's ability to engage in asset substitution. Opponents, in contrast, worry that secured credit can induce the debtor to undertake projects that have a negative net present value.

The case for secured credit in some countries may be stronger than the case for secured credit in the United States. In the United States, secured credit only provides modest procedural advantages to the secured creditor that wants to foreclose on its collateral. Each state provides a relatively simple system by which an unsecured creditor who is not paid can get the state to sell the debtor's property to satisfy the debt. For this reason, the literature examining American secured credit law centers on the benefits that may accrue by providing the debtor with the ability to give a creditor a priority right in certain assets in advance of default.

To the extent, however, that a country does not have a legal system that allows for the easy enforcement of unsecured debt, a system of secured debt that carried with it credible enforcement mechanisms could well increase a debtor's access to capital. In such a situation, the crucial attribute is not so much priority as it is ensuring the creditor that it can in fact reach the debtor's assets should the debtor default on its repayment obligation.

In addition to the efforts to increase the number of countries with a functioning law of secured credit, there are the attempts to coordinate the various existing national secured credit systems. The main problem here is with collateral that, by its nature, moves from one country to another. Registry systems tend to be national or even local in terms of coverage. Goods that move between multiple jurisdictions create the risk of conflicting security interests in the same goods. To the extent that one concludes that secured credit provides efficiency gains, national systems should be coordinated so as to minimize the total cost of secured creditors maintaining their secured interests as goods move across national boundaries and the costs of third parties in the new country discovering the interest of the secured creditor.

To address this problem, UNIDROIT has created a convention on mobile

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[55] See Barry E. Adler (1998), 'Secured Credit Contracts', in Peter Newman (ed), *The New Palgrave Dictionary of Economics and the Law*, vol. 3, Stockton Press, 405.

goods.[56] The convention contains a protocol on the handling of security interests in airlines, and efforts are under way to draft protocols covering other types of mobile collateral. A number of states have signed the convention and the protocol. Neither, however, is yet in force. The convention has received sufficient ratifications to enter into force, but only to the extent that a protocol is in force. As to the only existing protocol, the United States has ratified it, but it currently falls three ratifications short of coming into force.

Along the same lines, but to date even less successful, UNCITRAL has sent out to its member states a convention on receivables. The proponents of the convention assert that its adoption would facilitate securitization transactions. This convention has yet to garner sufficient adoptions to enter into force. The United States has signed, but not ratified, the convention.

It will be interesting to see whether these efforts to provide uniformity in the law of secured credit ultimately enjoy the success of the UCP. In the letter of credit context, large banks have been able to press successfully for a uniform standard that applies across jurisdictions. Large banks and similar providers of capital are involved both in financing arrangements involving airplanes and in securitization transactions. Whether they have similar incentives to press for an international law on these topics, and, to the extent that they do have such incentives, whether they have the clout to influence the drafting of the proposed laws and then to engineer the adoption of these proposals remains unclear.

2.4. Bankruptcy law

The problems that arise when a business has assets in more than one jurisdiction have occupied the attention of legal scholars for over 100 years.[57] It used to be the case that foreign creditors had difficulty establishing their claims in the bankruptcy court of another country. Such a lowering of priority would make an international commercial transaction more expensive than an identical domestic one. A foreign party would realize that, at the time of the transaction, it faced a greater loss upon insolvency than would a similarly situated domestic party. Thus, this would, at the margin, give a competitive advantage to the domestic party. Indeed, such a system could, in some settings, encourage domestic lenders to invest in projects that have a negative expected rate of

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[56] See Roy Goode (2003), 'The Cape Town Convention on International Interests in Mobile Equipment: A Driving Force for International Asset-Based Financing', *UCC Law Journal*, 36, 1.

[57] See John Lowell (1888), 'Conflict of Laws as Applied to Assignments of Creditors', *Harvard Law Review*, 1, 259.

return.[58] Most countries today, however, provide for equal treatment of foreign and domestic creditors. To the extent that they do not, there is no economic justification for such treatment.

The larger extant problem is administering the assets of the business. Most large businesses today are corporate groups. The assets in one country will reside in a different legal entity from the assets of the same enterprise that are located in other nations. For some businesses, this may not present much of a cost upon insolvency. To the extent that the assets in each individual country have little synergy with assets in other countries, countries could follow the traditional practice of administering the assets within their borders – the 'territorial approach' – without much loss of efficiency.[59]

Yet it is undoubtedly true that for some corporate groups, despite the fact that the assets rest in distinct legal entities, it may be the case that the combined value of the business is worth more if the assets are administered together.[60] Indeed, recent trends suggest that more and more enterprises fall into this category. The challenge thus becomes one of cooperation between two or more sovereigns. One problem is that countries may differ on the goals that bankruptcy law seeks to implement. Some countries may have a law that puts an emphasis on ensuring that the assets are put to their highest valued use; other countries may place a premium on keeping the business operating and the employees employed.

Even if two countries have insolvency regimes that seek to maximize the same goal, it may be that they differ in the way they implement this policy. For example, most countries have laws that allow the bankruptcy estate to recover certain payments before bankruptcy on the theory that they were 'preferences'. What constitutes a preference, however, differs from country to country.

When systems are not coordinated, there is a higher probability that corporate entities in each country will be administered separately rather than administered as a unit. Administering assets separately creates a push towards liquidation. To the extent that liquidation fails to put assets to their highest valued use, this in turn will raise the cost of credit.[61]

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[58] See Lucian Arye Bebchuk and Andrew Guzman (1999), 'An Economic Analysis of Transnational Bankruptcies', *Journal of Law and Economics*, 42, 775.

[59] See Robert K. Rasmussen (1997), 'A New Approach to Transnational Insolvencies', *Michigan Journal of International Law*, 19, 1.

[60] Of course, administering the assets together does not necessarily entail a reorganization of the enterprise. A sale of the enterprise as a going concern is a viable, and often used, alternative. See Douglas G. Baird and Robert K. Rasmussen (2002), 'The End of Bankruptcy', *Stanford Law Review*, 55, 715, 777–8; Douglas G. Baird and Robert K. Rasmussen (2003), 'Chapter 11 at Twilight', *Stanford Law Review*, 56, 673.

[61] See Bebchuk and Guzman, *supra,* note 58.

The *Maxwell* bankruptcy illustrates the potential to be gained from cooperation. The assets of the business were in one country – the United States – and the management was primarily located in a second country – England. There exists no formal mechanism to coordinate insolvency proceedings between the two countries. The parties, however, drafted a protocol designed to coordinate the two proceedings. That the parties were willing to incur the cost of negotiating this deal suggests that they viewed coordination as having positive benefits.

The standard response to this situation has been to call for a 'universalist' system under which one bankruptcy court takes the lead and the others defer to the major decisions made by that court. The court that is to have primary authority is the court located in the business's 'home country', which is defined as the principal place of business. Such an approach can lower a business's cost of credit as opposed to the territorial approach.[62] Even so-called 'non adjusting creditors', those creditors who would not change their behavior based on a change in legal regimes, can be made better off by a universalist system as compared with a territorial one.[63]

Proponents of universalism recognize that their approach should be implemented via a treaty among nations. Historically, treaties on insolvency matters have been rare. The notable exception has been the treaty among the Scandinavian countries, which has been in force since 1933. In 2002, the European Union established its own method for coordinating bankruptcy proceedings among the member states. UNCITRAL has produced a model law on the subject, which the United States adopted as part of its Bankruptcy Code in 2005. It remains to be seen the extent to which the American adoption will stir other nations to similar action.

As with other areas of international commercial law, the political economy of the production of international insolvency law remains under-explored. As to the substance of the model law that UNCITRAL has put forward, it should come as no surprise that it contains few clear rules. The process of drafting the insolvency text mirrors that that produced the CISG. The hallmark of the Model Law is that it provides a list of actions that a court 'may' take once it recognizes the existence of an insolvency proceeding in another country. The list of what a court is required to do, in contrast, is modest at best. By its own terms, the Model Law sets up a framework for cooperation, if the courts decide in fact to cooperate. Thus, even if the Model Law were adopted by all

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[62] The best economic defense of universalism is Andrew T. Guzman (2000), 'International Bankruptcy: In Defense of Universalism', *Michigan Law Reviews*, 98, 2177.

[63] See id. at 2187–204.

countries, it is far from clear that the universalist vision will have become a reality.

Universalism and territorialism do not exhaust the possible responses to the plight of an insolvent transnational enterprise. Another alternative is to allow the business to contract for how its financial distress would be handled.[64] It can remain with the current default standard, that of territoriality, or it can include in its contracts choice of forum clauses. These clauses would select the jurisdiction that would take the lead in sorting out the debtor's financial distress. The theory is that, to lower its cost of capital, the business would have an incentive to select the jurisdiction that provided the most efficient bankruptcy system.

Much remains to be explored in the area of transnational insolvencies. In addition to the general problem of inducing cooperation when such cooperation is efficient, there is the problem of competing goals, and there is the problem of integrating details such as which pre-bankruptcy transactions can be unwound in bankruptcy.[65]

3. Conclusion

International commerce is growing, and international commercial law is expanding as well. The increase in commerce can be explained by falling trade barriers, decreasing transactions costs, and growing economies worldwide. Few economists decry any of these trends. The increase in law may well be another matter. Some development may promote efficiency. Contract terms set by organizations to handle cross-border sales may be an efficient response to the shortcomings of the public legal system. Some areas of commercial law, perhaps letter of credit rules and the financing of mobile collateral, may be worldwide in scope and operate best under a single set of rules. Economic analysis of the legal rules in this area may reveal that these rules increase social welfare.

Yet one can be skeptical. Much of the new law comes from international organizations whose workings have yet to be subject to sustained analysis. Uniformity is not always the preferred outcome, either in domestic settings or international ones. Moreover, we know precious little about the actual contracting behavior of parties to international transactions. Much work remains to be done.

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[64] See Rasmussen, *supra,* note 60; Robert K. Rasmussen (2000), 'Resolving Transnational Insolvencies Through Private Ordering', *Michigan Law Review*, 98, 2252.

[65] For a lucid and careful discussion of these problems, see John Pottow.

8. The economic underpinnings of international taxation

*Julie A. Roin**

The term 'international taxation' is an oxymoron. There is no such thing as 'international taxation' because no international governmental organization has the power to levy a tax. Rather, the term refers to the uneasy interface between national tax rules and transnational taxpayers, transnational transactions and the income earned through such transnational transactions. This interface, a creature sometimes of national statutory law and sometimes of bilateral or multilateral treaties, attempts to answer the two vexing questions that arise in this area: how much total tax should be paid on the income generated by transnational transactions and to which government(s) should such payments be made? The answers governments provide to these questions affect not only the amount of revenue collected by affected governments but often the scope and direction of transnational investment activity.

This chapter tries to explain how and why various national governments have chosen to answer these questions in the income tax context. Section I lays out the economic stakes for both taxpayers and countries in devising an answer. Section II explains one of the problems governments face in this area, the problem of double taxation, and how attempts to solve that problem often lead to the converse problem of undertaxation of transnational income. Section III explores additional sources of undertaxation, both those stemming from the inevitable variety in national tax systems and those attributable to difficulties in attaching values in intercompany transactions. It also evaluates some of the solutions proffered for these problems. Section IV briefly considers the pros and cons of substituting another revenue source, the value added tax or VAT, for an income tax. The chapter concludes with a prognosis of future developments.

1. The economic dilemma

Income taxes, like tariffs, can impede international trade and investment (Slemrod and Avi-Yonah 2002, pp. 539–42; Slemrod 1996, pp. 302–3). Most

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economists believe that maximizing worldwide wealth and economic development requires eliminating impediments to international trade and investment (Graetz 2001, p. 270; Richman 1963, pp. 5–6). Thus, there has been little dissent from the prescription that tariffs be abolished. Indeed, the 'general view is that governments should eliminate trade barriers even unilaterally in the interest of national welfare' (Bird and Mintz 2003, p. 415). However, the fact that most jurisdictions levy income taxes on domestic income makes advocating the elimination of such taxation on transnational activities difficult. The fear is that abolition would merely substitute one distortion for another. By advantaging transnational income relative to domestic income, abolition would encourage taxpayers to engage in international transactions and investment rather than domestic alternatives.

It is worth noting that not all economists share this fear. Some economists believe that, despite appearances, developed countries do not tax capital income. For example, several studies purport to show that the average tax rate on capital income in the US and other developed countries is zero or negative (Gordon 2000, p. 34). Further, most of these same economists applaud the absence of such a tax on grounds that in a 'small' country, defined as one which is a price-taker rather than a price-setter in world capital markets, the tax on the return to domestic investment 'ends up being paid by labour through lower wage rates . . . [while introducing] a variety of extra distortions that are not created by direct taxes on labour income' (Gordon 2000, p. 21; Devereux 2000, p. 117). Because they prefer direct taxes on labor to indirect taxes on labor income effected through a corporate income tax, presumably they would prefer that the corporate income tax follow tariffs into oblivion; as it is, they regard corporate taxes on 'the income accruing to foreign owners . . . [as] serv[ing] mainly as an implicit tariff' (Gordon 2000, p. 34). These economists generally prefer VATs to income taxes for labor income as well.

However, even these economists recognize that an effective labor income tax must be accompanied by a cash-flow tax on corporate income to prevent labor income from being disguised as corporate income (Gordon 2000, p. 37). Other economists focus on the fact that corporate income taxes remain a significant and necessary source of revenue in many jurisdictions; indeed, even those who bewail the disappearance of the corporate income tax actually end up complaining more about the fact that increases in tax revenue have been funded by sources other than corporate income taxes rather than about actual declines in corporate tax collections (Avi-Yonah 2005, p. 378). Abolishing the tax on transnational income is anathema to both groups because of the discrepancy that would be created between the tax treatment of foreign and domestic transactions, and thus investment. The question then becomes how to structure such taxation so that neither domestic nor transnational transactions and investment are favored.

This turns out to be extremely difficult if not impossible to accomplish in a world of sovereign nations which exercise almost unfettered control over the construction of their tax systems and which have different views of the role of government and its revenue needs. The first problem that arises stems from the existence of two generally accepted yet overlapping bases of income tax jurisdiction: source and residence. This overlap creates the potential for 'double taxation' which, if unchecked, could severely discourage international economic endeavors.

2. The double taxation problem

All countries assert a right to tax the income generated within their borders regardless of the identity of the taxpayer earning such income. Countries also claim the right to levy income tax on the worldwide income of their residents and, in the case of the United States and a few other countries, their nationals (McIntyre 1992, pp. 1–3). There is a reason both jurisdictional claims are accepted: both source and residence countries confer benefits, and often expensive benefits, on taxpayers involved in the generation of transnational income. Source countries generally (but not always) provide the bulk of the governmental benefits directly and indirectly utilized in connection with the taxpayer's income-producing activities while the state of residence provides services enjoyed by virtue of residency. The package of governmental benefits actually enjoyed by a transnational taxpayer thus is a combination of these individual countries' benefit packages, a combination that may be greater or lesser in value than the benefit packages enjoyed by a wholly domestic taxpayer from either the source or residence country. The question is what amount of tax the transnational taxpayer should pay for receipt of these benefits.

One approach would be to require taxpayers benefiting from services provided by more than one jurisdiction to pay the full tax liabilities determined under each jurisdiction's rules. After all, it may be argued, many fully domestic taxpayers pay taxes to support benefits they expect or hope never to take advantage of; the fact that transnational taxpayers are likely to take only partial advantage of each country's benefit package makes them no different than these other partially benefiting taxpayers. However, the high rates of income tax prevailing in most national jurisdictions make such an alternative unpalatable. Consider the tax predicament caused by two overlapping jurisdictional claims when taxpayer X is a resident of country A and earns $300 in country B. Suppose A imposes income tax at a 50% rate on all income earned by its nationals while B imposes a 40% tax on all income earned within B. If both A and B exercised their full taxing rights over X's $300, A's tax would amount to 50% of $300, or $150, while B's tax would be 40% of $300, or $120, for a combined tax obligation of $270. After paying $270 in taxes from

the $300 in profits, X would be left with $30. A slight change in the assumed tax rates would leave X with no income – or even negative after-tax income. Obviously, few taxpayers would find cross-border activities worthwhile if they were subject to such duplicative tax claims. Any believer in the economic benefits of free trade or foreign investment would find this result repugnant. And even short of completely shutting down cross-border investment and expansion opportunities, differential taxation unaccompanied by offsetting benefits imposes burdens that disfavor foreign ownership as compared to national ownership. Given that 'ownership is likely to be associated with significant productivity differences' (Desai and Hines 2003, p. 489), a tax regime which distorts ownership decisions may have a deleterious effect on overall economic efficiency and thus world welfare (Desai and Hines 2003, p. 494).

Though 'double taxation' may be inimical to the interests of both capital-exporting (residence) and capital-importing (source) countries, that fact alone does not provide much help in determining how the result should be avoided, that is, in deciding which country should cede how much of its taxing authority. Should X pay $120 of tax, the amount X would pay if it were a resident of B earning domestic income, and if so, should the entirety of that $120 go to B, or should some of the $120 go to A's treasury? If some should go to A's treasury, how much should be diverted there? Does it matter if there are more residents of A earning money in B than there are residents of B earning income in A? Should it depend on whether the multinational X is better or worse off in terms of the amount of government benefits received than a wholly domestic (to B) Y? If the multinational X is better off because it receives some benefits from A in addition to the normal package of B benefits yet pays only B taxes, the Ys of this world will strive to become multinationals. Such behavior would adversely affect national treasuries, distort economic behavior, and eventually distort government behavior. Yet, in the real world, determining whether, let alone the extent to which, a multinational X receives more benefits from the A and B combination than a fully domestic Y is probably impossible. So the question is what tax policy ought to be in the face of this uncertainty.

Traditionally, countries have vacillated among three alternative conceptions of neutrality: national neutrality, capital export neutrality and capital import neutrality. The features of each of these alternatives are detailed next.

2.1. Methods for avoiding double taxation

As explicated above, the immediate and overwhelming difficulty facing the international income tax 'regime' is the prospect of double taxation caused by the overlapping jurisdictional bases of national income tax systems. Elimination of this barrier to transnational transactions requires either the source or residence country to cede portions of its normal tax claim. There are

two independent issues that arise in the context of such cessions: first, the need to determine how much tax should be collected from particular taxpayers with respect to particular items of income – that is, at what point does taxation become duplicative? – and second, the need to determine how the tax revenue that is collected should be allocated between the respective countries. Historically, these two issues have been decided in tandem. Countries kept whatever tax they collected; no tax clearinghouse existed through which such proceeds could be reallocated to other countries. This situation can be changed. Not only has the European Union (EU) devised a deferred payment or postponed accounting system utilizing such a clearinghouse for purposes of imposing national value-added taxes on products sold through cross-border trades between registered businesses (Cnossen 2002, p. 28),[1] its new regime for the taxation of interest income requires source countries to transfer a portion of their withholding tax revenues to the taxpayers' countries of residence. But at least at present, these sharing regimes remain tiny exceptions to the more general revenue distribution technique incorporated in the various tax coordination methods described in the next subsection.

2.2. Coordination methods: an outline

It did not take countries very long to realize that income derived from transnational business transactions should not be subjected to two full sets of national income taxes. Nor did it take them long to decide which of the affected countries should cede taxing jurisdiction. By the 1920s, an international consensus had developed granting 'primary' taxing jurisdiction to the country of source, leaving the country of residence with 'secondary' taxing jurisdiction[2] (Graetz and O'Hear 1997, p. 1103). As a practical matter, this meant that residence countries were supposed to take source country taxes into account for purposes of assessing the

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[1] Operation of the payment system is effected through the 'VAT Information Exchange System' or 'VIES', which requires taxable persons to file quarterly reports on out-of-state supplies and acquisitions. The accuracy of the information collected through individual reporting is checked against statistical data collected under the 'Intrastat' system which collects data on goods traded between EU member states (Cnossen 2002, p. 28). The system remains imperfect. Concerns about continued opportunities for tax evasion have generated numerous reform proposals (Cnossen 2002, pp. 28–32; McClure 2000, pp. 723–4; Keen and Smith 1996, pp. 384–7).

[2] Substantial dispute exists as to whether this consensus allocated primary jurisdiction over all income to the source country, or only active business income, with primary jurisdiction over passive or portfolio income going to the residence country (Graetz and Grinberg 2003, p. 541). The distinction between 'active business income' and 'portfolio income' is tenuous at best. As for the larger point, suffice it to say here that residence countries could enjoy a 'primary role' only when the source country agreed to give it this role pursuant to a bilateral income tax treaty.

taxes due on their residents' foreign earned income. However, this consensus did not extend to the method by which residence countries were to take source country taxes into account. Instead, three methods of residence country coordination arose, each embodying a different theory of 'tax neutrality'. These methods differ both as to the amount of tax revenue allowed to the residence country as well as to the relative competitiveness of foreign and domestic investment.

The method allowing the largest scope for residence country taxation is entitled 'national neutrality'. Under a 'nationally neutral' method of tax coordination, the residence country collects the same percentage of income in the form of tax from foreign as domestic income. Foreign taxes are, however, allowed as a deduction in computing a taxpayer's taxable income base for purposes of calculating the residence country tax; they are treated as any other cost of carrying out that business (Hufbauer 1992, p. 56; Musgrave 1969, pp. 134, 153–4). Returning to our original example of the A country taxpayer X earning $300 in country B with a tax rate of 40%, X would pay $120 in taxes to B and 50% of the remainder, or $90, in tax to A for a total tax liability of $210. A would be left with $90 of after-tax profit, which is better than $30 (the amount that would have been left had each country collected its full tax share) but less than the $150 X would have earned after tax had it earned this income in A or the $180 X would have earned had it been a country B taxpayer earning its income in B. For a foreign investment to be economically attractive to a taxpayer covered by a nationally neutral taxing regime, the foreign investment's post-foreign-tax return would have to be equivalent to the competing domestic investment's pre-tax return.

The second approach, known as 'capital export neutrality', allows taxpayers to credit source country taxes against the residence country liability otherwise computed under normal domestic rules (Graetz 2001, p. 271). The taxpayer pays taxes equal in amount to those it would have paid had it earned the income in its country of residence but the tax revenues are split between the residence and source countries. The source country collects its full tax claim and the residence country picks up any amount by which that source country tax claim falls short of its own. Again working with the facts provided in the initial example, taxpayer X would pay $120 to B and $30 to A for a total tax liability of $150 under a capital export neutral regime. This $150 total tax liability is the same tax liability X would have incurred had it earned its income in A. Note that this approach leaves A, the country of residence, with no tax revenue from X in the event the source country's tax rate equals A's tax rate. Theoretically, the residence country A would owe X a refund should B's tax exceed X's tax liability to A but the obvious moral hazards attendant upon such refund opportunities have kept residence countries from providing such refunds. In practice, then, taxpayers end up paying tax at a rate equal to the higher of the source or residence country rate of tax. The capital export neutral method of tax coordination

eliminates the advantage of earning income in a low tax jurisdiction, but does not discourage foreign investment relative to domestic investment unless the source country's tax claims are greater than the residence country's claims.

The third method, denominated 'capital import neutrality', requires the residence country entirely to forego its tax claims with respect to foreign income. Taxpayer X would pay $120 to B and nothing to A under this 'territorial' approach, leaving X with $180 after-tax profit, the same amount as enjoyed by a domestic B taxpayer with the same pre-tax income (Frisch 1990, pp. 582–5). This method maximizes the benefits of earning income in a low tax jurisdiction and provides no revenue to the residence country to compensate it for the provision of benefits.

No country slavishly adheres to any one of these methods. The tax rules of actual countries can best be described as incorporating a 'mix and match' approach, with investment income generally taxed under regimes approaching the capital export neutrality ideal and business income treated more in accord with the capital import neutrality ideal. But significant differences exist between countries in the degree of adherence to these approaches in various contexts. To understand the choices that have been made requires one to understand the supposed advantages and disadvantages of each of these coordination methods. That is the subject of the next subsection.

2.3. Choosing among the coordination methods: policy considerations

Each of the above described coordination methods (national neutrality, capital export neutrality, and capital import neutrality) impact affected taxpayers and countries on three different margins: they determine the total amount of tax collected from each taxpayer and (at present) the distribution of such tax revenues among the affected countries; they also affect the amount of foreign investment by and in each jurisdiction. The choice of coordination methods thus reflects at least in part choices about the desirability of their effects on these margins. However, one cannot evaluate the choices that have been made without taking into account more prosaic, administrative considerations. Policies that seem preferable in theory often have a way of misfiring in real world conditions leading to the eventual adoption of what may have seemed initially to be a less preferred alternative.

2.3.1. National neutrality Traditionally, national neutrality was thought to 'maximize the national welfare of the capital-exporting nation' (Feldstein and Hartman 1979, p. 617; Musgrave 1969, p. 134, 153–4). This maximization would occur, it was argued, because a capital exporting nation benefits only from returns earned by its investors and taxes paid to its government; taxes paid to other governments are costs of generating such benefits rather than additional benefits in and of themselves (Graetz 2001, p. 286; Musgrave 1969,

p. 134). Further, national neutrality has been defended as the 'fairest' approach from the perspective of residents of the capital exporting nation since it requires all residents of that nation of equivalent economic means to pay an equal percentage of income for government services provided by the home country (Musgrave 1969, pp. 121–2). Both of these justifications have come under attack in recent years.

A. NATIONAL NEUTRALITY AND ECONOMIC BENEFITS

BUSINESS INCOME In recent years, most economists have come to believe that the traditional view of the economic effects of a nationally neutral tax system is simply wrong. Far from increasing national welfare, they believe that the utilization of a nationally neutral coordination method decreases national welfare when employed in the context of active business income.

Some quarrel with the traditionalist's implicit assumption that foreign investment substitutes for domestic investment, relying as it does on the proposition that 'exports are perfect substitutes for foreign investment' (Graetz 2001, p. 289). They point to an increasing number of studies purporting to show that much foreign direct investment complements rather than substitutes for domestic investment and argue that discouraging foreign investment by making it more expensive actually harms national interests by diminishing such complementary and ultimately export-increasing investments (Desai and Hines 2003, pp. 494–5; Graetz 2001, pp. 286–90). This argument assumes, of course, that the transnational taxpayer does not derive additional benefits from its residence country approaching its tax costs; if it did, it would not find itself at a competitive disadvantage relative to foreign competitors. This assumption in turn relies on one of two others: either the transnational government does not gain value from some of the benefits provided by the residence country or those benefits have been amply supplied by the source state.

Others find national neutrality unattractive because of the likelihood of 'potentially offsetting or retaliatory actions by foreign governments' (Graetz 2001, p. 292; Hufbauer 1992, p. 57; Frisch 1990, pp. 583–4). If other governments respond to one country's adoption of such a 'beggar-thy-neighbor' policy by enacting similar taxation rules, the argument goes, inbound foreign investment would decrease in tandem with outbound foreign investment. Such a 'collapse' of multilateral investment would cause a general decrease in economic well-being, serving neither national nor worldwide interests (Hufbauer 1992, p. 57). At least, national interests would not be served to the extent a country has a substantial 'source country' interest in attracting foreign investment; if it has vastly more outgoing than incoming investment, perhaps a case for nationally neutral tax treat-

ment could still be made. But only perhaps, since if foreign direct investment by domestic multinationals is 'complementary to domestic investment rather than a substitute for it', as many economists believe (Graetz 2001, p. 289), the costs of reducing outgoing investment might well outweigh any immediate fiscal benefits. Again, underlying this analysis the assumption is that the transnational's benefit package does not justify the higher level of tax costs.

INVESTMENT INCOME These objections to a nationally neutral tax regime carry less weight when the income at issue consists of 'portfolio'[3] investment income, especially when that income is earned by individuals rather than corporations. From an economic perspective, portfolio investors, unlike business investors, are fungible. While business investors make decisions regarding the location of underlying business investments in plant and equipment, and often do so based on the business owner's unique 'opportunities to exploit economies of scale, economies of scope, or proprietary business advantages' (Graetz and Grinberg 2003, p. 549), portfolio investors contribute nothing more unique than raw capital. As long as some business continues to have access to this portfolio capital, the argument goes, the rate of tax imposed on the resulting portfolio investment income should not affect the location or rate of corporate investments in real business assets such as plant and equipment. (Graetz and Grinberg 2003, p. 555; European Commission 2001, p. 223) If, for tax reasons, US businesses decide to borrow more from US investors and less from UK investors, UK businesses would have more domestic capital available and would correspondingly reduce their demand for US capital. Neither the available amount of capital, its cost, or its use should change as a result of the imposition of a nationally neutral income tax system.

At least, nothing should change if the amount of after-tax portfolio income remains the same. If the imposition of a nationally neutral tax system leads to the imposition of higher taxes on portfolio income, the amount of future portfolio capital may decrease leading to an eventual increase in its cost. Since all multinationals draw from the same pool of international capital, however, no country's multinationals should be systematically favored or disfavored by a move to a nationally neutral tax system; all would face the same increase in

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[3] Since the foreign business operations of many multinational companies are carried out through foreign incorporated subsidiaries, the distinction between 'foreign business income' or 'foreign direct investment' and 'portfolio investment' cannot turn on the categorization of the income being received as 'dividend income' or 'business income'. Under US law, the distinction is based on the degree of shared ownership between payor and payee; payor and payee must own less than 10% of the other before dividend or interest income is considered 'portfolio' in nature (Graetz and Grinberg 2003, p. 547).

the cost of capital. None would be expected to have a competitive advantage or disadvantage relative to other corporations doing business in another country due to differential costs of capital. Concerns about the secondary effects of such differentials on exports and domestic investment, of such great import when the taxed income arises in the context of active business operations, thus would not arise.

This rosy evaluation of national neutrality may be over-optimistic, however. At the very least, if overall tax burdens on international portfolio investment income go up and investors begin to prefer domestic to international portfolio investments, investors' portfolios will become less diversified. Although the average returns may not change, the variability of returns may increase to the dismay of risk-averse individuals. The only empirical study to date suggests that foreign portfolio investors are not very tax sensitive (Dickson and Shoven 1993, pp. 12–16). However, in the intervening decade data regarding the tax implications of various mutual funds investments have become much more readily available, which should (if it has not already) increase the tax sensitivity of both investors and managers of such capital (Graetz and Grinberg 2003, pp. 549–50).

Perhaps more importantly, while it is convenient to assume that investment flows between most developed nations are equivalent and thus that discouraging foreign investment will not affect the location of business assets, what might be true over the long term may not be true over the short term. Over the shorter term, local capital shortages and surpluses may develop; the additional tax imposed on foreign investment may well create a tax wedge which leads to real changes in investment location by changing the relative price of domestic to foreign investment. Whether these short-term dislocations will be significant or not is hard to project. And, of course, longer term dislocations will occur to the extent countries are primarily source or primarily residence countries for substantial periods of time. At the very least, the national origin of the owners of the companies owning the plant or equipment may change (Graetz and Grinberg 2003, p. 556). Not all economists view such a change as insignificant (Desai and Hines 2003, p. 494).

No dislocations will occur if, as some of the current proponents of nationally neutral taxation of portfolio income assume, source countries react to residence countries' adoption of nationally neutral tax systems by eliminating their source tax claims (Graetz and Grinberg 2003, pp. 577–8; Hufbauer with van Rooij 1992, pp. 67–8). National neutrality proponents argue that eliminating source taxation of portfolio income would engender an additional advantage, namely to increase overall 'fairness' and 'inter-nation equity' in the operation of the tax rules.

B. NATIONAL NEUTRALITY AND FAIRNESS In evaluating the 'fairness' of an

international tax coordination mechanism, two perspectives must be considered. The first is the perspective of the taxpayer being subjected to the tax. The other is the perspective of the governments receiving – or being denied – the revenues generated by the taxes allowed by the taxing mechanism. Since there is no consensus on the definition of fairness, the section below compares, contrasts, and critiques the definitions of fairness found in the literature.

TAXPAYER FAIRNESS A nationally neutral tax system is sometimes said to be fairer than other tax coordination methods for two distinct reasons. First, under such systems, all residents of a given country pay the same percentage of income to the government. Second, only residence country taxation is capable of scaling such tax obligations in accordance with a taxpayer's overall ability to pay. Thus, both vertical and horizontal equity concerns militate in favor of the only coordination method that provides substantial room for residence country taxation (Graetz and Grinberg 2003, pp. 569–70).

The first justification holds only if one accepts the underlying premise that all residents should pay the same percentage of income tax to their countries of residence regardless of the source of their income. Not all do. Particularly when it comes to active business income, some contend that residence country tax levies should be reduced to reflect the lower level of benefits accorded such income and such taxpayers by their residence countries. Viewing services provided by source countries largely as a substitute for rather than a supplement to residence country benefits, they regard the extraction of the full tax percentage as overtaxation, since taxpayers operating under a nationally neutral tax system end up paying a higher percentage of their income in taxes if the source country levies any tax at all (Richman 1963, p. 13). This view does not necessarily translate into a belief that no taxes need be paid to the country of residence but it does suggest that the rate of tax applied to foreign earned income should be lower than the standard rate applied to domestic income.

Nor does the progressivity argument sway many taxpayers, at least when it comes to corporate income, for the simple reason that in most countries corporations pay tax at a single rate (Graetz and Grinberg 2003, p. 569). Since scaling of tax obligations does not occur, residence country taxation has no advantage over source country taxation effected under that country's normal tax rules.

Fairness arguments have more weight, however, when applied to situations involving passive or portfolio income, and especially passive or portfolio income earned by individuals. And, in fairness to the modern proponents of nationally neutral tax systems, their recommendations are for the most part limited to this situation (Graetz and Grinberg 2003, p. 568). Here the problem is not source country taxation *per se*, but rather the form source taxation must

take due to the limited nature of contacts between those countries and most taxpayers earning such income. Often, the only point of contact between portfolio investors and the source country is the income itself; the investor and the investors' assets are located elsewhere. In a world in which source countries lack independent jurisdictional claims over such taxpayers and assets and in which other countries routinely refuse to help other countries enforce civil tax claims, source countries wishing to exercise their primary taxing have been forced to tax such income under a special set of rules designed with these limitations in mind. Typically, such income, consisting largely of royalties, dividends and interest, is subject to a flat tax imposed on the gross income amount rather than a progressive tax calculated with respect to net income. This flat tax is then enforced by imposing a withholding obligation on the domestic payor. The US, for example, by statute levies a tax equal to 30% on most categories of 'fixed or determinable annual or periodical gains, profits, and income . . . not effectively connected with the conduct of a trade or business in the United States' (IRC § 871(a)(1)).

The defects of such a tax are obvious, at least when measured against an ideal 'ability to pay' tax and even against the pale shadow of such taxes embodied in most countries' regular income tax rules (Graetz and Grinberg 2003, p. 570). Not only does the use of this taxing mechanism eliminate any possibility of rate progression, but by ignoring all deductions, it leaves open the possibility of confiscatory taxation for some and undertaxation of others. While residence countries may be able to remedy the undertaxation problem, they are uniformly loathe to solve the overtaxation problem for fear that other countries will impose ever higher taxes on foreign investors in an effort to create home-made foreign aid.

Indeed, the defects of a taxation mechanism based on gross income amounts are so obvious that since the inception of the income tax, countries have entered into tax treaties under which they agreed to reciprocal reductions or waivers of their right to levy such taxes on residents of the treaty partner. The US, for example, has entered into treaties mandating the elimination of all source taxation of royalties, interest and dividend income earned by a resident of one treaty partner in the other treaty partner. The point of such treaty arrangements is not, and never has been, to eliminate all taxation of such foreign income; to do that would simply encourage investment in foreign portfolio assets at the expense of investment in domestic portfolio assets. Instead, the aim has always been to substitute taxation by the residence country, taxation effected under its normal rules and rate structures, for the gross income taxation that otherwise would have been levied by the source country. Such substitute taxation was and is meant to achieve two laudable goals: impose a fairer tax levy from the taxpayer's perspective with little impact on the total revenues received by the treasuries of the treaty partners (Haug 1996, p. 202; Roin 1994, p. 285).

INTER-NATION EQUITY Advocates of nationally neutral methods of taxation of portfolio income point to the fact that most bilateral tax treaties allocate tax revenues from nonbusiness income to the residence country, as well as to the more recent statutory exemptions from source taxation provided for certain categories of portfolio income, as support for the proposition that residence countries rather than source countries should be allowed primary – or even exclusive – taxing jurisdiction over such income as a matter of inter-nation equity (Avi-Yonah 1996, p. 1307; Graetz and Grinberg 2003, p. 569). In their view, 'a source country's claim to the tax revenues from [foreign portfolio income] is more attenuated . . . [because] the residence country . . . has funded the government services that provide for the well-being of the portfolio investor' (Graetz and Grinberg 2003, p. 569). This argument misconstrues the history of most treaty arrangements and the background of the exceptions found in current statutory law. In so doing, they overstate their equity claims.

Tax treaties From a legal perspective, tax treaties are just like other international agreements denominated as 'treaties'. In most countries (but not the US[4]) this means that they supersede domestic law. Procedurally, they are entered into with the same degree of formality and the same political safeguards as other types of treaties, though the actual treaty negotiations tend to involve representatives of the respective countries' treasuries rather than foreign affairs departments.

Substantively, tax treaties are written in the shadow of pre-existing statutory law and to a large extent incorporate those laws by reference. For taxpayers from countries with well-established and detailed statutory regimes for the relief of double taxation, the major advantage conferred by treaties may be the establishment of bilateral dispute resolution procedures and institutions and, for the governments involved, the commitments to greater transparency and cooperation in tax enforcement. Nonetheless, tax treaties usually do make changes in the underlying substantive law. They may be used to harmonize conflicting rules which would otherwise lead to duplicative taxation (ALI 1992, p. 8; Rosenbloom 1982, pp. 28–30). For example, one country's tax rules may provide that income from the performance of personal services is taxable in the country in which the benefits of those services are enjoyed while another country conditions taxation on where those services are performed. In the absence of a treaty, an architect working in an office in the second country to design a

[4] The US has long taken the position that treaties can be overridden by domestic legislation. This view is embodied in a statute providing in relevant part, 'For purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law' (IRC § 7852(d)).

dam to be built in the first country could find himself taxable in full on the income from this project in both countries, without any concessions by either as each would consider itself the source country. A treaty would assign taxing jurisdiction over this income to one of the countries while requiring the other to take those taxes into account when levying its tax assessment (Isenbergh 2003, pp. 107:7–107:8; ALI 1992, pp. 7–8). Most tax treaties also reduce the amount of source taxation to levels below those authorized by the underlying statutory law, thus transferring tax revenue from the source to the residence country (Dagan 2000, p. 982). They do so both by raising the minimum contacts necessary for a taxpayer resident in one treaty partner to become taxable on business income arising in the other treaty partner and by reducing or eliminating the withholding tax levied on nonbusiness income of a resident of the treaty partner by the country of source (Roin 1995, p. 1764). Finally, treaties require the treaty partners to relieve their citizens and residents of double taxation of income allocated to the treaty partner under the terms of the treaty. Often the treaty specifies the particular form of double taxation relief – usually either the credit or exemption method.

Although the vast majority of treaties are at least loosely based on 'model treaties' promulgated either by the OECD or the United Nations (ALI 1992, pp. 3–4), each is individually negotiated. These negotiations are required both for purposes of resolving conflicts created by unsatisfactory interactions of the peculiar provisions of each of the treaty partner's underlying statutory laws and because of the revenue implications of the source tax concessions contained in such treaties (Rosenbloom 1982, pp. 35–6). Source tax concessions are relatively easy to obtain and tend to be larger when the investment flows between the prospective partners are similar enough that each country can expect to offset their source tax losses through additional residence tax receipts (ALI 1992, p. 220). When investment imbalances make it clear that the additional residence taxes collected by one treaty partner will not offset its source tax losses, countries typically refuse to enter into a tax treaty or demand compensating adjustments in treaty terms. One difference between the OECD model, which is generally deemed suitable for use between developed countries, and the United Nations model, which was drafted for use between developed and less-developed nations, is that the United Nations model provides for greater taxation at source. Its terms provide for higher withholding tax rates on portfolio income and a lower level of physical presence before a foreign enterprise is deemed to have a 'permanent establishment', and thus becomes subject to taxation of its business profits in the source state (ALI 1992, pp. 220–1; Surrey 1978, pp. 10, 13–14, 25). Some lesser developed source countries prefer to opt instead for the preservation of investment incentives and seek treaties obligating the residence country to grant tax credits for taxes waived by the source country in hopes of attracting foreign investors (Dagan

2000, p. 993; Surrey 1978, p. 45). The US has never agreed to enter into a treaty containing such a 'tax sparing' provision, but many European nations have.

The history of tax treaties, then, provides little if any support for the existence of an international norm favoring the primacy of residence country taxation of passive investment income. Rather, it illustrates a norm of source country primacy coupled with a pragmatic willingness to consider alternative methods of collecting this tax obligation when circumstances allow. These alternative mechanisms include, as they do in some other tax contexts, substitute taxation. However, this substitute taxation only works when the investment flows are approximately equal in both directions, and even then, it may be questionable (Isenbergh 2003, p. 101:4; Roin 1995, pp. 1775–6).

Statutory exemptions for nonbusiness income Though the history of tax treaties provides little support for the existence of an international norm against source country taxation of nonbusiness income, advocates of national neutrality have pointed to the fact that many source countries have exempted the most important form of passive investment income, interest income received from unrelated taxpayers, from the withholding tax as a matter of statutory law as support for their position that this norm exists. This voluntary ceding of taxing jurisdiction, they argue, shows that source countries believe that residence countries have a greater right to tax this income (Graetz and Grinberg 2003, p. 541). However, the history of these statutory exemptions also lends little support for that interpretation of their rationale.

Ultimately, the genesis of these statutory exemptions can be traced to failures in the tax treaty regime. As described above, many bilateral tax treaties provide reciprocal reductions in the withholding taxes imposed at source on certain types of nonbusiness income, including interest income. These reciprocal reductions were supposed to result in a trade of imperfect source taxation for more perfect residence taxation, leaving the national treasuries of the treaty partners in approximately the same position they would have been in had the treaties never been ratified. However, all too often tax treaties became the vehicle for avoiding taxation of such income in both the country of source and the country of residence. Some countries, often but certainly not exclusively small island nations that inherited treaty relationships upon attaining independence from a larger nation, decided to position themselves as financial centers by offering tax concessions for certain types of treaty-protected income. In short, they became 'tax havens', helping taxpayers generate income that would be taxed by neither the source nor residence country.

This result was made possible by the confluence of two generally applicable tax rules. First, corporations are deemed to be residents of the countries in which they are formally incorporated rather than where their businesses are

carried out or their shareholders live. Second, corporations are treated as taxpayers distinct from their shareholders; this means that, as a general rule, shareholders are not taxed on corporate income unless and until such income is distributed to them in the form of a dividend or is realized through the sale of appreciated shares. These rules make the following technique possible: Taxpayers form a corporation in a tax haven jurisdiction. Then, they make deductible payments from their operating businesses to those tax haven corporations. Because these payments are deductible from the income of the operating company, they reduce the tax payable by the operating company in its countries of source and (if different) residence. Meanwhile, a tax treaty prevents the source country from taxing the payments in the hands of the recipient tax haven corporation. And finally, there is little or no residence country tax on the tax haven corporation because, by definition, the tax haven tax rules either exclude foreign sourced income from tax or subject it to tax at very low rates. As long as the tax haven company refrains from distributing its profits to its shareholders in the form of a dividend, the income diverted from the operating company remains free of tax. Income earned through 'financial intermediaries' located in tax haven countries often remains effectively untaxed for many years. This deferral can be long enough to constitute the economic equivalent of exemption. In addition, taxpayers may hope for legislative changes granting full or partial exemption for deferred foreign income. The US recently enacted legislation which allows corporations to pay only a 5.85% income tax with respect to foreign earnings repatriated in 2005 (American Jobs Creation Act of 2004, PL 108-357 § 422, codified at IRC § 965). Though fully domestic taxpayers also interpose corporate entities for tax reduction purposes, the scale of the tax avoidance opportunities tends to be greater in the international sphere simply because the rate differentials are greater. Moreover, there is more concern about secondary effects of such interpositions in the international context, such as possible distortions in the location of corporate activities.

The most widely used mechanism for transferring income from operating companies to financial intermediaries was debt. A parent company would contribute money to a tax haven intermediary; this money would then be borrowed by the operating company to fund its operations, and then the operating company would make deductible payments of treaty-protected interest on this outstanding debt to the tax haven company. This interest income would not be taxed at source because of the treaty provisions, it would not be taxed in the intermediary company's country of residence because of that country's decision to become a tax haven, and it would not be taxed in the parent company's country of residence.

Both source countries and parent company residence countries have undertaken some measures to try to eliminate these tax reduction maneuvers. The

US enacted the subpart F regime in 1962, one part of which deems passive income such as interest earned by certain foreign subsidiaries as having been immediately paid to the US parent company; the US parent is then taxed on this constructive dividend. Where it applies, this regime ensures that the foreign interest income is subject to tax at the same rate, and at the same time, as if it had been earned in the US. Other countries have adopted similar or analogous tax regimes. Some countries also attacked these schemes in their role as source countries by restricting the deductibility of interest paid to related creditors. These 'earnings stripping' rules lead to greater taxation at source, again reducing if not eliminating the tax advantages of establishing an intermediary in a tax haven jurisdiction. On occasion, source countries have gone so far as to terminate their tax treaties with tax haven nations in their entirety, leading to the reimposition of high withholding taxes (Isenbergh 2003, pp. 101:3–4). More frequently, they insisted on the insertion of 'limitation of benefits' provisions in treaties to prevent their use by corporations owned by third country nationals.

Nonetheless, taxpayers found ways around these rules and the scale of this tax avoidance remained huge. Literally billions, and perhaps hundreds of billions, of dollars of debt was issued by Netherlands Antilles finance subsidiaries alone (Isenbergh 2003, p. 110:8). By the 1980s, non-tax haven countries had two options: they could alter or eliminate their tax treaties with low tax countries (and selected high tax countries[5]) to make avoidance of source taxation harder and less likely or they could give in to taxpayers by repealing their withholding taxes on interest and making the treaty avoidance methods unnecessary.

Almost universally, countries chose to encourage investment at the expense of tax revenues. Fearful that doing otherwise would leave US businesses with a higher cost of capital than foreign businesses, for example, the US Congress rationalized its partial repeal of its withholding tax on interest as necessary in a world in which other countries already had foregone their source tax revenues to attract foreign investors (Staff of the Joint Committee on Taxation 1985, pp. 391–2). Whether it should have been so worried is another issue. There is no way to tell what would have happened had Congress made the opposite choice and revoked or substantially amended the treaties it had with the Netherlands Antilles and other 'tax haven' countries. Other countries may have done the same. We do know what happened after the partial repeal of the

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[5] One of the problems with residence taxation of treaty-protected income is that source states usually do not provide their treaty partners with the information necessary to effectively levy a tax on such income. Aware of this information deficit, many taxpayers simply neglect to report their foreign income to residence country tax authorities.

withholding tax on interest. Other countries followed suit and ultimately all were left in the same relative position competitively but with less in the way of tax revenues. Further, these statutory repeals created untraceable income because taxpayers were allowed to issue unregistered bearer bonds to foreign investors. In the US for example, although most bonds must be registered for the interest paid with respect to them to be deductible, an exception was made for bonds marketed and sold abroad (IRC § 163(f)(2)(B)). This means that no one, not even the issuing corporation, has a record of who owns such bonds. Although foreign marketed bonds are required to bear a legend stating that they are for sale only to non-US persons, no one has any doubt that some US persons evade tax by purchasing these bonds and failing to report the interest derived therefrom to US tax authorities. All too often, these statutory repeals, like the treaties that preceded them, lead to 'nowhere' income, income taxable by neither the source nor residence country.

Countries are just beginning to reassert their revenue interests and grapple with the consequences of the virtually untraceable 'nowhere' income generated by investments in portfolio bonds. After 20 years of determined effort, for example, the EU has just begun implementation of its 'savings directive', under which member countries are required either to levy a substantial withholding tax at source on interest earned by residents of other EU nations (with the revenues to be split between the countries of source and residence) or to provide information about investments and income earned by foreign investors to those investors' countries of residence (Kirwin 2005b, p. G-3). The agreement covers a few non-EU countries as well to forestall the possibility that taxpayers would simply switch all their funds to accounts and entities located in those countries. The effectiveness of this agreement remains to be seen. But even if it works and its operation is expanded to cover other countries, it does not necessarily advance the argument that residence countries 'deserve' primary taxing authority over nonbusiness income. Rather, it is equally plausible to explain this directive as part of an ongoing attempt to effectuate the revenue trades agreed to in treaties because of the relative virtues of a net income tax over a tax on gross income.

In sum, rather than providing an example of an international consensus in favor of exclusive residence country taxation of nonbusiness income, the portfolio interest story provides a lesson in the dangers of reliance on residence country taxation for such income as well as a lesson in the reciprocal nature of most source tax 'concessions'. A corollary of the latter lesson is the desirability of continuing to allow source taxation when such reciprocity does not exist.

<u>Inter-nation equity, re-visited</u> As an analytic matter, a norm against source taxation (and for enhanced residence country taxation) of most types of nonbusiness income seems neither equitable nor logical. At first blush, it

makes sense to treat dividend income as a 'return to capital' to which the source country has only an 'attenuated' taxing claim given that the source country should have already levied a business profits tax that could have reimbursed it for the 'benefits it provides that allow that income to be earned' (Graetz and Grinberg 2000, p. 569). At least one academic has suggested that two-level taxation of corporate income is preferable to integrated taxation of corporate income precisely because it makes it easy to divide the resulting tax revenue between source and residence countries (Schlunk 2003, p. 177). His argument assumes that appearances convey an underlying economic reality, and that the corporate level tax has been calculated to recompense the source country for the costs associated with benefits provided to the operating business while the dividend tax corresponds to the cost of residence benefits which are not provided by the source state. However, it is unlikely that the amount of the two tax levies are calculated this way. For example, international organizations have long advised countries interested in attracting and retaining foreign investment to levy a combination of low corporate level taxes and heavy dividend taxes to encourage reinvestment without undo sacrificing tax revenues (UN Centre on Transnational Corps 1988, pp. 21–2).

Moreover, this analysis falls apart completely when applied to 'returns to capital' that are deductible by the payor for purposes of determining the payor's business income in the country of source. These other payments, including interest, royalties, and rents, in many cases constitute alternative forms of paying out active business income, income made possible in part by services provided by the source country government and for which that government deserves recompense. Though these payments may include a 'passive' return to capital, it is impossible to distinguish between these income items and ordinary business profits and indeed, taxpayers regularly switch between these characterizations as required to achieve tax minimization goals. For example, a pharmaceutical company X, a corporate resident of B, may manufacture and sell a patented drug in country A. If X owns the patent, we would treat the entirety of X's profits derived from the manufacture and sale of these drugs as business profits taxable by the source country A. But if X manufactures the drug using a patent licensed from Y, a country C resident, the license fee is deducted from X's income and included in Y's. In what way has the change in patent ownership, the division of the income generated by the sales transaction between two taxpayers, diminished A's equitable claim to tax the entire income amount? Surely the license fee would not have been earned absent A's maintenance of the marketplace, its protection of the patent rights, the services provided to the manufacturer, and so forth – all factors which justify A's taxation of X's business profits and in the absence of a treaty, the royalty payments received by Y. As long as the business income and various forms of passive income are effectively as well as economically

interchangeable, it makes no sense to contend that the source country is adequately recompensed for one type of income 'simply from the use of capital from abroad' (Hufbauer with van Rooij 1992, p. 67) while the other should give rise to a source tax obligation. Nor is this analysis affected by whether Y is an individual or a corporation. Of course, the legitimacy of the source country's claim to tax revenue is more obvious if Y is a corporation that is related to X. However, the benefits provided by A to the patent owner remain the same regardless of Y's identity or characteristics.

Source countries are hardly oblivious to tax-driven attempts to manipulate income characterization. Many countries, including the US, have enacted statutory limits on some of these recharacterizations or associated deductions. 'Earnings stripping' rules, for example, limit the deductability of certain types of interest to a specified percentage of the taxpayer's operating income. Countries also try to police the amount of deductions claimed as license fees and royalty payments; some have completely disallowed deductions for such expenses when paid to related parties. But taxpayers have learned how to minimize the effects of many of these restrictions to the detriment of source countries. Often, the taxpayers' efforts work to the detriment of both source and residence countries because the income that disappears from the tax base of the source country reappears, if at all, in the tax base of a tax haven country.

The fact that the country of source has an equitable claim to tax revenues from nonbusiness income does not mean that the residence country does not also have a valid taxing claim. Particularly when the recipient of this nonbusiness income is a natural person, one can be fairly certain that the individual benefits from his or her residence country's expenditures and thus should contribute towards their financing. The issue is how large that contribution ought to be, or more broadly, how the international tax base or international tax revenues should be allocated among the affected nations. This problem becomes exceedingly difficult if one assumes that the source state has supplied (and the taxpayer's tax payments to the source state pay for) many of the benefits the residence country provides domestic taxpayers. Ultimately, the question is the same as the one that faced governments that chose to adopt integrated income tax regimes, regimes which treated the corporate income tax as a mere prepayment of the personal income tax. The identity of issues should be no surprise since the various earnings stripping mechanisms utilized in the transnational arena often provide home-made integration as well as deferral.

No satisfactory answer was ever generated to the question of how integrated tax regimes should operate in the transnational arena. Most countries operating integrated corporate tax regimes dealt with the issue by ignoring foreign income taxes and foreign tax claims when the time came to grant integration credits against the personal tax, and effectively overtaxed transnational

corporate income relative to domestic corporate income. They neither allowed foreign taxes paid at the corporate level to be credited against the personal income tax liabilities of their residents nor allowed their own corporate taxes to offset the withholding tax liabilities imposed on foreign shareholders of domestic corporations, essentially reverting to a two-level, classical tax system for such income and allocating the second level of tax to the residence country. The resulting pattern of taxation closely resembled national neutrality except for a timing differential; instead of being imposed in the year such income was earned, the residence country tax was imposed when dividends were paid out of the foreign earnings. Because this tax practice so obviously favored domestic over foreign investment, it was held to violate the EU treaty's prohibition of domestic legislation inhibiting the free movement of capital in *B.G.M. Verkooijen*, 2000 ECR I-7071 (Graetz and Grinberg 2003, p. 565; Warren, 2001, p. 166). In part because of the anticipated revenue losses associated with complying with this and other similar decisions, EU countries have begun moving away from integration and imputation systems and towards schedular systems for the taxation of dividend distributions and other capital income (Cnossen 2002, p. 52).

One scholarly article which thoroughly explores this revenue split issue in the context of an integrated tax regime and details available options and methods for achieving them ultimately remained agnostic about which is preferable, stating only that '[t]he central point . . . [is] that these issues must be analyzed explicitly in terms of overall policy goals in the taxation of international income and specific relations with particular treaty partners' (Ault 1992, p. 595). Another set of authors, analyzing the revenue split situation more broadly, pessimistically opines that 'there do not appear to be principles that are both acceptable and feasible with respect to how to divide up such a complex and changing target as the international tax base . . .' (Bird and Mintz 2003, p. 422).

It may not be necessary to come up with an answer to this question for situations involving countries with approximately even investment flows and approximately equal tax rates. Substitute taxation effected through tax treaties may leave the countries in approximately the positions they and their treasuries ought to be in, and taxpayers may pay about the right amount of tax. If the countries have approximately equal tax rates, they probably offer similar packages of benefits so that between the two countries, the transnational taxpayer ends up with about the same level of governmental benefits he or she would have enjoyed if fully domestic to either one of the jurisdictions, and payment of a full set of residence taxes ought to be around the right tax price for those benefits. Likewise, each government should come out in about the right place. Though ideally they should collect the source share from the foreign resident and the residence share from the domestic resident, with equal

income flows running in both directions, each is made whole financially if they collect both the source and residence shares from their own residents and none from residents of the treaty partner.

This happy outcome is conditional on the residence country's actual taxation of the treaty-protected income. In real life, such taxation often does not occur, either because the income is paid to a financial intermediary or holding company located in a tax haven jurisdiction or because the residence country taxes are offset by foreign taxes levied on other foreign income through a process known as 'cross crediting', described in more detail *infra* pages 330–331.

Although the cross-crediting problem could be (but at least in the US has not been) ameliorated by requiring taxpayers to isolate treaty-protected income for purposes of computing the foreign tax credit limitation, or to treat treaty-protected income as domestic income for purposes of the residence country income tax, such an easy resolution is not available in the case of unequal investment and income flows nor even, perhaps, in the case of unequal tax rates. Countries which are predominantly source countries, the countries which presently find themselves reluctant to enter into tax treaties, would find themselves in a very difficult situation indeed. Instead of granting investors a full offset for a limited amount of source taxes under a tax credit, as most residence countries presently do either as a matter of statutory law or pursuant to tax treaties,[6] under a nationally neutral regime residence countries would grant only a partial offset in the form of an income tax deduction. This means that investments in nations that continued to levy a source tax would be relatively more expensive than domestic investments or investments in countries levying no source tax unless the transnational investor's package of governmental benefits grew as a result of the investment. In short, many countries will lose the option of collecting some tax while still being relatively tax-efficient from an investor's standpoint. Indeed, that deleterious effect on investment is precisely why some proponents of national neutrality expect that residence countries' adoption of 'nationally neutral' rules for the taxation of passive income will result in an elimination of source country taxation (Graetz and Grinberg 2003, p. 568; Hufbauer 1992, p. 67).

But eliminating or reducing source tax levies carries its own risks. When there is little or no additional residence tax to offset the reductions in source tax, the reductions damage the national fisc. And because the choice of tax reduction or not would have to be made outside the context of treaty negotia-

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6 Even countries which maintain territorial systems of taxation for foreign business income tend to employ a tax credit system when taxing their residents' foreign nonbusiness income.

tions, these countries would lack any opportunity to bargain for compensating adjustments.

Again, the point is not that residence countries deserve no tax revenues in these situations but rather that the amount they would collect under a nationally neutral system may be too much. The question then is what the right amount would be. One of the interesting features of the new advocacy of nationally neutral tax systems is the attempt by its advocates to limit its use to contexts in which they (rightly or wrongly) expect its effects to largely mimic those of a capital export neutral tax system. The total amount of tax extracted from each taxpayer would be the same under the two approaches if national neutrality advocates are correct in their projection that this would lead to the virtual elimination of source taxation of portfolio income; the only difference would be a partial redirection of the tax revenues from source country treasuries to residence country treasuries. And if that is so, perhaps what is really being advocated is capital export neutrality, albeit with a different distribution of tax revenues. It is to an evaluation of that policy that this chapter turns next.

2.3.2. Capital export neutrality As described earlier, under a capital export neutral system, the residence country treats taxes paid to the source country as a credit against the taxpayer's residence country tax obligation. The residence country collects a tax on transnational income only if and to the extent that its tax claim exceeds that imposed by the source country. The US ostensibly uses a capital export neutral tax system, although in actual operation, its system is a hybrid of capital export neutrality and capital import neutrality. Many European nations also use capital export neutral systems for the taxation of transnational nonbusiness income.

Support for capital export neutrality traditionally has rested on the belief that capital export neutrality maximizes worldwide income (Graetz 2001, p. 270; US Treasury Department 2000, p. 23; Horst 1980, p. 796). In theory, capital export neutral tax systems encourage business investments to be made in the location in which they generate the largest pre-tax return and thereby discourage tax-induced distortions in business location which would 'reduce productive efficiency and create deadweight economic losses' (Graetz and Grinberg 2003, p. 559; Frisch 1990, p. 581). The earliest economic models of international taxation suggested that capital export neutrality would maximize worldwide income and productivity (Richman 1963, pp. 4–5; Musgrave 1969, pp. 74–5). More recent proponents have defended it on grounds that it would reduce or eliminate tax competition, allowing source countries to impose taxes on foreign investment (Avi-Yonah 2005, p. 383).

However, this belief in the desirability of capital export neutral tax systems is coming under increasing challenge on a number of fronts. Some have begun to question whether worldwide welfare should be the overriding goal for

drafters of national legislation. Others have challenged capital export neutrality on its own terms. Questions have been raised as to whether capital export neutrality maximizes worldwide production if some countries use tax coordination mechanisms that depart from the norm, whether apparent conformity to the norm translates into effective conformity to the norm, and whether effective conformity to the norm is even possible. Finally, some have questioned whether the allocative efficiency promoted by capital export neutrality overcomes the business inefficiencies created when competing businesses pay taxes at different rates due to their country of residence.

A. CHALLENGES TO THE UNDERLYING THEORY OF CAPITAL EXPORT NEUTRALITY

Although the early models show that uniform application of capital export neutral rules leads to greater economic output, these models do not consider situations in which some countries attempt to implement capital export neutrality while others follow a different coordination norm such as capital import neutrality. Thus these models do not show that one country's decision to abide by the capital export neutral norm in a mixed world advances worldwide economic welfare; indeed, they leave open the possibility that doing so would actually decrease world welfare. While some have argued that world welfare would decline as a result of attempts by some countries to pursue capital export neutrality (Desai and Hines 2003, p. 495; National Foreign Trade Council 1999, p. 63; Hines 1999a, p. 401), others contend that the lack of uniformity would not change the desirability of following a capital export neutral approach from the perspective of worldwide welfare (Altshuler 2000, p. 260).

The newest arguments against capital export neutrality suggest that it may not further worldwide welfare because it interferes with worldwide business efficiency by discouraging foreign investment 'driven by the needs of firms in markets' (Desai and Hines 2003, pp. 488–9). In its latest incarnation, this argument takes the form of an argument for 'NON' or 'national ownership neutrality' (Desai and Hines 2003, pp. 496–7). To prevent business dislocations, the argument goes, the amount of tax paid by a business should not depend on the identity of its owners. In particular, these economists worry that residence country taxation under a capital export neutral regime would impact on the decision as to whether foreign exploitation would be effected directly, through a vertically integrated enterprise, or indirectly, through a contractual arrangement with an unrelated foreign company. This sort of decision, they argue, should be made on business rather than tax grounds (Desai and Hines 2003, pp. 488–99).

Even those predisposed to favor capital export neutrality's goal of optimizing worldwide welfare worry whether the tax credit mechanism traditionally used to implement capital export neutrality – or any other mechanism that

equalizes nominal tax levies – actually creates capital export neutrality. A perfectly operational tax credit system has one inherent flaw. The economic models supporting capital export neutrality treat taxes as pure costs; they fail to recognize any linkage between levels of tax and levels of governmental benefits (Richman 1963, p. 8). In the real world, lower tax rates may be correlated with a less valuable package of government services. When taxpayers pay for the missing services out of their own pockets, a territorial tax regime apparently following the capital import neutrality norm may come closer to actually achieving capital export neutrality than would an ostensibly capital export neutral tax credit system (Roin 2001, p. 587; Hines 1999a, p. 398; Stephens 1998, p. 167).

Alternatively, true capital export neutrality may require a payment that is unrelated to the tax charge imposed at source and only tangentially related to the charge imposed on domestic taxpayers in the country of residence. Although the roads and ports utilized by a transnational business in its source country may be relatively poor, that does not mean that it therefore benefits from and thus should pay for the better roads and ports of its residence jurisdiction. Nor, just because the roads and ports are exceptionally good and expensive in the source country, does it mean that the taxpayer enjoys less in the way of diplomatic or consular benefits from its residence jurisdiction. Going back to the example from the very first section of the chapter, there is no particular reason to believe that the package of combined benefits received by a transnational taxpayer totals the $120 extracted by the source state or the $150 that would be the residence country's levy on domestic income. It could well be some amount in the middle, or above $150 or below $120. Yet none of the classical methods for coordinating double taxation allows for this possibility. Indeed, all but the national neutrality method leave open a substantial possibility that the residence country provides benefits while collecting no tax revenue at all. There is another option, of course. A residence country could impose tax on foreign source income at some, probably relatively low, rate regardless of the amount of source tax imposed. This rate could reflect the country's best guess as to the quantum of benefits provided on the basis of residency. This rate, like all tax rates, would be a rough approximation, and it might differ depending on whether the taxpayer is a corporation or a natural person. If imposed on individuals, it could be imposed with or without deferral when attributable to foreign corporate earnings. The resulting tax burden might more closely approximate true capital export neutrality than one measured in nominal dollars.

Interestingly, the only situation in which this approach came close to being used (and in truth, it was not very close) was when the US limited the percentage of alternative minimum tax liability that could be offset with foreign tax credits. That limitation was repealed in the last tax act (American Jobs

Creation Act of 2004, PL 108-357, § 421, repealing IRC § 59(a)(2)). Although last year's tax act also reduced the tax rate on dividend income received by individuals, the reduced rate applies equally to dividends paid by domestic and foreign corporations. Moreover, recipients of foreign dividends remain eligible for direct foreign tax credits. The one year reduced rate of tax imposed on repatriated intra-corporate dividends enacted at the same time comes closer to conformity with such a policy.

Assuming for the moment that capital export neutrality is achieved by a tax credit system which equalizes the tax burden placed on foreign and domestically earned income, another problem arises: a perfectly operating system is remarkably hard to construct and maintain. Some of the problems encountered in the operation of such systems are described in the next section.

B. IMPLEMENTATION ISSUES No tax credit system completely implements the capital export neutrality norm in even nominal terms. Much of the slippage is deliberate. The United States, for example, limits its tax credits to the amount of tax that would have been paid with respect to foreign income had it been earned domestically. So for example, if a US taxpayer X earns $300 in country A on which it pays $150 in A country tax, and US tax law imposes a 40% tax rate so that the additional $300 of income increases X's US tax liability by $120, the US would allow X to claim $120 of foreign tax credits. Although those credits would offset the entirety of the US income tax due on the $300 of foreign income, X's total tax burden would be $30 higher than it would have been had it earned all its income in the US. Though good reasons exist for having a foreign tax credit limitation (namely the fear of home-made foreign aid effected through the imposition of excessive taxes on foreign investors resident in tax credit countries)[7] there is no question that it violates the capital export neutrality principle by discouraging investment in A.

Much of the sting of this tax credit limitation, however, is alleviated by 'cross crediting'. Cross crediting occurs when a taxpayer combines high taxed and low taxed foreign income for purposes of satisfying the foreign tax credit limitation. Suppose our taxpayer X has two foreign income streams, one from country M which generates $100 in profit but is subject to a foreign income tax of $50, and another from country N which generates $200 in profit while being subject to a foreign income tax of $20. Suppose further that X is a corpo-

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[7] Though alternative controls such as nondiscrimination rules, which tie the treatment of foreign investors to that of local businesses and other foreign investors, might operate to prevent some of the worst abuses, these alternatives are partial correctives at best (Hufbauer and Van Rooij 1992, p. 52; Roin 1989, pp. 928–9). In addition, in the absence of a credit limitation, taxpayers would have no incentive to 'arrange their affairs to minimize foreign taxes' (Graetz 2001, p. 292).

rate resident of country A which levies a corporate income tax of 35%. In the absence of cross crediting, X would be entitled to take a foreign tax credit of $55 ($35 of M's $50 tax and all $20 of N's $20 tax) against its A country tax obligation of $105, leaving a residual A country tax of $50 and an after-tax profit of $180, or $15 less than if all the income had been earned in A. If X can consider the two income items together for tax credit limitation purposes, however, it can claim a tax credit for all $70 of foreign taxes paid because $70 is less than 35% of $300, leaving it with a residual A country tax of merely $35 and an after-tax profit of $195, the same as if all the income had been earned in A. Such cross crediting reduces the impact of the foreign tax credit limitation on investments in M while encouraging taxpayers like X who would otherwise find themselves in 'excess credit' positions, to invest in low taxed countries like N, thus simultaneously undercutting the rationale behind both using a tax credit and having a tax credit limitation (Roin 1989, pp. 927–37). Even worse, the low taxed foreign income often consists of treaty-protected income, income bearing low or no source taxes because the US gave up its claim to source taxation of residents of its treaty partner. Since cross crediting denies the US the revenue meant to offset its source taxation concessions, it turns treaty arrangements from relatively revenue neutral agreements into money losers (Roin 1995, pp. 1774–5).

Additional slippage exists in the rules regarding the taxation of foreign subsidiaries of US corporations. As discussed earlier, because corporations are treated as distinct taxable entities for US tax purposes, as a general rule shareholders are not deemed to receive and thus do not pay income tax with respect to their aliquot share of corporate earnings until those earnings are distributed to them in the form of a dividend. And, of course, the US has no basis for asserting taxing jurisdiction over foreign corporations earning only foreign income. Together these rules provide US businesses with a legal escape from the demands of capital export neutrality. All a US parent company has to do is carry out its foreign business operations through a separately incorporated foreign subsidiary. The foreign subsidiary cannot be taxed by the US on its foreign profits; its US shareholders enjoy only unrealized, and thus untaxed, gain until such time as the foreign profits are distributed in the form of a dividend or other taxable distribution. When that distribution takes place and the residence tax must be paid, corporate shareholders become entitled to claim tax credits based on the foreign income taxes paid by the foreign subsidiary (IRC § 902). The residence tax is thus 'deferred' until the year such a distribution takes place, with the deferral operating as an interest-free loan from the US government.

The effects of these rules can be demonstrated in the following example which assumes a US corporate income tax rate of 40%, a B country corporate tax rate of 30%, and posits a US corporation X carrying out foreign business

operations in B through an incorporated foreign entity Y. In the year Y earns $300 in country B, no portion of this $300 is taxable in the US unless and to the extent that money is distributed to X in the form of a dividend. Assuming no such dividend payment is made, Y pays $90 in tax to B and nothing to the US Treasury. Y would be left with $210 of after-tax profit to reinvest in its B country operations, the same amount it would have if it were a resident of a territorial tax jurisdiction. However, when Y distributes that $210 to X in a later year, X would have to pay US income taxes of $30. Technically, X would be treated as receiving a dividend distribution of $210 (the cash actually distributed) plus $90 (the amount of tax paid to B with respect to the distributed cash) for a total of $300. X's US tax obligation, assuming a US tax rate of 40%, would be $120, its foreign tax credit would be $90 and its residual US income tax obligation would be $30 (26 USC §§ 78, 902). X's business operations in B thus benefit from 'deferral' of its US tax burden; at its extreme, this deferral is economically equivalent to exemption or a territorial system of taxation (Hufbauer with von Rooij 1992, p. 57). This example assumes, perhaps counterfactually, that B does not levy an additional income tax obligation on the dividend payment from Y to X. Such a tax would create additional complications, but probably would not change the bottom line result (Roin 1989, pp. 952–63).

Note that this example accurately describes the tax treatment of a corporate X. If the domestic shareholder is an individual person, a different treatment follows. First, no credit is granted for foreign taxes paid by the corporation. However, X would not be responsible for paying to the US a tax equal to the difference between the US corporate tax on the distributed income and the foreign tax actually paid with respect to it. Instead, the individual X would be subject to the individual level tax on this dividend income, a tax currently imposed at a marginal rate of 15%.

It is the existence of deferral which leads the US tax credit system to be described as being a compromise between capital export neutrality and capital import neutrality. A great deal of ink has been spilled on the question of how different deferral is from capital import neutrality. One traditional question in the academic literature is the effect of this 'not quite capital export neutral' tax regime on tax-motivated investments in low tax countries, and in particular, whether companies respond to deferral by making investments in low-tax jurisdictions. In theory the answer depends on where one assumes the investment funds are coming from, new investments monies drawn from the residence country or reinvestments of foreign earnings. Viewed *ex ante*, the prospect of a step-up tax on repatriated profits may deter some new investments on the margin. Alternatively, the effect merely may be to instigate a change in financing structure. Several economists contend that the current constellation of rules encourages US multinationals to undercapitalize their

foreign subsidiaries (Altshuler 2000, pp. 264–5; Hines 1999a, p. 400). Others suggest that it changes the form rather than the fact of corporate distributions (Altshuler 2000, p. 265). When it comes to decisions about where to invest retained earnings, however, most economists agree that home country taxation should be irrelevant. The idea is that since future foreign earnings will be subject to the same repatriation tax, these taxes should neither discourage nor encourage the continued reinvestment of foreign earnings abroad relative to distributions to the domestic parent (Altshuler 2000, p. 264; Hartman 1985, p. 111). However, this result holds only under fairly stringent and not particularly realistic conditions (Altshuler 2000, p. 264 note 39; Hines 1997, pp. 428–9). Recent empirical work appears to show that repatriation taxes have little effect on choices among foreign investment locations, suggesting that the effect of deferral approximates that of a territorial or exemption system (Grubert and Mutti 1999, pp. 13–15).

However, these studies do not specifically look at changes in the level of domestic versus foreign investment (Altshuler 2000, p. 266). Moreover, other empirical studies suggest that the effects of cross crediting may overwhelm any capital export neutralizing tendencies of the foreign tax credit mechanism. (Altshuler 2000, pp. 265–6). This provides another reason for discounting the significance of the empirical literature equating the effects of deferral with the effects of territorial systems; the equivalence may be the result of cross crediting rather than deferral.

The implementation issues detailed above could be ameliorated if not solved by legislative action. The tax credit limitation could be refined to avoid overtaxation of corporate dividend income while minimizing the effects of discriminatory taxation. Cross crediting could be eliminated by mandating the operation of an item-by-item credit (Roin 1989, pp. 947–9) or reduced by other reforms of the tax credit limitation (Fleming and Peroni 2004, pp. 1396–7; Peroni et al. 2003, p. 1211). Cross crediting of treaty-protected income in particular could be eliminated by separately basketing such income for foreign tax credit limitation purposes or by redesignating this income as US source income by statute (Roin 1995, p. 1775). Deferral could be eliminated either by extending the subpart F regime to tax US shareholders on their pro rata shares of all income earned by subsidiary foreign corporations, by directly taxing the profits of those foreign subsidiaries, or by some combination of the two (Fleming et al. 2000, pp. 847–50). All of these solutions are expensive however and that expense could itself breed unpleasant ramifications. The question is whether such expense would be justified. In short, is it reasonable to believe that capital export neutrality will confer enough economic gain to justify the costs of achieving it? If one believes that the tax system's goal should be to maximize world welfare and that equalizing nominal tax liabilities leads to a reasonably close approximation of capital export

neutrality, the answer is probably yes. But if the goal is to further national self-interest rather than world welfare, as the next subsection makes clear, the answer is much less clear.

C. NATIONAL VS. WORLDWIDE WELFARE Maximizing worldwide economic welfare does not necessarily improve every country's economic position; a slice comprising one-fifth of a larger pie may have a smaller surface area than a slice comprising one-third of a smaller pie. Many have begun to question whether the overriding goal of tax policy should be national rather than worldwide welfare (Graetz 2001, p. 277; Dagan 1998, pp. 365–6). There are many who contend that, whatever its implications for worldwide welfare, capital export neutral tax policies undercut national welfare.

At base, the policy debate revolves around the relative importance of two possible tax equivalences in maintaining the economic attractiveness of a residence country such as the US. Those who support capital export neutrality on national welfare grounds maintain that it preserves the tax base of residence countries because equalizing tax rates between domestic and transnational income leads to more investment in the residence country at the expense of investment in low tax countries. Opponents of capital export neutral tax systems argue that it is more important to maintain tax parity between the foreign operations of resident companies and their foreign competitors, even if both end up paying less in tax than their fully domestic competitors. Although the result of such a tax policy may well be the demise of the fully domestic competitor (although perhaps not if the lower tax rate on foreign operations reflects a lower level of governmental services), at least the foreign operations owned by resident companies may survive. Under a capital export neutral tax system, the critics argue, all domestically owned and operated business operations would likely fall to the low taxed, completely foreign competition. And that, for a country, is the worst of all worlds because ownership matters. Though in our increasingly globalized securities markets, portfolio investors can invest in foreign multinationals, thus reducing or eliminating distortions in actual investment flows caused by tax rules disfavoring US corporations, supporters of territorial tax systems contend that domestically owned businesses are more likely to use domestic suppliers and contractors than are foreign owned businesses, directly increasing the economic health of the residence country (Hufbauer with van Rooij 1992, p. 58).

It is unclear how seriously to take these concerns about ownership neutrality and/or the demise of foreign operations of resident companies given the artificial and mutable nature of corporate residence. Corporate residence generally depends upon under which country's laws the corporate entity was formed. Incorporators of new corporations can choose from among many countries with relatively decent sets of corporate laws and institutions, and not

surprisingly, many now base their choice on tax considerations – perhaps to the detriment of shareholders' corporate law interests (Johnston 2002, p. C-1). Reincorporation of an existing corporation in a new jurisdiction may be more difficult and expensive, and at least in the US, often entails a significant tax charge (Chorvat 2003, pp. 484–9; Hines 1997, pp. 434–5). However, a sufficient number of long-established corporations reincorporated in low tax jurisdictions to cause the US to enact legislation under which some expatriations are disregarded for tax purposes (American Jobs Creation Act of 2004, PL 108-357, § 801(a), codified at IRC § 7874). It remains to be seen whether this statute will be effective. But the larger point is that given the formal nature of corporate residence, one must wonder whether corporate residency means enough to be taken seriously. Would an expatriated General Electric really use fewer US suppliers than a General Electric formally incorporated in the US but actually operating in another country? Perhaps answers can be gleaned from the behavioral changes (if any) of owners of Liberian or other flag of convenience ships.

On the other hand, there does not seem to be much point in attempting to levy a residence country tax that, as a practical matter, cannot be collected, particularly if there is a danger that the readily available avoidance techniques may have undesirable collateral consequences (Graetz 2001, p. 323). Even if legislation like the recently enacted US anti-expatriation statute is effective, at best it will operate only to delay the disappearance of multinationals resident in high tax countries (again, unless those countries confer sufficiently valuable benefits to their residents which are not available to nonresidents), for it does nothing to stop the incorporation of new entities in low tax countries.

Countries could take the more drastic step of imputing upstream to the ultimate individual owner of corporate capital a constructive dividend equal to each year's foreign profits. The consequences of expatriation tend to be more severe for people than for corporations. Though a few notable and noted examples of tax-motivated expatriations exist, most commentators assume that relatively few taxpayers will actually give up home, family and friends to live in a low tax country. But as the US has learned from operation of its subpart F regime which goes partway in this direction, doing so is immensely complex, quite dependent on the availability of information that neither taxpayers nor other countries are particularly interested in supplying, and still risks disfavoring the business prospects of the foreign entity relative to its all-foreign competitors. Although any tax liability would be incurred by the individual residence country shareholder rather than the operating business, shareholders may demand distribution of current cash dividends to defray this expense. This would have the effect of reducing the amount of self-generated funds for business investment and expansion. As tax rates vary among countries, so too would the amount of demanded distributions and the effect on

investment funds. As one economist put it, 'the national composition of world foreign-owned capital stocks will be affected under a system of capital-export neutrality' (Richman 1963, p. 8). Although this particular economist believed that '[t]his consideration . . . is not important on efficiency grounds' (Richman 1963, p. 8), those economists who believe that 'the productivity of capital depends on the identities of its owners' (Desai and Hines 2003, p. 494) would disagree with that assessment.

Opponents of capital export neutrality tend to be proponents of the final method of tax coordination, capital import neutrality or territoriality. Capital import neutrality occurs when all businesses operating in a given jurisdiction face the same level of tax. It can only be achieved if the residence country gives up the entirety of its tax claim, or if the source and residence country agree to split the proceeds of the source country tax.

2.3.3. Capital import neutrality Most European nations have chosen to use a capital import neutral method of taxing foreign business income, while the US tax credit mechanism, because of the allowance of deferral for income generated through the foreign business operations of foreign subsidiaries, employs a method of taxing such income that falls in between capital import and capital export neutrality. The traditional argument in favor of capital import neutrality stems from its supposed reduction of distortions in savings levels. Under a capital import neutral regime, all taxpayers would receive the same after-tax return and thus face the same trade-off between current and future consumption (Graetz 2001, p. 271; Keen 1996, p. 205). Because the elasticity of savings is 'an unresolved empirical question' (Keen 1996, p. 206) and we know even less about the 'quantitative welfare implications of alternative treatments of cross-national direct investment' (Keen 1996, p. 206; Graetz 2001, p. 273; Altshuler 2000, pp. 257–8), capital import neutrality's current appeal stems from the perceived importance, as discussed in the preceding section, of maintaining the economic health of foreign subsidiaries of resident corporations. Counterbalanced against this interest is the concern that capital import neutrality encourages destructive tax competition and encourages free-riding on expensive benefits provided by the country of residence.

A. THE TAX COMPETITION FEAR Tax competition occurs when countries try to attract additional foreign investment by reducing their tax levies. Additional investment can be valuable to a jurisdiction because it adds jobs to its economic base and, perhaps, tax revenues to its financial base. Indeed, standard economic models suggest that the optimal tax policy for a small country in an open economy is to levy no capital income tax at all (Bucovetsky and Wilson 1991, pp. 338–41; Frenkel et al. 1991, p. 206; Frey 1990, p. 89). This investment attraction strategy works only if other poten-

tial source countries fail to follow suit by reducing their own tax rates. Should other countries retaliate by enacting similar tax reductions, the situation can devolve into a classic 'prisoners' dilemma'. Investment locations remain unchanged while government income tax revenues drop (Avi-Yonah 2000, p. 1675; Wilson 1999, p. 269). It is essentially the converse of the beggar-thy-neighbor retaliation expected following adoption of a nationally neutral tax coordination system; tax revenues rather than foreign investment drop. Although these lost revenues may be recouped through increases in other taxes or fees, the argument continues, the fact that governments had not chosen to use such alternatives earlier suggests that these revenue alternatives would be inferior in some way to the income tax they would be replacing or may be unavailable altogether. If the latter is the case, the reduction in income tax revenues attributable to tax competition would lead to an undesirably low level of government spending (Bratton and McCahery 2001, p. 693; Avi-Yonah 2000, p. 1578; OECD 1998, p. 14).

At first glance, it is hard to understand why 'tax competition' should be regarded as a problem. Why should tax-induced relocations be labeled a distortion while relocations induced by other factor prices such as labor costs are hailed (by economists if not politicians) as efficient? And indeed, historically, the US's use of a tax credit mechanism was attacked as an imperialist interference with the domestic economic policies of source countries using low tax rates to attract foreign investment. Similar criticism has been leveled at its refusal to enter into 'tax sparing' treaties, treaties which obligate the US to grant US taxpayers foreign tax credits in an amount equal to income taxes deliberately forgone by the treaty partner under a special investment incentive regime (Laurey 2000, p. 471; Surrey 1978, pp. 45–6). Relocations and initial location decisions always have winners (generally consumers who are enabled to buy goods more cheaply as well as underlying holders of capital and the government in the chosen location) and losers (governments, would-be employees and landlords in the locations not chosen); the question should be whether the winners' gains outweigh the losers' losses.

Nor are we ordinarily troubled when such competition drives down prevailing prices for a good or service. Indeed, that is generally considered to be the point of competition. Why should governmental prices, or taxes, be any different? The answer, to the extent there is one, must lie in the special nature of governmental services. The aspect of tax competition that seems most worrisome to critics is the possibility that it will result in the elimination of the social safety net – governmental expenditures which operate to redistribute income to the less fortunate (Avi-Yonah 2000, p. 1578; OECD 1998, p. 14). Underlying this concern must be one of two fears. One possibility is that transnational taxpayers do not value such expenditures and thus

will gravitate to those jurisdictions which do not incur them, or at least do not charge the transnationals any part of the cost of making those expenditures. Alternatively, tax competition might drive down the extractions from transnationals to the marginal cost of providing their benefits, and the very features that make governmental services proper for public provision – nonexcludability and economies of scale – ensure that there is a large difference between average and marginal cost of benefit provision. In either case, the argument goes, fully domestic taxpayers would be left bearing financial responsibility for these redistributive (and perhaps other) programs. The result could be merely unfair, with the different groups paying different amounts for identical benefits, or disastrous, if the burdened group lacks the financial resources necessary to continue to fund the desired programs (Avi-Yonah 2005, p. 375).

This story is not without its problems. For example, if transnationals truly derive no benefit from safety net expenditures, it is not axiomatically unfair for them to fail to contribute towards their cost. After all, they are not deriving 'the same benefits' as those residents who do ascribe value to the safety net, and a different tax extraction can be justified. Nor is it economically 'wrong' for them to move to jurisdictions that do not supply these benefits. Indeed, one could reinterpret tax competition as leading to the establishment of a Nash equilibrium, in which countries compete for investors by offering variable packages of tax costs and social benefits. And indeed, the current state of the world seems more consistent with the development of a Nash equilibrium than one in which corporate taxes or taxes on foreign investment disappear altogether. Substantial dispute exists over the extent to which tax competition has led or will lead to reductions in effective corporate income tax rates (Bratton and McCahery 2001, p. 709). Evidence of actual effective (as opposed to nominal) rate declines is equivocal (Scott 2003, p. 1271; Barker 2002, p. 166) and more recent economic models suggest more complicated and less clear-cut conclusions as to the effects of tax competition (Baldwin and Krugman 2002, pp. 1–2; Eggert and Genser 2001, pp. 524–5; Bratton and McCahery 2001, pp. 708–9; Wilson 1999, p. 298). Even the most vociferous opponent of tax competition complains more about the fact that increases in tax revenue have been funded by sources other than corporate income taxes than about actual declines in corporate tax collections (Avi-Yonah 2005, p. 378).

Not only is it not clear that worldwide welfare is decreased by such competition, it is not even clear that it necessarily harms the welfare of individuals living in high-tax countries (Littlewood 2005, p. 415). One of the politically difficult aspects of globalization is that it makes most residents of developed countries both winners and losers. Residents 'win' when they put on their consumer hats from the lower prices made possible by the various

forms of competition including tax competition and they 'lose' when they put on their worker and (perhaps) citizen hats because of the downward wage pressures and the lessened ability to shift taxes to businesses. Whether the shift in tax burdens actually hurts them depends on the as yet unanswered question of who actually pays corporate taxes, customers or owners of corporate capital. If one is willing to assume rational decision-making by national authorities, tax competition would seem to lead to a desirable outcome (Littlewood 2005, p. 415; Roin 2001, at p. 561).

The more serious problem is that taxpayers may move some tax attributes to low tax jurisdictions to decrease their tax liability while maintaining enough of a presence in a higher tax jurisdiction to continue to qualify for the receipt of the same amount of expensive benefits. There is substantial evidence that companies have moved income and to a lesser extent actual business activities to low tax jurisdictions (Sullivan 2004, p. 1190; Hines 1999b, pp. 318–19). Such 'free-riding' could lead to mispricing and associated economic distortions, including the needless substitution of transnational for fully domestic investments. The worst case scenario for a residence country is to find itself in the position of having to impose very high tax rates on domestically produced income to pay for benefits being provided to residents earning income and paying (lower) taxes abroad rather than at home. Not only might such a country find itself short of revenue, but high domestic tax rates will literally push the country's economic base abroad for the simple reason that domestic businesses could find themselves unable to compete with more lightly taxed foreign businesses enjoying similar governmental benefits.

Capital import neutral tax systems appear to allow such schemes free rein by allowing taxpayers to retain the fiscal advantages of earning income in low-tax jurisdictions. This seems particularly dangerous given that, as detailed in Section III of this chapter, taxpayers have many options for relocating domestic or highly taxed income to low-tax jurisdictions. The question is whether there is an effective response to such maneuvers.

B. TAX COMPETITION 'SOLUTIONS' The standard criticism of capital import neutral tax systems is that, while in the short term, they seem to advance national welfare, in the longer term, as with nationally neutral tax systems, they decrease both national and world welfare because of the inevitable response to tax competition. The solution, it is argued, like solutions to other prisoners' dilemmas, requires centralized coordination, perhaps by the OECD, perhaps by the WTO and perhaps by some new tax-oriented world organization (Avi-Yonah 2005, pp. 385–6). This centralized solution could take one of two forms: it could restrict the ability of source states to maintain tax rates below a certain level or it could require residence countries to

operate their tax systems in accordance with the capital export neutrality norm. Each of these solutions, though, has substantial problems.

The most complete solution to tax competition would involve multilateral tax harmonization, or regulation of the tax rates set by source countries. Thus far, relatively little political support for tax rate harmonization exists even within relatively integrated political units such as the EU. Academic support also is muted due to concerns about 'the divergent preferences of citizens of democracies for particular government sizes' (Avi-Yonah 2000, p. 1626). Stated simply, for a variety of institutional as well as political reasons, no consensus has been reached as to the proper role of government; in the face of such a divergence, there is no prospect of identifying a uniform share of national product that should be taken by governments in the form of taxes. In addition, it is not clear that restricting tax rate competition will free up corporate tax revenues for redistributional purposes. Directed spending programs can provide benefits to domestic businesses and producers as effectively as can tax cuts, and perhaps even more so. Restricting tax competition may just move competition for businesses to other realms with similar economic consequences (Roin 2001, pp. 569–70). To make the exercise worthwhile, then, may require any harmonization arrangement to cover much more than taxes.

At present, political opinion seems to have coalesced solely against countries engaged in 'harmful tax competition' (OECD 1998, p. 7), defined mostly by the maintenance of 'ring-fenced' regimes or tax regimes which provide especially favorable tax rules for particularly mobile forms of financial income (OECD 1998, pp. 19–21; Bratton and McCahery 2001, p. 685), though others have defended them (Keen 2001, p. 757). Countries which maintain generally low rates on active business income such as Ireland largely though not entirely escape criticism. The argument is that ring-fenced regimes 'distort' both investment flows and the 'desired level and mix of taxes and public spending' by luring certain investments to low-tax jurisdictions and simultaneously reducing the tax bases of the lured-away-from jurisdictions (OECD 1998, p. 16). Of course, to have a 'distortion' requires that one have a defensible baseline; it is unclear how opponents of tax competition justify a non-ring-fenced taxing regime as the optimal baseline.

One view might be that ring-fenced regimes effectively constitute a subsidy for certain types of domestic production or income generation (Slemrod and Avi-Yonah 2002, p. 550). But it is not clear what is wrong with an industry-specific subsidy, unless that industry is so closely allied with export activities that it can be reframed as an export subsidy. If it constitutes an export subsidy, of course, it would be impermissible under GATT. And there is no question that providing favorable tax treatment for income generated by export-related activities constitutes an export subsidy,

as the US found to its displeasure in the string of WTO actions against the successive DISC, FSC and ETI tax regimes.[8] Although at some level, all subsidies for domestic activities inherently disfavor imports while subsidizing exports, at present generalized production subsidies remain permissible under GATT.

The most likely explanation for targeting ring-fenced subsidies is simply that in the short run, they are the most attractive method for countries to lure foreign investors. Limiting the tax reductions to foreign investors poses the smallest immediate danger to a host country's treasury. Reducing effective tax rates on business income generally risks tax collections from pre-existing domestic businesses, and for that reason will be less attractive to most jurisdictions. And particularly when it comes to financial income, the option of providing disproportionate benefits may be unavailable. Indeed, one of the reasons why it makes financial sense for a jurisdiction to try to attract such financial income in the absence of associated tax revenues is that the income producing 'activity' places few if any demands on governmental infrastructure.

But the fact that the ring-fenced option is attractive does not make it wrong. Foreign investors may not obtain all the benefits offered by their host country by virtue of their foreignness; they may instead rely on their country of residence for some benefits. If so, why should they be paying a full set of source taxes? In an ideal world, perhaps the source state should collect its full tax claim and then cede some of those tax revenues to the country of residence (which might still want to levy some additional residence-based taxes to pay for additional benefits conferred). Making such revenue flows transparent might be helpful from a political, if not economic, standpoint. Alternatively, such a distribution of taxing jurisdiction and revenues might be achieved through a revenues clearinghouse. However, as long as a source country does not impede residence country efforts to impose its own taxes through secrecy laws or the like, merely imposing a lower tax rate on foreign

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[8] The FSC regime and other similar regimes which preceded and followed it were attempts to provide territorial tax treatment of foreign profits generated through export activities. Although this tax treatment matched the tax treatment provided for export income in countries which generally followed capital import neutral tax policies, countries following such capital import neutral policies also eliminated the tax on foreign income generated with respect to import transactions. By providing more favorable tax treatment of export income than import income, the WTO concluded that the US favored export activities in violation of its obligations under GATT. In short, it held that although the US is free to adopt a capital import neutral, territorial tax system, it must do so for all income or at least a category of income more broadly defined than export income (Sheppard 2003, pp. 113–16; World Trade Organization 2000, ¶ 140; World Trade Organization 2002, ¶120).

earners is one plausible approach to the overtaxation problem. Indeed, if the residence states utilized a fully capital export neutral tax regime or imposed a lesser amount of tax on foreign earnings, one could see ring fencing as leaving room for residence country taxation. Similar arguments can be made to justify a taxing regime ring fenced on the basis of industry type as opposed to ownership.

Of course, one suspects that few source countries would offer any sort of tax concessions in a world of capital export neutral regimes since their revenue losses would not translate into additional investment attractiveness but rather gains to the residence country treasury. They would place national welfare above the claims of interjurisdictional equity and grab as much revenue as possible. That fact should make one suspicious of a country's motives in offering such tax concessions, but the real problem may lie with the residence country's choice of coordination method (or, to put it another way, the strategic behavior of source countries makes it unlikely that residence countries will be adequately compensated in the event they adopt a capital export neutral system of tax coordination) rather than the source country's actions. The point is not that all ring-fenced regimes or all tax competitions are good; it is simply that they are not necessarily bad and in the real world it may be very difficult to distinguish between good and bad situations.

Coordination of source country taxation is one alternative; another is coordination of residence countries. In particular, it has been argued that residence countries could enter into a multilateral agreement to operate their tax systems in accordance with the capital export neutrality norm and to help each other achieve that goal through the mutual provision of tax information (Avi-Yonah 2005, p. 384). However, this would merely shift the locus of competition rather than shut it down. As long as countries maintain tax systems with different underlying rates, businesses resident in the lowest tax countries would still have (or be perceived as having) an advantage over other international competitors. As discussed earlier, the result may well be that corporate taxpayers in particular become residents of those lower tax jurisdictions while their individual shareholders remain in the high-tax jurisdiction, receiving expensive benefits and perhaps even demanding benefits on behalf of the corporation. From a financial perspective, the results would be the same as if the coordinating countries simply adopted capital import neutral tax systems.

To have any chance of success, the agreement would have to mandate carrying the capital export neutrality scheme on a non-deferred basis down to the level of the relatively immobile individual shareholder. That would raise some technical issues, ranging from whether to require full payment of the corporate as well as the individual level tax, possibly disadvantaging investments in these foreign corporations relative to investments in domestic ones,

or whether to forgive the shortfall in corporate tax and simply impose the individual income tax, possibly leading to undertaxation. And of course, the operation of such a scheme would require either very honest taxpayers or extensive cooperation by the low tax source and 'intermediate' residence countries. Inasmuch as such cooperation would be contrary to the national interests of countries which would not be residence countries for other than tax reasons, it cannot be assured. Although buying off such countries is theoretically possible, in actuality it is impossible to imagine, given the number of countries likely to claim that they could/would/were thinking of becoming tax havens and the difficulties involved in determining which countries should provide how much of the side payment required. Collaboration on punitive actions is only slightly more plausible.

In short, it may be impossible to do more than delay the advance of tax competition through either the choice of tax coordination method or by multilateral agreement among source or residence countries. 'Fiscal termites' (Tanzi 2001, p. 1261) will find ways to defeat such attempts. That raises the question, discussed in the next section, whether direct attacks on the ability of multinational taxpayers to mis-source or hide income would be more effective at dealing with the problem. That is, the most that a jurisdiction can hope for is to ensure that income legitimately sourced within its borders is fully taxed – and that that tax does not encourage its earner to legitimately re-source it in a lower tax country.

3. Fudging the numbers

The discussion contained above focuses on the superstructure or design principles underlying different methods of coordinating tax systems. However, actual coordination implicates more than overall design issues. Whatever method of tax coordination is chosen, implementation of the choice involves meshing what are often inconsistent concepts of source, character and income computation. Rules developed in the context of national tax systems often work poorly when placed in international contexts, and taxpayers often take advantage of their defects to undercut countries' attempts to implement their design choices. The devil, it turns out, really is in the detail in the tax area, and more than ever, the question has become whether exorcism is possible. This section details two specific areas in which problems have arisen, so-called 'tax arbitrage' and intercompany pricing, and explains the difficulties encountered in trying to deal with them. A common feature of both problem areas is that they allow taxpayers to reallocate income from high-tax countries to low-tax countries without making any changes in actual business practices. This makes the adoption of methods of tax coordination that reward taxpayers for earning income in low tax countries particularly dangerous (Sullivan 2004b, p. 32; Sullivan 2000, p. 1352).

3.1. Tax 'arbitrage'[9]

Tax liabilities are a function not only of the 'grand design' of a tax system, but also of the minor and often arbitrary rules enacted in order to effectuate that larger design. Although all income tax systems use a number of common legal concepts such as debt, equity, corporations, leases, sales and ownership, these terms are often defined somewhat differently from country to country. One country's definition of a lease may encompass some transactions that in another country would be denominated a sale for tax purposes. For the most part, both definitions are 'right' in that neither is categorically superior to the other, although one definition may work much better than the other within the design constraints of a particular tax system. One feature of the latest generation of tax planning has been an increased emphasis on the exploitation of inter-country differences in these minor rules. Often such exploitation allows taxpayers to receive better tax results when engaging in cross-border transactions than would be allowed domestic taxpayers engaging in the same transaction. That is, if X, a resident of country A, earns $300 in country B, X's tax liability may be less than the tax that would have been due had it earned the $300 in A and also less than if a resident of B had earned the $300 in B. This result goes beyond capital import neutrality and constitutes an incentive for many taxpayers to invest in countries other than their own. Such disincentives for domestic investment violate economic rationality, to say nothing of their effect on government revenues and the waste of resources involved in looking for and combating such tax stratagems. At other times the results of tax arbitrage are less obviously irrational, though still suspect, as when the effect is to make X's tax liability the same as it would have been had it earned the $300 in A but less than it would have been had X been a resident of B earning the $300 in B.[10] Favoring foreign investors over domestic ones seems politically dangerous as well as economically questionable – but it happens, particularly when governments are eager to attract foreign investors.[11]

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[9] As a number of other observers have already noted, the term 'tax arbitrage' is a misnomer for the various transactions discussed in this section. They fit neither within the classic definition of financial arbitrage nor the expanded definition of tax arbitrage. 'Arbitrage' has, however, become the accepted nomenclature for transactions which 'take advantage of inconsistencies between different countries' tax rules to achieve a more favorable result than that which would have resulted from investing in a single jurisdiction' (Shaviro 2002, pp. 321–3).

[10] Note that this would also result from A's maintenance of a pure capital export neutral system of residence taxation. But countries which use tax credit systems generally depart from pure capital export neutrality by limiting the amount of foreign tax credits that can be claimed. Of course, as explored in Section 2.2.3 above, cross crediting may generate similar effects.

[11] Such favoritism often results from the interplay of domestic tax rules and

There are many examples of inconsistent rules leading to questionable tax results. Most are too technical to appeal to a general readership, but it is worth explaining some schemes to give an idea of how they work or used to work. Both of the schemes described below utilize the 'check-the-box' regulations that the US Treasury issued in December 1996. The 'check-the-box' regulations allow US taxpayers to elect whether to treat certain ambiguous legal entities as corporations or as partnerships or as some other tax-transparent entities for US tax purposes. Originally, there was no duty of consistency; taxpayers could treat an entity as transparent for US tax purposes and as a 'real' corporation for foreign tax purposes. For example, a US corporation X may have treated a wholly owned legal entity Y as a separate corporation for British tax purposes while treating it as a 'tax nothing' for US tax purposes. When Y made a payment to X under a purported loan agreement, the UK would have treated the payment as interest, entitling Y to an interest deduction against its income for British tax purposes and X to an exemption from the withholding tax under the terms of the UK–US tax treaty. However, this same payment could have been treated as a non-event for US tax purposes, although X's income would have included all of Y's income unreduced by the alleged interest payment. The ultimate result would have been 'true' capital export neutrality in that the 'interest payment' would have been taxed along with Y's other income in the US at US rates while avoiding the higher UK tax rates. Under an even more aggressive variation, Y was a 'tax nothing' appendage of the British corporation Z for US tax purposes. Then, when Z deducted the payment to Y for British tax purposes, reducing British taxes, the US failed to recognize or tax the payment to Y. As far as the US was concerned, the nontaxable foreign Z still held the amount paid out to Y. As long as Y itself was located in a low tax jurisdiction and the payment was exempt from source taxation by Britain pursuant to a treaty or statutory rule, no residence or source tax would be payable on the amount paid to Y until a further distribution took place. Whether one approved of this result, and perhaps the rule allowing inconsistent and opportunistic box-checking, depended in part on what one thought of US businesses in Britain being taxed at lower rates than UK investors in Britain. One's attitude might also depend in part on one's suspicion that neither Britain nor the US intended this result to occur and that this result violated aspects of both countries' policies as expressed in the balance of their tax codes. Further, it is reasonable to be concerned about the waste of time and talent spent looking for such mismatches (Roin 2002, pp. S72–S73).

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treaty concessions. One as yet unexplored legal question is whether treaty relationships that provide this sort of benefit to foreign taxpayers should be considered the legal equivalent of 'ring fencing', a practice that violates – and thus is potentially sanctionable under – the OECD's program against harmful tax competition.

Another variation of this scheme involved 'domestic reverse hybrids'. This scheme involved a foreign parent corporation, P, and two US subsidiaries, S-1 and S-2. P was a resident of a country Y with a tax treaty with the US providing for a 10% withholding tax at source on dividend income and no withholding tax on interest income. P owned S-1 and S-1 owned S-2. Although both S-1 and S-2 were treated as 'real' corporations for US tax purposes, only S-2 was treated as a 'real' corporation for Y tax purposes. S-1's funds came in the form of a loan from P. S-2 operated a successful business in the US and paid a 'dividend' to S-1, which then made an offsetting 'interest payment' to P. Because the US treated S-1 as a 'real' domestic corporation, S-1's payment to P escaped US source tax. S-1 itself escaped US tax because of the intercorporate dividend exclusion. Meanwhile, P's residence country treated S-1 as a passthrough tax nothing and treated its receipt of S-1's payment as a receipt of a dividend from S-2, triggering total exclusion if P came from a country maintaining a territorial tax system or a foreign tax credit if it came from a tax credit country. In short, by using a 'domestic reverse hybrid', P avoided the source tax on dividend income called for under the tax treaty, reducing its overall tax burden and undermining the treaty's implicit revenue trade.

Many arbitrage opportunities can be remedied on an individual basis. A country may enact statutory or regulatory rules that take away arbitrage opportunities once the tax authorities become aware of them. For example, the US could (and to some extent has) shut down the 'hybrid entity' schemes detailed in the paragraphs above by denying tax treaty benefits in the case of straight hybrid entities and by disallowing a deduction for interest payments made by reverse hybrids (Kane 2004, p. 161; Isenbergh 2003, pp. 107:12–107:23). Such counterbalancing rules can raise revenue and increase economic efficiency.

However individual statutory fixes are no panacea. In the first place, disputes may arise over which country ought to enjoy the increase in revenues created by such 'fixes', particularly in situations where either of the affected countries has the option of passing corrective legislation. Worse still, both countries may enact legislation, leading to overtaxation or distortions of taxpayer behavior as certain business configurations are avoided to elude overtaxation (Shaviro 2002, p. 328). Further, these statutory remedies come with the problem of reactive solutions, as do most attempts to shut the proverbial barn door after the cow has left the barn. As a political matter it can be quite difficult to take benefits away from taxpayers after they have become accustomed to them, and taxpayers become accustomed to all benefits remarkably rapidly. Congressional opposition to one group of anti-hybrid entity regulations resulted in the insertion of taxpayer-friendly transition rules and a five-year moratorium on additional regulations (Kane 2004, p. 160 note 159; Engel 2001, pp. 1552–7).

Even when the benefits turn out to be temporary, incentives remain for taxpayers to search out and exploit new arbitrage opportunities. This is important because new ones will always exist. As legislation shuts down existing opportunities, other legislative changes aimed at solving unrelated domestic problems create new inconsistencies that can be twisted to create new arbitrage opportunities (Roin 2002, p. S76).

Members of the EU face another obstacle in dealing with tax arbitrage. Court decisions have held some anti-abuse legislation to be in violation of the 'freedom of establishment' clause of the Treaty of Rome. For example, the European Court of Justice ('ECJ') is currently considering whether Britain must allow a taxpayer to offset a loss incurred by a foreign subsidiary against British income, even though income generated by that subsidiary had never been subjected to British tax. Should the ECJ uphold the principle, espoused by the Commission, that foreign subsidiaries must be granted all the tax advantages of a domestic subsidiary while they continue to enjoy tax advantages such as deferral or exemption for foreign profits, arbitrage opportunities will multiply (Sheppard 2004, p. 1490). Such an outcome is likely given that the ECJ's advocate general came down in favor of the taxpayer claiming a right to relief. The court adheres to such recommendations about 80% of the time (Kirwin 2005a, p. G-4). Moreover, that outcome would be consistent with what some see as the ECJ's not so hidden agenda of forcing the harmonization of national tax systems and the adoption of formulary accounting methods (Sheppard 2004, p. 1491; Cerioni 2003, p. 136).

Multilateral adoption of a uniform tax base or 'tax base harmonization' would provide a systemic correction of the arbitrage problem. The prospect of such harmonization has been the subject of extensive commentary (Selbach 2003; Roin 2002; Brauner 2003). Such harmonization would come at a price. New institutional structures would need to be formed, not only for the one-time purpose of bringing existing inconsistent laws into concordance but also for the ongoing task of interpreting and administering those laws and enacting any subsequent legal changes. The required multilateral organizations would run the risk of being either anti-democratic or schlerotic, slow to make necessary changes in a world of rapidly changing economic circumstances. It is hard to know how to evaluate this trade-off between uniformity and institutional complexity in theoretical, let alone practical, terms.

Despite these problems, some economic blocs, including the EU, have tax base harmonization proposals under active consideration. The tax base harmonization proposal under consideration by the EU is part of a larger proposal designed to move the Community away from separate accounting and towards mandatory combined reporting and formulary taxation of related businesses (Gerard 2002, p. 3; Cnossen 2002, p. 62; Brauner 2003, p. 14; European Union Commission IP/1/1468 (October 23, 2001), at 2001 WTD 206–27). By

combining tax base harmonization with a scheme for the allocation of tax revenues, the EU obviously hopes to deal with what might be considered the most dangerous arbitrage opportunity of all: taxpayers' ability to strategically locate income and losses through the manipulation of transfer prices between related entities. As the next section makes clear, such valuation issues may be the knottiest problem facing designers of rules for the taxation of international transactions.

3.2. Source rules, transfer pricing and tax avoidance

Territorial and tax credit systems both require taxpayers to determine the source of their income and deduction items. Source determinations also are critical to source countries as they define the extent of their taxing jurisdiction. Because source determinations often establish how much tax will be paid as well as the jurisdiction to which such payments should be directed taxpayers too are extremely concerned about them. But source, it turns out, is a rather fuzzy concept.

Source determinations actually involve three distinct analytic tasks. The first is the definition of the income being earned or expenses being deducted in terms of the categories established by statute or treaty. Most source rules by their terms apply to particular types of income; the first challenge is to fit actual income items into one of those defined types. The second involves application of the source rule to the income so defined. That is, once the income has been determined to be of a certain type, facts surrounding that income may have to be analyzed in conjunction with the applicable source rule to assign the income to a particular source. Third and finally, in many cases taxpayers will have several different types of income, or will derive a single type of income from several sources. In such situations, the taxpayers have to allocate their income and expenses among those various types or sources of income. None of these tasks is straightforward and, more importantly, all can be manipulated by taxpayers seeking to minimize their tax obligations.

Many taxpayers structure their business transactions to ensure that they generate the 'right' type of income. In most cases, this means generating a type of income that can be sourced in a low-tax jurisdiction under the applicable source rule or otherwise subject to tax under a favorable tax regime. Source rules, or more precisely the categorization of income items in connection with source determinations, can also affect the income's eligibility for treaty-based tax relief. Much of the maneuvering and tax planning is aimed at qualifying the income for source tax relief under a treaty rather than changing the source of the income *per se*.

Tax-motivated structuring can be as simple as financing operations with debt rather than equity, since interest income is often subject to less tax at source than dividend income (to say nothing of the possible avoidance of the

initial source tax on the corporate profits underlying the dividend payment). The reduced source taxation can often be combined with low residence country taxation by ensuring that the recipient of the interest income is an entity located in a low-tax jurisdiction. Alternatively, a taxpayer may change the type of income that it generates by documenting its transactions differently. A taxpayer may use differential pricing schemes to 'slice and dice' its income into smaller or larger numbers of component parts to generate the best tax results. For example, most lending transactions include a service element (loan processing), an interest element (the time value of money charge), and a risk (credit risk) charge. In the absence of tax considerations, a bank might charge a single sum, denominated 'interest', as its compensation for undertaking these different functions. If it followed that pricing system, most tax systems would source the resulting income according to the rule applicable to the 'dominant' income-producing function, the time value of money function – or, in short, as 'interest'. However, a bank may split the unified transaction and its accompanying unified 'interest' fee into the three component parts, with a separate fee – and depending on the jurisdiction perhaps a separate source – for each of the parts if that leads to more desirable tax results.

Other schemes require more elaborate and perhaps more expensive alterations in business arrangements. The owner of valuable intellectual property can exploit such property in a number of ways. It could simply license the property in exchange for royalties. Alternatively, it could manufacture goods incorporating the intellectual property for resale and then sell the goods, generating income from manufacturing and sales with nary an intellectual property return in sight. In yet another variation, the taxpayer could hire someone else to perform manufacturing services and to sell the resulting products, all on behalf of the taxpayer. Such hired manufacturers are known as 'contract manufacturers' or 'consignment manufacturers' and sales operatives as 'commissionaires' or 'consignment sellers' (McGill and Yoder 2003, pp. 147–55). Even after paying these subcontractors, the taxpayer could be left with substantial income because of its ownership of the intellectual property and its acceptance of business risks, not to mention the recompense it deserves for its exercise of managerial or entrepreneurial skill in locating and overseeing the work of such subcontractors – but its income looks like general business income rather than royalties or insurance premiums or income from the manufacture or sale of goods, and would be sourced accordingly. It is clear that many taxpayers choose among these alternatives based in part on tax considerations.

Once the income has been given the proper character, the taxpayer ensures that the facts support the desired source assignment under the rule applicable to that category of income. For example, under the laws of some jurisdictions including the US, sales income is located in the country in which the sale is

deemed to take place, defined in terms of where title or the risk of loss of the goods passes rather than where the sales-related activities are performed. Taxpayers routinely draft documents of sale and arrange insurance purchases in whichever plausible country leads to the lowest tax burden.

Once a taxpayer has arranged its affairs to create a category of low-taxed income, the third level of tax avoidance begins. Taxpayers assign as much income (and as few deductions) as possible to the tax-favored category. Generally this is accomplished by manipulating the price at which goods and services are provided for or by related entities. For example, suppose a taxpayer engaged in the business of manufacturing widgets in a high-tax jurisdiction arranges its affairs to sell its output to a related company located in a low-tax jurisdiction for distribution to third party retailers located in other high-tax jurisdictions. If the widgets cost $6 to make and another $6 to market and ship while retailers pay $30 per widget, the price the manufacturer charges the related distributor for each widget determines how much of the $18 of profit is allocated to the manufacturer and how much is allocated to the related distributor. In this hypothetical case, the lower the 'transfer price' from manufacturer to distributor the better the tax results from the taxpayer's perspective. If the manufacturer charges the distributor a mere $6.50 per widget, the highly taxed manufacturer would be left with a profit of $0.50 per widget while the lightly taxed distributor would turn a profit of $17.50 per widget. Because the manufacturer owns the distributor (or vice versa), neither entity should care about this profit misallocation; their sole objective should be to reduce overall tax obligations. By contrast, the countries to which these taxes are owed do care about these pricing decisions because they affect their revenue stream.

Virtually every country has laws allowing its tax authorities to adjust transfer prices between related entities to better reflect income. Almost all apply the same standard: prices should equal an 'arm's length charge' or the price at which the goods or services would have been provided to an unrelated purchaser. The problem lies in enforcement of this standard. Few intercompany transfers involve fungible items with clearly defined market prices. Elements of difficult-to-value intellectual property ranging from trademarks to patents to goodwill infect almost every transaction. So too do location factors arising from special market and supply factors. Finally, transfer pricing decisions inevitably necessitate allocating the efficiency gains generated by vertical integration of the business enterprise. Third party comparables are very difficult to locate and are generally imperfect leading to disputes about the type and extent of necessary corrections. Quite often transfer pricing disputes devolve into a contest of dueling experts. In addition to generating contestable results, the need for expert testimony supported by voluminous information creates expenses which are deleterious for both taxpayers and taxing authorities. The detriment to taxpayers caught up in a transfer pricing controversy is

obvious. From a governmental perspective, the cost of each audit proceeding limits the number of enforcement actions that can be taken and encourages taxpayers to play the audit lottery.

Further, it is not uncommon for several countries' tax authorities to make conflicting claims as to the correct pricing of intercompany transfers. Although taxpayers may use treaty-based procedures in an effort to force the governments to reconcile their conflicting claims, these procedures do not always work, leaving taxpayers to pay national income taxes on amounts in excess of 100% of their income. EU members entered into an arbitration convention to ensure resolution of transfer pricing disputes among themselves but the convention expired in 1999 and has only recently been revived. Overall, however, it appears that taxpayers fare better than governments when it comes to transfer pricing. The latest statistics coming out of the US show that 58% of the profits earned by US multinationals were allocated to 18 tax haven countries, 'a figure that far exceeds the share of economic activity that multinationals conduct in those low-tax countries' (Sullivan 2004a, p. 1190).

Not surprisingly countries have developed a number of alternative techniques for dealing with transfer pricing and source manipulation problems in an attempt to avoid this expensive case-by-case analysis. One is to remove favorable tax treatment for some types of suspicious income. Under the subpart F regime maintained by the US, the deferral privilege cannot be claimed for certain types of movable income and most nonbusiness income earned by foreign subsidiaries; instead such income is treated as if it had been distributed back to its US parent corporation or individual shareholders in the year earned. The removal of deferral eliminates the tax advantages normally associated with transfer price manipulations. However, taxpayers have largely learned how to avoid its strictures by avoiding the creation of affected income. The 'commissionaire' and 'contract manufacturing' structures described above were designed to avoid the strictures of subpart F. Though some dispute exists as to whether these structures should allow taxpayers to escape subpart F's strictures, practicing attorneys believe that they do. Other countries have adopted alternative methods of achieving similar results. Some switch from territorial tax treatment of foreign income to tax credit treatment of income earned in suspect jurisdictions. Still other countries simply disallow deductions for certain categories of expenses paid to related parties. More recently, some countries have experimented with negotiating transfer pricing methodology in advance of actual transactions (Ring 2000, pp. 147–8).

Another option gaining increasing currency involves moving from an arm's length standard to a formulary method of allocating income. The states of the US have long used such a method to allocate interstate corporate income, and some of the federal tax rules regarding the allocation of deductible expenses implicitly employ a formulary approach. But it is the EU that is currently

expressing the greatest interest in moving towards formulary taxation; the incoming European Union Taxation Commissioner recently announced that pursuing a 'consolidated corporate tax base for EU companies' would be a 'top priority' (Kirwin 2004a, p. G-6).

The EU has examined the US experience with formulary taxation, identifying pitfalls and possible ways of avoiding them. There are many such pitfalls. For such a regime to work well requires harmonization not only of the rules for calculating the tax base but also of the formula used to allocate that base across the affected jurisdictions. Even before the economic literature began suggesting that 'to the extent tax rates vary across jurisdictions, formula-apportioned corporate income taxes are similar in their incidence to a set of implicit excise taxes on the apportionment factors' (Edmiston 2002, p. 240), states of the US had begun moving from an allocation formula that equally weighted property, payroll and taxes towards a single factor sales allocation formula. This trend accelerated as the economic literature convinced states that such a move would reduce the costs of production and stimulate economic development (Edmiston 2002, pp. 239–40). The states that have remained resistant to this trend generally have significant natural resource extraction industries (Anand and Sansing 2000, pp. 192–3). This experience shows that should the EU settle on a multifactor formula, tax rate competition may continue unabated, though within more defined constraints. Nor is it easy to assign value to property for purposes of operating the multifactor formula as intangible and intellectual property becomes an ever more important element of business value. Indeed, countries may find the valuation problems currently afflicting transfer pricing decisions reappearing if they attempt to implement a multifactor income allocation formula that includes a property component.

None of these corrective mechanisms is perfect; all bring new problems in their wake, while most provide only a partial corrective to the existing transfer pricing and source manipulation problems. Moreover, while countries despair over taxpayers' ability to reduce their taxes through paper transactions, reforms which clamp down on easy avoidance techniques run the risk of encouraging taxpayers to take more substantive actions to lessen their tax burdens. These substantive actions, which generally involve moving actual business activities to low-tax jurisdictions, may cause even more severe damage to the economy of the reforming country. It has been argued that both deferral and the even less favorable subpart F rules enacted by the US have done more harm than good by encouraging taxpayers to expatriate actual business operations and, increasingly, corporate headquarters, to avoid its reach (National Foreign Trade Council 1999, p. 60; Hufbauer 1992, p. 131). And if the competitive and institutional imperatives of formulary apportionment lead ineluctably towards use of a heavily sales-weighted allocation formula, one

must wonder whether the easier road to that result would be replacement of the corporate income tax with a VAT.

4. The VAT alternative

Most developed nations, including most European countries, Canada and Japan levy VATs in addition to corporate and individual income taxes. Only in the US, which as yet has no VAT, is there serious discussion of replacing the income tax system with a VAT or some other form of consumption taxation. Although some of the support for this drastic change comes from diehard consumption tax proponents, much is driven by despair over the possibilities for adequate reformation of the income tax and especially its international aspects. Among its other advantages, a destination-based consumption tax such as a VAT would eliminate the transfer pricing issue and significantly reduce source determination issues; the only problem would be determining the destination country. Moreover, there is no possibility of duplicative jurisdiction or collection.

VATs and other consumption-based taxes are controversial because of the presumed distributional impact of switching from an income to a consumption tax base. Although many (but not all) economists contend that (aside from the elimination of graduated tax rates inherent in a VAT) there is relatively little difference between a consumption tax and an income tax (Shaviro 2004, pp. 98–100; Bankman and Griffith 1992, p. 377), that debate is beyond the scope of this chapter. Even when viewed from an international perspective, though, VATs are far from perfect. VATs have different, but still serious, enforcement problems. The absence of effective border controls leads to tax avoidance through smuggling. Internet transactions also generate enforcement issues. Tax competition remains a problem (Keen and Smith 1996, p. 376). Additional enforcement problems are created if a legislature enacts a multi-rate rather than a uniform VAT. Moreover, switching to a VAT would change the international allocation of tax revenues away from producing nations and towards consuming nations, replicating the distributional effects of a sales-weighted formulary income tax.

Another serious problem stems from the coordination issues that would arise in a world such as the current world in which other countries maintained income tax systems alongside consumption tax systems. A country maintaining only a consumption tax system would effectively act as a tax haven country with respect to income tax countries, attracting investment from and decreasing both tax revenues and economic activity in those countries. Unpleasant retaliatory action would be likely (Avi-Yonah 1996, pp. 262–3). Some countries may cancel existing income tax treaties, resulting in higher (and even confiscatory) taxation at source of profits earned by companies resident in the consumption tax country. Such cancellations may also limit the tax

relief granted their own residents investing in the consumption tax country (Musgrave 2000, p. 97). Finally, the capital exporting countries may increase taxation of residents investing in the consumption tax country by moving from a territorial coordination method such as exemption to a capital export neutral method such as a tax credit. Such a shift would effectively eliminate the consumption tax country's desired investment advantage and on balance leave that country in a worse position than before it switched tax systems (Avi-Yonah 1996, pp. 262–3).

Over the longer term, though, such retaliation could have a deleterious effect on the income tax country as consumption tax residents increased domestic investments at the expense of foreign investments. Nor would it be easy, from either a political or economic standpoint, to maintain a capital export neutral tax regime in a tax competitive world. If it was, there would be no 'tax haven' problem.

Successful implementation of a VAT, then, might depend on the duration of the 'short term'. That would depend on exactly the sort of international cooperation which has proven to be so difficult to attain in the income tax context. The only possible grounds for optimism is that it may be easier to discern the optimum around which countries should coalesce in the VAT context.

5. Conclusion

While analysts regularly predict the imminent collapse of the 'international tax system' (Graetz and O'Hear 1997, p. 1024) or of the disappearance of national income taxes due to globalization (Tanzi 2001, p. 1261; Avi-Yonah 2000, p. 1576), in fact both have experienced relatively little change over the past 80 years. The reason for this stasis is depressingly obvious. There are no easy answers, no clever solutions, to the perennial problems facing those seeking to design a more rational system. Indeed, time has revealed that even the meaning of 'rational' is contestable, and certainly context dependent whether one views global efficiency or national self-interest as the overarching goal. From a national self-interest perspective, most countries face internally conflicting goals. On the source side, there is an inherent trade-off between investment attractiveness and revenue generation, the boundaries of which change along with economic circumstances. On the residence side, tension exists between ensuring the competitiveness of domestically owned foreign businesses and their wholly foreign competitors and, on the other hand, maintaining the competitiveness of wholly domestic businesses with the foreign operations of domestically owned businesses. Moreover, policies that seem to be in the best interests of a country when viewed from its source country perspective may be detrimental when its residence country interests are taken into account. The statutory exemption from taxation provided for portfolio interest income is a

perfect example of that phenomenon. Further, even if a country can reach internal consensus as to the most rational policy given its economic circumstances, any actions it might take may be undercut by offsetting actions of another country with a different agenda. Because these different agendas exist, it may be impossible for countries to establish the common ground necessary for cooperative action, which is the only route to effective change. Even then, enforcement difficulties will arise as taxpayers look for opportunities to further their selfish interests.

In the absence of clear and sustainable goals, the most likely trajectory for legislative 'tax reform' is continued cycling between the three forms of neutrality detailed in Section 2.1. Such cycling is unlikely to do more than provide political window-dressing for politicians; as explained above, none provides neutrality of any sort under real world conditions. Certainly, in the absence of worldwide harmonization of tax rates, they are incapable of simultaneously preventing both under- and overtaxation of transnational income. But some progress may be made around the edges of the problem through the development of better control over the underlying numbers used by taxpayers. This control will come from a slow but steady march in the direction of formulary taxation. Although this is a march that began with independent legal actions of sovereign states (such as earnings-stripping laws), as more countries move in this direction, the fear of duplicative taxation and the weight of accounting costs may lead taxpayers to press for greater tax base harmonization, just as cross listing on securities exchanges has been a spur to the development of international accounting standards. Given the difficulties involved in valuing intangible intellectual property, the formula that results is likely to include at most two factors, sales and payroll. If the formula reduces to one factor sales test, the resulting tax may be close enough to a destination-based VAT to make reconsideration of the relative enforcement costs worthwhile. The political costs of such a transition, however, may outweigh any economic savings.

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9. International finance: rule choices for global financial markets

Hal S. Scott

This chapter is an overview of the field of international finance from the perspective of law and regulation. It is organized as follows. First, it examines what the field of international finance is, with respect to law, regulation and policy. Second, it discusses the degree of integration of national financial markets, a matter affecting a multiplicity of issues. Third, it looks at the sources of international financial law and regulation – both national and international. Fourth, it evaluates the overall costs and benefits of the increasing globalization of international finance. These four sections are all introductory to the fifth section, the burden of this chapter, which analyzes, with respect to securities and banking regulation, the decision as to what rules, for example of the home or host country, or international, apply in particular cases of regulation. The chapter then further examines this issue in the context of sovereign debt.[1]

The chapter concludes that, as a positive matter, there has been and will continue to be a progression toward harmonized rules created and supervised by supranational authorities in the field of international finance because this approach minimizes global financial instability and maximizes efficiency. It also concludes that various schemes to allocate authority between host and home countries will fail to accomplish these ends satisfactorily.

1. What is international finance?

For economists, international finance has traditionally meant the study of exchange rates but for policy makers and lawyers it means much more. Generally, it involves the study of international financial transactions, transactions that have some cross-border element with respect to payment, credit or investment, or a financial contract (Dufey and Chung 1990).

The cross-border aspect of finance can arise from the fact that the activity of the provider and the user of funds may be located in two different countries. A lender can market and transfer funds to a borrower in another country, or the

[1] This chapter draws heavily on Scott (2005).

borrower can seek and attain funds from the lender in the lender's country. Similarly, an issuer of securities can market and distribute securities to investors in another country, or foreign investors can make investments by coming to the issuer's country, as when a foreign investor buys US equity on a US stock exchange.

Economic definitions of international transactions would normally exclude cases where foreign citizens resident in a country engage in transactions in that country, for example a US citizen resident in Japan buying securities in Japan. Nevertheless, such transactions may pose concerns for countries like the US that believe in protecting their citizens abroad through extraterritorial reach.

More generally, definitions of international transactions almost never include purely domestic activity, for example a Japanese citizen in Japan borrows from a Japanese bank in Japan. Nevertheless, in an increasingly integrated financial system and world economy what happens in one country may have substantial impact on other countries. It is clear that the lending practices of Japanese banks and the forbearance of their regulators were important factors in the 'lost decade' of the Japanese economy. This financial depression directly affected the entire international financial system. In this lens, what happens in any country that impacts the rest of the world is the proper subject of international finance.

Generally, concern with other countries' domestic policies is mainly a matter of mutual concern for the most developed countries, the countries with the most tightly linked economies. Nonetheless, we have seen an expansion of international concern in recent years to the domestic economies and financial systems of almost all countries. There are a variety of reasons for this expanded concern – political (a stagnating country may ferment radicals), foreign aid consequences (a stagnating country may require more foreign aid) or debt subsidies (a stagnating country may borrow more from the developed countries and the International Monetary Fund).

In short, international finance is very broad. It may effectively include any transaction or issue that involves more than one country.

2. Globalization of financial markets

There are difficulties in defining and measuring the globalization of financial markets. There appear to be four main approaches. First, one can look at the correlation of prices between markets. The higher the correlations in rates of returns on similar assets across countries, arguably the more integrated the markets. One might also look to integration across asset classes internationally as compared to domestically.

A second approach looks at quantity. For example, one can look at portfolio diversification. The evidence here is that investors overweight domestic securities in their portfolios. This so-called 'home bias' effect is prevalent to

various degrees in all local markets. 'For example, in 2001, the portfolio share of foreign equities of US investors was 22 percent of what it would have been had these investors held the world market portfolio, so that the home bias measure was 78 percent. The measure averaged 63 percent in 2001 for a sample of 18 developed countries' (Stultz 2005). There is continued debate as to whether this home bias is due to transactions costs, information availability, or just a preference for what investors are familiar with (Portes and Rey 2005).

A third approach looks at the links between savings and investment levels within countries. Feldstein and Horioka (1980)[2] have showed that there is a very tight link between domestic savings and domestic investment levels. However, as investors diversify internationally, these domestic links should relax but recent studies have shown that these domestic links continue to be strong.

A fourth approach looks at formal barriers to trade in financial assets. Quinn (1997) has shown, for example, based on an index of openness with values of 1–12, that most developed countries became fully open by 1997. However, this index (and others like it) only deal with explicit barriers rather than implicit ones. For example, the US may be fully open to foreign banks, but may calculate their capital adequacy differently, or be fully open to foreign companies listing in the US, but require them to reconcile their accounts to US generally accepted accounting principles (GAAP). Further, implicit barriers may be created just because two countries have different rules. For example, integration of global equity markets is impeded because the US has different rules for distributing securities than do other countries, thus making global offerings more expensive than they would be if all countries had the same rules.

3. Sources of law and regulation

Law and regulation in the field of international finance is mainly the purview of national governments, but multilateral institutions are becoming more important over time.

3.1. National governments

National governments are the principal regulators of international financial transactions and the formulators of international policies. Every country has an international dimension to its domestic economic regulation. Consider, for example, the issues posed by the establishment of branches of foreign banks in a country. The host country may be concerned about protection of its depositors who may place funds with such banks, the competitive impact on domestic

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[2] See also Kearney and Lucey (2004).

banks, or the systemic impact of failure of the foreign bank. In the case of branches, the home country is charged with keeping the bank safe and sound, but the cost of the home country not doing so may impact the host country. Another example may be taken from the capital markets. If a foreign issuer issues securities to the public in a host country, the host country investors may be at risk. This is why host countries generally require such offerings to be registered in the host country. Moreover, certain risks of the offering, for example tax consequences, may well differ for different markets, requiring special legislation in the home country.

A variety of different regulators within a single country may be involved in regulating foreign transactions or institutions. For example, transactions within and outside the European Union may be regulated by both national and European Union regulators. Moreover, the regulators of banks, insurance companies, and securities firms or issuers of securities, may be different. This poses a major problem for countries seeking to coordinate policies with each other.

3.2. Multilateral institutions

3.2.1. IMF and World Bank For international finance, the IMF and the World Bank, established in 1944, are quite important. The IMF, which is effectively controlled by developed countries, with the United States as primus inter pares, was set up to help member countries maintain agreed exchange rates. However, with the abandonment of fixed rates in 1972, its mission has shifted to dealing with the financial problems of developing countries and the promulgation of international standards.

3.2.2. Intergovernmental groups, the G8 There are also a number of important intergovernmental groups that formulate policies that lay the foundation for internationally coordinated law and regulation. The most important of these is the G8, which is composed of the major democratic industrial countries – Canada, France, Germany, Italy, Japan, Russia, the United Kingdom and the United States. The G8 holds annual economic summits at the head of state level and preparatory meetings at the finance minister level. These summits formulate important policies, such as debt forgiveness for heavily indebted poor countries at the meeting in 2005, which get translated into action through international institutions or sovereign initiatives.

3.2.3. Functional regulators Increasingly important for international finance are functional international regulatory bodies that operate at more technical levels than the G8. The most important of these are the Banking Supervision Committee (the Basel Committee) of the Bank for International

Settlements, the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS) and the International Accounting Standards Board (IASB).

The Basel Committee is the most influential of the international functional regulators as a result of its formulation of the Basel capital adequacy standards. First formulated in 1988, and revised in substantial measure in June 2004, for the internationally active banks of the G10 countries (Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States), these standards have been adopted by more than 100 countries worldwide. In addition, the Basel Committee has formulated 'core principles' for effective banking regulation and Concordats that allocate supervisory responsibility between home and host countries. IOSCO has formulated basic financial disclosure requirements for publicly issued securities, modeled after US requirements, which have been adopted in the US, EU and Japan. The IAIS has also adopted core principles and standards for insurance companies and products that have been implemented worldwide. Implementation of the core principles of these functional regulators in developing countries is done largely through the IMF. The IASB has formulated international accounting standards that have been adopted in 2005 by the EU and will likely be adopted in the future by other countries, at least as an alternative to local GAAP rules for foreign issuers.

One should also include in this group the Organisation for Economic Cooperation and Development (OECD), composed of 24 industrialized countries. Although its scope is much broader than finance, it has been influential in formulating international corporate governance standards and tax policy. Two other important entities are the Financial Action Task Force (FATF), an organization of 31 countries, including the United States, concerned with preventing money laundering and terrorist financing, and the Paris Club, an informal group of 19 permanent member countries, with no formal legal status, whose role is to find coordinated and sustainable solutions to the payment difficulties experienced by debtor nations.

3.2.4. Coordination among functional regulators The work of the functional regulators of course overlaps, as financial institutions increasingly offer all financial products (so-called universal banks). In addition, there are important overlaps between the functional regulators and the IMF and World Bank. As a result, the Financial Stability Forum (FSF) was established in 1999 to enhance cooperation in the area of financial market supervision and surveillance. It has 42 members consisting of 26 national representatives from 11 countries, plus 13 representatives of the multilateral institutions, plus two representatives from committees of central bank experts, a representative of the European Central Bank, and the Chairman, currently Mario Draghi, the

Governor of the Bank of Italy. Beyond the efforts of the FSF, multilateral organizations may work together on specific projects, for example in 1999 the Basel Committee and IOSCO issued a joint report on disclosure (Basel Committee on Banking Supervision and Technical Committee of the International Organization of Securities Commissions 1999).

3.2.5. The special case of the European Union The Commission of the European Union, together with the European Parliament and Council of Ministers, is probably the most influential of all multilateral institutions, although it is often regarded as a quasi-national actor (representing the 25 member states of the EU). The Commission has formulated important Directives in many areas of finance that are implemented through national legislation, particularly measures seeking to enhance the operation of the EU 'single market'. Implementation of these Directives is coordinated through EU-wide functional regulators, such as the Committee of European Securities Regulators (CESR). These EU efforts are not only important in their own right but have offered a model, and an experimental laboratory, as to how regulation might be formulated and implemented in the international system at large.

3.2.6. Trade associations It is also important to mention the numerous trade associations that formulate industry contractual standards for various financial transactions, like the Bond Market Association (BMA) and the International Swaps and Derivatives Association (ISDA). Common standards for contracts are important for reducing transaction costs and for increasing liquidity through the creation of standardized instruments, for example credit derivatives. These organizations also coordinate activities in overlapping areas. For example, the BMA, the International Securities Market Association (ISMA) and the International Primary Market Association (IPMA) in 2005 integrated their European-based activities into the International Capital Market Association (ICMA) and established a global partnership between the BMA and ICMA.

3.2.7. The General Agreement on Trade in Services (GATS) The GATS should be singled out for special attention because it is an international trade agreement that affects financial services. The 1994 GATS resulted from the Uruguay Round of trade negotiations that closed in December 1993. The Uruguay Round produced a new structure, the World Trade Organization (WTO), as well as the agreement on services. The core principle of GATS, expressed in Article II, is unconditional most-favored-nation (MFN) treatment: each service or service supplier from a member country must be treated no less favorably than any other foreign service or service supplier. In addition, there is a transparency requirement. The GATS includes each country's

schedule for specific commitments and a list of MFN exemptions for that country. For financial services, there is a unique additional element, namely, the Understanding on Commitments in Financial Services (Understanding).

In the GATS, market access and national treatment are 'specific commitments' as opposed to general obligations. As a result, national treatment and market access do not apply across the board to all services sectors; instead, they apply only to sectors, subsectors, or activities that are listed in a country's schedule of commitments. Countries that choose to schedule commitments in accordance with the Understanding undertake commitments to market access and national treatment for all financial services subsectors. They then use a negative list approach to scheduling – that is, everything is included unless excepted. The Understanding also contains a standstill provision that limits exceptions to existing nonconforming measures.

GATS also includes a so-called 'prudential carve-out' for domestic regulation that permits a country to take prudential measures 'for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed', or 'to ensure the integrity and stability of the financial system' regardless of any other provisions of the GATS. Disagreement over whether a particular national measure falls within the prudential carve-out is subject to WTO dispute settlement procedures and, if necessary, to a determination by a dispute settlement panel. However, most regulators do not appear to be particularly concerned about this possibility. For one thing, if a country is concerned that a particular measure might not be generally accepted as prudential, it could simply list the measure as an exception in its initial schedule of commitments.

Ensuring financial services expertise in the handling of disputes involving financial services was another issue of particular concern to financial services regulators. The concerns of financial officials were addressed by inserting a requirement in the Annex that dispute settlement panels on prudential issues and other financial matters must have the expertise necessary to deal with the specific financial service under dispute.

A final agreement on financial services was reached in 1997. Reaching an agreement does not, of course, mean that markets are truly 'open'. It only means that the over 140 countries involved in the WTO have all made commitments of various kinds. The 1997 agreement 'was probably notable more for its airing of issues and the consequent increased transparency concerning the sector than for its concrete achievements in terms of market opening. Many countries' commitments simply specified rules already in place . . . and in some cases less than this . . .' (Cornford 2004).

In November 2001, the WTO members authorized a new round of trade negotiations, the so-called Doha Round, which once again includes financial services. These negotiations are still under way. The current results are

disappointing. The existing offers for a new set of financial service commitments are limited in scope and scale. Also, WTO does not presently have the mandate to deal with the more difficult questions of indirect barriers to trade such as US requirements prohibiting use of international accounting standards or EU country restrictions on acquisitions of local banks. There are a variety of these barriers, which are prevalent even more in developed than developing countries (Asian, European, Japanese, Latin American and the US Shadow Financial Regulatory Committees 2004).

3.2.8. Bilateral arrangements There are a variety of bilateral understandings between countries, particularly in the area of enforcement. For example, the Securities and Exchange Commission (SEC) has entered into over 20 bilateral enforcement Memoranda of Understanding (MOUs) that permit the SEC and its country counterparty to obtain information necessary to investigate and prosecute enforcement matters. Each MOU is tailored to fit the particular legal frameworks of the two parties to the agreements. The MOUs set forth the permissible uses of information, including use for SEC investigations and proceedings and for assisting the Department of Justice. Apart from permissible uses, the SEC and foreign authorities commit to maintaining the confidentiality of non-public information shared pursuant to the MOU.

Another important development in bilateral arrangements is the establishment of 'Regulatory Dialogues' between particular countries that deal with areas of regulation of mutual concern. For example, the US and EU have been engaged in such a dialogue since 2002. The US is represented by the Treasury, the Federal Reserve Board and the SEC, and the EU is represented by the EU Commission. These meetings are supported by other bilateral meetings of technical regulators, for example meetings between CESR and the SEC. The meetings began due to EU concern with the foreign impact of US laws such as Sarbanes-Oxley that made it more costly to access US capital markets. Today the dialogue is focused on several issues, including the US acceptance of international accounting standards, EU acceptance of SEC holding company regulation, and issues of financial privacy. A major concern about the Dialogue is whether US–EU financial issues can be resolved in isolation from greater differences between the two sides, over matters like Iraq and trade. One critical issue on the economic front is whether the US and EU will seek to compete or collaborate. For example, the EU might respond to increasing US regulation by providing a less regulated alternative, rather than pursuing efforts to relax US regulation and further the integration of the two markets.

4. Costs and benefits of international finance

A debate about whether the internationalization of finance – often referred to

as globalization – is good or bad rages worldwide. The potential benefits of international finance are fairly clear. First, access to worldwide capital markets may allow a country to smooth its financial needs, borrowing in bad times and lending in good times. Second, as a related matter, international markets can promote domestic investment and growth by allowing countries to import capital. Third, globalization may enhance macroeconomic discipline – capital flows may police bad government behavior. Fourth, internationalization may discipline regulators. The possibility of financial institutions changing the locale of their operations, or investors investing in foreign markets abroad, may constrain excessive domestic regulation. Fifth, internationalization may increase competition, and therefore lead to more efficient banking systems or cheaper securities offerings.

Economists debate the effect of financial integration on growth (Agénor 2003).[3] A study of 57 countries, using many measures of financial integration, was not able to reject the hypothesis that international financial integration does not accelerate economic growth even when controlling for particular characteristics of the country (Edison *et al*. 2002). On the other hand, it seems clear that better financial systems do increase growth by providing information about possible investments that enable the more efficient allocation of capital, by monitoring investments and insisting on high standards of corporate governance, by facilitating the trading, diversification and management of risk, by mobilizing and pooling savings and by easing the exchange of goods and services (Levine forthcoming).

An active area of inquiry is the role of legal institutions in explaining financial development. Basically, the literature finds that the Anglo-Saxon countries with stronger protection of property rights have had higher levels of financial development (La Porta *et al*. 1998). One study finds that effective legal institutions, particularly those requiring disclosure and enforcing those requirements, also reduce firms' cost of capital. The effects of disclosure requirements are weakest for markets that are integrated, cases where such disclosure may be less important due to the market discipline of one market upon the other (Hail and Leuz 2005).

There are also some arguable costs of globalization. First, markets are not politically correct, so hostile or poorly performing markets may fail to attract capital, and may experience capital outflows and unemployment. Second, the volatility of capital flows can quickly destabilize an economy, as was the case in the 1997 Korean crisis, where short-term international bank lending quickly dried up. Third, the entry of foreign institutions, while increasing competition and efficiency, can lead to the demise of local financial institutions. Fourth,

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3 For a recent critique of globalization, see Stiglitz (2004).

the integration of the world's financial system can result in quick transmissions of economic shocks between world economies, a phenomenon often referred to as contagion (Ehrmann *et al*. 2005).

5. Approaches to regulation

A major problem in international financial transactions is which countries' rules should apply to a transaction. This section examines this problem in the context of securities regulation and banking.[4] In the securities regulation context the issue is which rules apply when an issuer in one country (the home country) sells securities to investors in another country (the host country).

5.1. Securities regulation

In approaching the subject of what rules to apply in the area of securities regulation, one must keep in mind that the dominating objective of regulation is to protect investors in public markets, although sometimes this objective gives way to other considerations, like maintaining the competitiveness and attractiveness of national capital markets. In open economic systems, rules that are too onerous may result in issuers and investors moving their business elsewhere. Extraterritorial rules, like those of the SEC's Regulation S, may inhibit this movement but cannot stop it.

There are several basic approaches one can take to securities regulation. First, one could harmonize all securities regulation, so that the same rules applied in all markets. Second, one could allow issuers of securities to choose which regulatory regime they would prefer. Third, one could always apply host country rules, so-called national treatment. Fourth, one could always apply the home country's rules, so called home-country approach. Fifth, as between two countries, Country A would apply Country B's rules if Country B would apply Country A's, so-called mutual recognition. Sixth, the host country would apply its own rules unless the home country's rules were 'equivalent' to those of the host country. Seventh, the host country would apply the home country's rules but the issuer would have to explain how its home country rules differed from those of the host country.

5.1.1. Harmonization

A. HARMONIZING RULES ACROSS COUNTRIES If rules were harmonized, issuer costs would be substantially reduced since the same rules could be applied wherever the securities were sold. Ideally, rules would not only be harmonized

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[4] Derivatives and insurance are also part of international finance but are not covered in this piece.

for disclosure, but also for the primary distribution process, for example registration requirements and restraints on communications, and enforcement. Harmonization is, however, very difficult to achieve. The EU unsuccessfully pursued this approach in the 1970s and 1980s in trying to integrate its financial markets. The EU Commission's 1985 White Paper, *Completing the Internal Market,* identified 300 pieces of legislation that the Community would have to enact to remove restrictions or to harmonize laws of member states, and as a result shifted its approach to mutual recognition, discussed below. However, in the last few years, due to limited success with mutual recognition, it has returned to the harmonization approach, at least for disclosure requirements, through the Prospectus and Transparency Directives. Rather than trying to get each member state to accept the same rules, it is basically mandating such commonality.

The power to promulgate and mandate common rules may require that states subject to such rules cede authority to an international authority. In the case of the EU, this has taken place to a significant extent. But this is not the case for the greater international community where harmonization requires detailed negotiations among countries and legislative changes in many countries, a difficult task. There has nonetheless been some progress in harmonizing international disclosure rules and accounting standards.

DISCLOSURE RULES In September 1998, IOSCO issued a consultation document entitled *International Disclosure Standards for Cross-Border Offerings and Initial Listings by Foreign Issuers*. The proposal was organized in two parts. Part I contained financial information that must be disclosed in a standardized way in all jurisdictions, as well as other information that any jurisdiction would require, for example business overview, risk factors. Part II dealt with 'disclosure issues outside the scope of the standards', such as materiality, projections and forward-looking information, indemnification of directors and officers, and derivatives and market risk. This part formulated no harmonized standards; instead, it discussed differences among countries on the issues.

On September 28, 1999, the SEC adopted a complete revision of Form 20-F, which contains basic disclosure requirements applicable to foreign private issuers based on the IOSCO proposals (SEC 1999). This change effects no real relaxation in standards for foreign issuers since the IOSCO proposals basically mimicked existing US requirements (Tahyar and Joseph 2001). The EU has also adopted these standards as part of its new Prospectus Directive and other countries have adopted the rules as well. Countries have taken different approaches to implementing IOSCO rules. Whereas the US and Switzerland have allowed foreign issuers a choice in using such rules, Singapore and Mexico have adopted the rules for both foreign and domestic issuers (Wolff 2001).

While these efforts at disclosure harmonization are generally applauded by the securities industry since they allow for standardized operations with reduced transaction costs, there is a serious problem of whether one size fits all. Standardization may be a particular problem for less-developed markets that do not have the professional capability to enforce detailed disclosure standards. This may lead such countries to formulate less detailed standards or to employ merit regulation, a system in which regulators decide which issuers should be given access to public markets. Another undesirable effect of harmonization may be the elimination of competing rules. With one set of rules, innovation and change may be stultified – although there could still be active efforts to change the one standard that prevails. After all, the US has one set of securities regulation rules, many of which are actively changed over time without international pressure, as a result of industry pressure or changes in regulatory philosophy.[5]

ACCOUNTING STANDARDS Another very significant harmonization effort is under way in the area of accounting standards. The IASB (and its predecessor the International Accounting Standards Committee) has been at work since 1973 to formulate international financial reporting standards (IFRSs) that would eventually replace the accounting standards of individual countries, so-called local GAAPs (generally accepted accounting principles). IASB has now formulated a comprehensive set of accounting principles that have been adopted by the EU as of 2005 (with some notable exceptions for financial instruments) and more than 90 countries are also expected to adopt them as well. These standards, however, will not be truly international unless they are adopted by the United States. It is now possible that the US may allow foreign issuers to use IFRS in the future, as a result of coordinated efforts between the EU and the SEC,[6] but the US has no plan to fully replace its own GAAP rules. Such rules will still be required of domestic issuers and will remain an option for foreign issuers.

There is an effort, however, to harmonize IFRS and US GAAP. In October 2002, IASB and FASB (the Financial Accounting Standards Board of the US responsible for US GAAP) announced a short-term convergence project known as the Norwalk Agreement with the objective of reducing the differences between the two accounting standards. There has been some progress on

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[5] The SEC's recent adoption of detailed changes in the way securities are offered in the United States had little to do with international pressure or the availability of competing foreign models (SEC 2005e).

[6] See the SEC 'roadmap' for accepting IFRS for foreign companies by 2009 (SEC 2005d). The details of the roadmap were oddly released in the form of a forthcoming law review article by the SEC's Chief Accountant. See Nicolaisen (2005).

both sides of the Atlantic. The IASB has eliminated many of the differences between US GAAP and IFRSs through its Improvements project and its standards on business combinations and discontinued operations. At the same time, the FASB has changed US practices on share-based payment, the treatment of idle capacity and spoilage costs in the cost of inventory and asset exchanges. Changes are also expected in the US standards on the calculation of earnings per share and voluntary changes in accounting policies to bring US GAAP in line with IFRSs. However, it appears that at best, in the short term, this will produce convergence of principles rather than detailed rules.

As in the case of disclosure, there is considerable debate in the accounting area over whether it is best to have only one set of harmonized rules. Accounting rules reflect, to a significant extent, real differences between countries. Thus, for example, rules requiring defined benefit pension plans to mark assets to market, and thus reveal funding gaps, might have more impact in countries with defined benefit as opposed to defined contribution plans where assets are always equal to liabilities. Also, the US rule-based rather than principle-based approach may result from stricter legal liability standards and class action enforcement in the US. Principles may offer less solace to companies looking for certain rules to follow in order to avoid liability. As with disclosure, there is also the question of whether one standard would preclude useful experimentation and the development of valid alternative models.

A very significant problem for the harmonized approach, particularly with respect to disclosure and accounting, is differential enforcement. If individual countries, as opposed to multilateral or transnational organizations, are to enforce standardized rules, the rules will be implemented differently in different countries and will not, therefore, actually be harmonized. Enforcement responsibilities could be given to an international body, but this is not a practical alternative at the present time. Even within the EU, enforcement is left to the member states rather than the Commission, albeit there is a high degree of regulatory coordination among the member states.

OTHER AREAS OF HARMONIZATION Some important harmonization measures have been achieved through trade associations or think tanks. For example, the Bond Market Association (BMA) and the International Capital Market Association (ICMA) have both promulgated a number of standard agreements for repurchase or securities loan agreements (BMA 2005 and ICMA 2000). In most cases, harmonizing trade rules operate to standardize contracting practices and require no facilitation or implementation through law or regulation. One of the most notable successes in private law initiatives was the work of the Group of Thirty (a think tank sponsored by major financial institutions) in formulating international standards for the clearance and settlement of securities, such as the famous T+3 standard, requiring securities trades to be settled

no more than three days after a trade. Some of these standards were resisted by the private sector, like T+3, and required national compulsion through regulation to become effective.[7]

B. EFFECTIVE HARMONIZATION THROUGH ISSUANCE AT A SINGLE LOCATION

Harmonization is only crucial if one is issuing securities in the territories of other countries. It is possible to avoid this problem by issuing securities in only one place and having investors come to the issue, through brokers and modern communications, rather than have the issue come to investors. This would allow an issue to be governed by one set of rules but also permit different jurisdictions to establish different rules. Thus, if one jurisdiction applied rules that issuers and investors believed were not optimal, issuers could move to a different jurisdiction.

Indeed, a 1998 report of the UK Treasury, 'Public Offers of Securities', found that the reason there had been so few cross-border securities offers in the EU was that large companies listed their securities on one member state exchange and let investors come to that exchange. This suggests that a single market could be achieved by simply ensuring that member states allowed foreign issuers to disseminate information to onshore investors and then let them purchase the securities in offshore markets. In the EU, member states have generally permitted offshore purchases, not choosing to apply their laws extraterritorially. However, certain member states have restricted onshore advertising of offshore issues. It appears such restrictions may be applied on a EU level under the new Prospectus Directive,[8] thus making the offshore alternative more difficult in the future.

This offshore alternative would be impossible on an international level under current US rules since the SEC's Regulation S prohibits offshore issuers from engaging in 'directed selling efforts' in the US and effectively prevents investors resident in the US from buying the securities of most offshore foreign issuers until 40 days after the offering.[9]

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[7] See SEC Rule 15c6-1, 58 Fed. Reg. 52891 (October 6, 1993) (requiring T+3).

[8] Article 15 of the Directive contains rules on advertising. Article 15(1) originally provided (Art. 13(1) of the May 2001 proposal): 'Advertisements, notices, posters shall be communicated in advance to the competent authority of the home member state which shall check them before publication against the principles contained in this Article [that advertisements be fair, accurate and consistent with that contained in the prospectus]. The documents shall state that a prospectus will be published and indicate where investors will be able to obtain it'. The requirement for presubmission has now been dropped; however, a competent authority must have the power to monitor such advertising.

[9] Scott proposed removing existing US restrictions on offshore offerings if such offerings met minimum disclosure requirements. See Scott (2000).

5.1.2. Issuer Choice Another approach to what law to apply, which is largely an academic idea not used in practice, is to allow issuers of securities to select whatever law they choose (Choi and Guzman 1998).[10] For example, a French company could choose to issue securities in the US under Nigerian law. The underlying idea is that market discipline would determine whether this was a viable strategy. If Nigerian law were too lax, investors would not invest in the French company's securities or would only do so at an appropriate price discount. Some versions of this idea have restricted this option to securities sold to non-public investors, but then the idea has little utility since private offerings are usually completely unregulated – there is no need to authorize issuer choice; the issuer is already free to make such choices. The two major problems with the proposal, as applied to public investors, is that reliance on discounting is misplaced, because it is hard to place an appropriate discount for knowledge you might not have, and because investors would be incapable of effectively enforcing their rights against many offshore issuers.

It is interesting, however, that a version of issuer choice does operate in the secondary securities markets. Issuers can choose in which country to list their securities, effectively opting into different disclosure and enforcement regimes for secondary market transactions. Commentators have questioned whether this 'bonding' strategy really works, insofar as local regulators may not really enforce their laws against foreign issuers (Siegel 2005). But the basic fact remains that issuer choice of trading venues is permitted.

This choice regime is permitted to function in secondary markets because countries generally do not apply their laws to restrict investors from trading already issued securities – these restrictions only generally apply (leaving aside countries with capital controls) in the primary markets, as in the case of the SEC's Regulation S. One reason why choice may be allowed in the secondary market is because traded securities have a 'market' price, as compared with primary markets in which prices are fixed – even in a Dutch auction, the price is fixed at the market clearing price of the bids, not on the basis of actual trading. Another reason may be that host governments to exchanges seek to promote use of their exchanges by opposing restrictions other countries may place on their own investors' access to foreign exchanges. It would appear that foreign issuers do not have the same political clout to open up the primary market as national exchanges have in opening up the secondary market.

In June 2006, it appeared likely that the New York Stock Exchange would merge with Euronext, the stock exchange resulting from the previous merger

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[10] For a similar proposal, see Romano (1998) and Romano (2001).

of the Amsterdam, Brussels and Paris exchanges. It also appeared possible that Nasdaq would merge with the London Stock Exchange. These cross-Atlantic mergers were largely spurred by the fact that US exchanges were finding it increasingly difficult to attract listings by foreign companies, in large part as a result of Sarbanes-Oxley and the US anti-fraud enforcement system – class actions, criminal liability, and SEC and state enforcement. The American exchanges through the mergers could give foreign customers a European choice free from US regulation. This strategy reflects the fact that issuers can choose where their shares will be traded.

Choice in the secondary market is, however, sometimes restricted, as by the US, to the freedom of investors to trade foreign-listed securities offshore as opposed to trading them in the host country. Steil (2002) has proposed the removal of US restrictions on EU exchanges having trading screens in brokerage houses in the United States. Screens are only permitted for foreign exchanges registered in the US and the regulatory cost of such registration has deterred foreign exchanges. Steil would also require the EU to provide the same market access for US exchanges. This issue is on the agenda of the US–EU Regulatory Dialogue discussed above.

5.1.3. National Treatment

A. BETTER THAN NATIONAL TREATMENT The traditional default rule for which law to apply is the law of the host country, national treatment. In the absence of harmonization, the national treatment approach exposes foreign issuers to a multiplicity of rules with consequential high transaction costs. It also piles law on law, since foreign issuers may be subject, in the same transaction, to both their own law and the law of the host country. National treatment is not, therefore, equal treatment. Apart from the relatively rare 'conflict' of laws that might arise – where it is not possible to doubly comply – double compliance routinely adds significant costs. The international side of a country's securities laws focuses on when to apply domestic law to foreign issuers. Often national treatment is modified for foreign issuers through partial or complete exemptions. An examination of the approach of the US to applying the 2002 Sarbanes-Oxley Act to foreign issuers illustrates the different approaches that may be taken to national treatment.

In some cases, US law is fully applicable to foreign issuers (either as a result of the language of the statute or SEC rule making), for example the requirement for certification of financial statements by the CEO and CFO, the obligations of attorneys practicing before the SEC to report material violations of securities laws up the line, and most of the requirements for improved and more continuous disclosure. However, important exceptions to national treatment were made with respect to the auditing process for foreign firms. For

example, while national treatment would have demanded that the audit committees of public issuers be fully independent, the SEC accommodated the German co-determination regime by allowing labor representatives who might not be considered 'independent' to serve on the audit committee. Also to accommodate two-tier boards, the auditor independence requirements apply only to the supervisory or non-management board (SEC 2003c).

The Act also requires companies to rotate key auditor partners periodically and prescribes a one-year cooling off period before certain members of the audit engagement team may accept certain employment positions with the issuer (SEC 2003a). These rules apply to foreign accounting firms that conduct audits of foreign subsidiaries and affiliates of US issuers. Between the proposal of the rules and their final adoption, several of these requirements were modified with foreign firms in mind, for example less strict rotation and cooling off periods, although the resulting rules do apply equally to domestic and foreign firms. Thus a single standard for domestic and foreign firms can reflect a concern with its particular impact on foreign firms.

The most significant exemption from Sarbanes-Oxley (at least temporarily) has been, after intense lobbying by the European Union and small companies, to delay until 2006 (SEC 2005a) the application of Section 404 – the provision that requires management to report annually on the adequacy of a firm's internal controls, as verified by a registered public accounting firm – to foreign listed firms (as well as small US firms), and then to delay until 2007, the application of 404 to all small firms, foreign and domestic.[11] The direct cost to companies of implementing Sarbanes-Oxley has been substantial, and compliance with Section 404, particularly the cost for the outside audit, has turned out to be the most significant area of cost. Korn/Ferry, an executive recruitment firm, estimated that the average cost for a Fortune 1000 company was $5.1 million, or $5 billion overall for those companies (Roberts 2004).

The SEC was obviously concerned with the impact the prospect of large costs could have on foreign firms seeking listings or those continuing to list in the US. This delay in implementation underscores an important reason why national treatment requirements may be relaxed – to prevent foreign issuers from bringing their business to foreign competing markets like London and Hong Kong.

A major impact of Section 404 was, of course, upon foreign firms already listed in the US. Many of these firms are said to be contemplating delisting and moving the trading of their shares to offshore markets. However, this is easier said than done. There is no general right to delist. The NYSE requires foreign firms to obtain the approval of the Board of Directors, publish a press release

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11 SEC Release No. 33-8618, September 22, 2005.

announcing the delisting and notifying at least its largest 35 US shareholders of the delisting. However, even if these conditions can be satisfied, the foreign firm would still be subject to the 1934 Act and Sarbanes-Oxley, as long as its shares were held by more than 300 US shareholders (500 shareholders for companies with less than $10 million in assets). As a practical matter, foreign firms would have to repurchase most of their US shares (Perino 2003). This aspect of the regulatory regime has been attacked by European business leaders.

On December 14, 2005, the SEC responded to these concerns by issuing a proposal[12] that would generally allow a large foreign issuer to delist if its primary trading market is in its home country and if it has either (a) a US average daily trading volume no greater than 5 per cent of the average daily trading volume in its home market and has US residents holding no more than 10 per cent of its worldwide public float (shares that trade in market); or (b) regardless of trading volumes, has US residents that hold no more than 5 per cent of the issuer's worldwide public float. The Europeans have claimed that the proposal's criteria are too strict and that only a few companies would be able to take advantage of them. One could view the impact of the US's current no exit policy as a form of capital control – it is one thing to apply national treatment to foreign firms, it is quite another to prevent firms from leaving a market if they want to. If US shareholders are concerned with losing Sarbanes-Oxley protections, they can simply sell their securities.

Outside of Sarbanes-Oxley, the US has exempted foreign firms from other requirements, like compliance with proxy requirements, or from Regulation Fair Disclosure (FD) which prohibits selective disclosure to analysts. Regulation FD, as proposed, would have applied to foreign as well as domestic issuers. The effect would have been for SEC policies to govern how foreign issuers made disclosures to analysts in their own markets. Foreign regulators, like many commentators, believed that the proposal could delay the timely release of information in order to avoid selective disclosure liability under US law. As adopted, Regulation FD excluded foreign private issuers (Fox 2001).

B. WORSE THAN NATIONAL TREATMENT When foreign firms are treated worse than domestic firms, at least *de jure*, this can be a matter of concern under GATS if such discriminatory treatment violates specific GATS undertakings, but only then. Countries like China are able to maintain discriminatory treatment of foreign firms, with respect to entry and ownership of local firms, because their commitments are limited. There is no broad automatic requirement under GATS for national treatment. The United States has entered

12 SEC Release No. 34-53020 (December 23, 2005).

into bilateral treaties with countries to ensure national treatment for US financial institutions, for example the Financial Services Agreement of 1995 with Japan.

5.1.4. Home country rules There are four variations on applying home country rules: always apply home country rules (a practical null set); only apply home country rules of another country on a reciprocal basis (mutual recognition); apply home country rules where they are 'equivalent' to host country rules, and apply home country rules provided an issuer explains how its home country rules differ from those of the host country. We will examine the latter three variations.

A. MUTUAL RECOGNITION

(i) The EU approach The EU has pioneered mutual recognition. When harmonization failed, the EU adopted a new strategy under which the harmonization of *essential* standards would provide the basis for mutual recognition by the member states of the equivalence and validity of each other's laws, regulations, and administrative practices that had not been harmonized at the EU level. Under a policy of mutual recognition, some member states in effect agree to offer treatment that is more favorable than national treatment to firms from another member state. This can occur, for example, when the home country permits types of transactions not permitted by the host state. This possibility then leads to convergence in rules as issuers headquartered in the state in which the services are provided (host country state) demand to be treated at least as well as issuers located in other member states (home country states).

The EU mutual recognition system is premised on minimum harmonization – an agreed level of commonality necessary for member states to tolerate differences. It is also premised on a high degree of trust among participating states, and on the Commission's transnational authority.

A corollary of mutual recognition is home country control: home country rules and supervisory practices must be accepted as controlling the operations of cross-border transactions. However, the principle of home country control adopted by the Community is not absolute. The Treaty of Rome provides, as implemented by judgments of the European Court of Justice and Commission Directives, that the host country retains the right to regulate the cross-border provision of services to the extent that doing so is necessary to protect the public interest. Furthermore, as previously noted, all enforcement in the EU takes place at the national level. This permits host countries to bring enforcement actions against out-of-state issuers. In a pure home country system such actions would be the exclusive purview of home country authorities. A pure home country system would be particularly unsatisfactory when host country

investors have limited private remedies, for example no class actions, and thus would be totally dependent on the enforcement by authorities outside their country.

In a mutual recognition system, there may be a question as to the proper home country of an issuer. For example, assume that a *French* company wishing to issue securities in France, first issues and lists its securities in Luxembourg, and then seeks to list its securities in France under Luxembourg rules. The EU rules seek to prevent this kind of country arbitrage by providing that you must first list in the country of your registered office if you are listing there at all. Of course, there would still be room to maneuver if a company could select, in Delaware fashion, any country in which to incorporate. This is prevented by EU member state rules that require a company to have its registered office in the country where the 'direction' of the company comes from, usually corporate headquarters, but these requirements have been put in doubt by a new line of cases in the Court of Justice holding that such restrictions violate the Rome Treaty's provision of freedom of establishment (Wymeersch 2003).

(ii) The US approach The US has conducted its own limited experiment with mutual recognition with Canada. In 1991, the SEC adopted the multijurisdictional disclosure system (MJDS) for qualified securities transactions by Canadian issuers.[13] The large number of Canadian firms issuing registered securities in the United States and the similarities between US and Canadian securities regulation made Canada an obvious choice.

The MJDS was designed to facilitate securities offerings in both markets by subjecting the issuer to the regulations of only one jurisdiction. Specifically, qualified Canadian issuers may use disclosure documents filed with the appropriate Canadian agency to meet the US registration and periodic disclosure requirements. As originally adopted, MJDS filings did not require Canadian financial statements to be reconciled with US GAAP, as long as they met Canada's GAAP requirements, but that approach was changed in 1993 – reconciliation is now required.[14]

There are also other exceptions in MJDS to the home country principle. For example, US requirements on the delivery of the prospectus, safe harbor

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[13] 58 Fed. Reg. 30036 (1991).

[14] 58 Fed. Reg. 35367 (1993). This change was based, in part, on the result of a study of the effect of different accounting rules on the statement of income and equity between the US GAAP and foreign GAAP of several countries including Canada. For Canada, the survey found that while the vast majority of registrants reported income variances of less than 10 percent from that obtained under GAAP, much larger variances did exist in some cases. SEC Division of Corporate Finance 1993.

provisions on advertisements, and rules on the publication of research reports and other communications during the public offering process still apply. Also, because Canadian law does not require disclosure of indemnification provisions regarding directors, officers, and controlling persons, or disclosure of the financials of segmented business lines, MJDS issuers must supplement their registration with such information. In addition, US fraud liability rules, for example Rule 10b-5, continue to apply, as enforced by the US, over and above whatever Canadian liability rules apply. Thus, the SEC topped-up Canadian rules by requiring compliance with US rules where it found Canadian rules inadequate.

The SEC has chosen not to extend the MJDS approach to other countries. There have even been reports in the past that the SEC staff has favored repealing MJDS for Canada. The public justification for abolishing MJDS seems to be that MJDS represents an anomalous bilateral arrangement, at odds with the multilateral approach of IOSCO. However, some feel the real reason is the SEC's lack of confidence in Canadian enforcement authorities. The enforcement issue is a primary concern in any mutual recognition system.

B. 'EQUIVALENCE' RECOGNITION Under the 'equivalence' approach to recognition of home country rules, the host country will only defer to the rules of the home country when it deems them equivalent to its own. Unlike mutual recognition, the approach does not *require* mutuality – Country A might recognize B's rules as equivalent even though B does not do the same for A.

The use of an equivalence determination as a predicate to recognition of home country rules has begun to develop on both sides of the Atlantic. The US has used the concept in determining whether to exercise control over foreign audits of US companies, while the EU has used the concept in determining whether to allow US firms to use US GAAP rules in issuing securities in the EU and whether to defer to US holding company regulation of US firms operating in the EU. Equivalence now seems the EU's preferred approach toward deciding the issue of whether to apply home or host country rules (Schaub 2003).

US REGULATION OF AUDITORS The Sarbanes-Oxley Act created a new Public Company Accounting Oversight Board (PCAOB) under the supervision of the SEC. The Board is responsible for establishing auditing, quality control, attestation and ethics standards for auditors of public companies. The PCAOB has adopted a paperless registration system for accounting firms that audit US-traded companies, which includes non-US as well as US accounting firms. As of April 2005, 567 foreign firms had registered with PCAOB. The effect of the registration requirement is to give the PCAOB oversight over foreign audit firms. The statute creating PCAOB provides that non-US firms are subject to

the Act and to the rules of the Board 'to the same extent as a public accounting firm that is organized and operates under the laws of the United States'. The EU protested this assertion of jurisdiction and threatened to retaliate by having each EU country assert jurisdiction over US firms.

In June 2004, PCAOB issued its Final Rules Relating to the Oversight of Non-US Public Accounting Firms (PCAOB 2004). The rules provide that the Board may rely – to the extent it deems appropriate – on foreign inspections under the home country's oversight system. The extent of reliance on the foreign system would be based on the 'independence and rigor' of the foreign system, as well as discussions with the foreign regulators. In judging independence and rigor, PCAOB will no doubt compare the approach of the foreign jurisdiction with that of the US, an equivalence determination (PCAOB 2004).[15]

ACCEPTANCE OF US GAAP IN THE EU The EU has required foreign companies to state their accounts in IFRS as of 2007. This is of direct concern to US companies that currently issue their securities in the EU under US GAAP. US and other non-EU companies will only be able to use US GAAP if the EU Commission determines that such standards are 'equivalent' to IFRS.

The Commission asked the Committee of European Securities Regulators (CESR) to assess this equivalence, which CESR did in its report of April 2005 (CESR 2005). CESR concluded that US GAAP was on the whole equivalent to IFRS, but that in some areas US companies would have to use IFRS rather than the US GAAP rules, for example, expensing of stock options. The US had adopted option expensing under FASB Accounting Standard No. 123 (revised 2004), Share-Based Payment, but on April 14, 2005, the SEC permitted companies to implement the requirement at the beginning of their next fiscal year (the first quarter of 2006 for a calendar-end reporting company) rather than in their next reporting period, which would have been after June 2005 (smaller companies were given more time) (SEC 2005c). The SEC attributed the delay to the need of companies to have more time to implement changes but it was unusual for the SEC to override FASB's implementation date (BNA Banking Report 2005). The SEC's action was perhaps related to the political challenge to options expensing being mounted by some firms in the US Congress.

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15 'Under these rules, the degree of reliance to be placed on a non-US system will be based on a 'sliding scale' and will depend on the Board's assessment of the independence and rigor of the non-US oversight system. The more independent and rigorous the non-US system, the higher the Board's reliance on that system. Conversely, the less independent and rigorous, the lower the Board's reliance on that system' (McDonough 2005).

CESR has indicated that while the EU should generally accept US GAAP, the home country rule, where that rule is unacceptable, it will continue to insist on its own rules – in effect topping-up areas of inadequacy or non-equivalence,[16] much as the US topped-up MJDS. CESR's recommendation may or may not be accepted by the Commission or ultimately the Council of Ministers or Parliament.

At the same time the EU was determining whether US GAAP was equivalent to IFRS, the SEC indicated it would be determining whether to allow foreign companies listed in the US to use IFRS without reconciliation. In April 2005, the SEC indicated that it had developed a 'Roadmap' with the goal of accepting IAS for foreign companies by 2009. This acceptance would depend on 'a detailed analysis of the faithfulness and consistency of the application and interpretation of IFRS in financial statements across companies and jurisdictions' as well as continued progress in the IASB-FASB convergence project discussed above.[17] This SEC position was confirmed in 2006.[18] In mid-2006, many foreign issuers will begin filing statements with the SEC that reconcile IFRS to US GAAP, thus permitting the SEC to see what the differences are between the two standards and to see whether IFRS is consistently applied by filers. The SEC is generally concerned with the uniform implementation and vigorous enforcement of IFRS in the EU.

European Commissioner McCreevy suggested in December 2005 that one way to proceed in the EU would be to delay the EU equivalence decision until such time as the SEC made its decision on IFRS – in the meantime the status quo would be preserved, allowing US companies to issue in the EU under US GAAP (McCreevy 2005). This statement shows how, in some situations, equivalence determinations may be linked through an implicit reciprocity requirement. Thus, here the EU would find US GAAP equivalent with IFRS only if the US did the same.

In the case that the SEC were to accept IFRS and/or the EU were to accept US GAAP, the enforcement issue of any home country rule system would remain. It does not seem feasible for the IASB to enforce IFRS in the US or for the US to enforce US GAAP in the EU. Local regulators will have to enforce the foreign standards, for example FASB and the SEC will enforce IFRS in the US. This leads to the possibility of non-uniform application of the

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[16] Shadow Financial Regulatory Committee 2004, recommending that the SEC accept IFRS in the US, as supplemented by US GAAP where the SEC finds IFRS materially deficient.

[17] SEC Release No. 2005-62 (April 21, 2005).

[18] SEC Release 2006-17, 'Accounting Standards: SEC Chairman Cox and E.U. Commission McGreevy Affirm Commitment to Elimination of the Need for Reconciliation Requirements', February 8, 2006.

home country rule through differential standards of enforcement in the home and host countries.[19]

THE EU CONGLOMERATES DIRECTIVE In April 2002, the EU adopted a Directive to deal with financial conglomerates.[20] The Directive was aimed at ensuring the capital adequacy and controlling the risk exposures of groups of companies. The Directive caused significant problems for the US since the EU applied the Directive to subsidiaries of US and other foreign holding companies who were not subject to equivalent holding company regulation in their own countries. This was not a problem for US financial services holding companies, such as Citigroup – a holding company that includes a bank – since these companies were comprehensively regulated at the holding company level by the Federal Reserve Board. In particular, Basel capital rules were applied to these firms at the holding company level. But US holding companies that did not own banks but engaged in other financial services, such as securities firms like Goldman Sachs, were not regulated in the US at the holding company level (there were no holding company capital requirements) even though many of their subsidiaries, for example broker-dealers, were regulated.

In response, in June 2004, the SEC for the first time formulated new holding company regulations for US securities firms, which included capital requirements, albeit in more lenient form than those of Basel (SEC 2004). Whether such regulation was adequate was left to the group's lead supervisor (or 'coordinator') in the EU. For most US firms, this was the UK and the determination fell to the Financial Services Authority (FSA), the UK regulator of all financial firms. If the FSA decides that these US firms are subject to effective consolidated supervision under the SEC's proposed regulation, that will be the end of the matter. If the FSA decides that is not the case, it has indicated it could: (1) itself undertake worldwide supervision, or (2) 'look to the group to organize itself in such a way that the objectives of group-wide supervision can be achieved by other means, such as establishment of a European holding company and restrictions of exposures between the European sub-group and the worldwide group ("ring fencing")' (FSA (UK) 2003).

In 2005, the UK worked with the SEC to determine whether the new SEC rules were equivalent to those of the EU (Sants 2005). Its equivalence review was broken down into two parts, capital adequacy and information exchange.

[19] Glaum and Street (2003) found that the average compliance level of companies with IAS or US GAAP on the New Market was low, suggesting that German enforcement of non-German standards, either US GAAP or IAS, was not high.

[20] Directive 2002/87/EC of the European Parliament and of the Council, December 16, 2002. For a general review of the Directive, see Gruson (2004).

With respect to capital, the issue was whether the SEC's net capital rules satisfy the equivalence test, given that EU securities firms are subject to Basel capital rules. The more difficult issue was the extent to which European regulators would have access to SEC information about the entities regulated in the United States.

It appears that these issues were favorably resolved when the FSA issued letters to various US firms indicating that it had found US rules equivalent. It is not clear why there had to be firm-by-firm equivalence determinations when the judgment pertained to the overall US regulatory system. Perhaps, the FSA had sought assurance from individual firms that they would supply the FSA with particular information.

The three cases discussed here, auditing procedures, accounting standards and holding company regulation are all highly technical areas where there is no easy answer to equivalence. Whether this approach will emerge as the dominant one to rule allocation remains to be seen.

C. DISCLOSURE OF DIFFERENCES A third variation on reliance on home country rules can be called the disclosure of differences approach. The idea is that one can rely on home country rules as long as host country investors are informed about and know the difference between their domestic rules and those of the home country. This disclosure approach obviously only works where one is regulating transactions, as in the issuance or trading of securities, as opposed to where one is regulating firms, for example the auditing and holding company regulation issues discussed above.

Both the New York Stock Exchange and NASDAQ have adopted new corporate governance listing standards which in some cases go farther than the requirements of Sarbanes-Oxley, for example independent directors must comprise a majority of a company's board, boards must convene regular executive sessions in which the non-management directors meet without management and the chair of the audit committee must have accounting or financial management expertise.[21] Foreign companies are not required to comply with these rules – except for the requirement for a financial expert on the audit committee – but if they do not comply, they must disclose any significant ways in which their corporate governance practices differ from those required of domestic companies by the NYSE (NYSE 2002). This is similar to the corporate governance approach within the UK. The UK Combined Code and listing standards require that at least half the board of directors be independent,

[21] Sarbanes-Oxley does not require that the audit committee have any person with financial expertise but Section 407 does require that companies disclose why they have no financial expert on the committee, if they do not have such a person.

excluding the chairman. This policy is not compulsory, however. Companies must either follow this policy or explain why they are not doing so (Smerdon and Hazell 2003), a disclosure rather than a mandatory approach. Most other countries in Europe also take a comply or explain approach to governance.

The disclosure of differences approach plays a small role in overall securities regulation policy – in the US, it is only an exchange rule applicable to corporate governance requirements for foreign issuers. It is conceivable that with added experience and analysis of the new mandatory governance requirements (some work suggests that some of the new independence requirements may not improve corporate performance)[22] the US will be more open to a wider application of the disclosure approach in the future, at least with respect to foreign companies whose governance is centered in another jurisdiction.

5.2. Banking regulation

Banking regulation issues are fundamentally different than those of securities regulation. In banking, the focus is on firms rather than transactions. There are consumer protection issues in banking that are somewhat analogous to investor protection issues, but there is very little cross-border banking that involves consumers. And in securities regulation, there are issues dealing with the cross-border operation of firms, but there is less concern with regulating these firms than there is with banks because the failure of a securities firm is unlikely to have the same systemic consequence as the failure of a bank. In banking, the major justification for regulation is the systemic risk of bank failures, the chain reaction of bank failures that can arise from the failure of a major bank.[23] This has been a major concern in the international context, since

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[22] A comprehensive study before the enactment of Sarbanes-Oxley failed to find any significant correlation between board independence and firm performance (Bhagat and Black 2001). Gompers *et al.* (2003) found that firms with strong shareholder rights have future risk-adjusted stock returns that are 8.5 percent per year higher than those of firms with weak shareholder rights, but did not establish causality. The 2003 study also found that poorer corporate governance did not result in underperformance in operating returns, probably a better measure of governance impact. A later study, however, found that while more poorly governed (based on an index) companies have lower stock returns, these returns are not caused by poor governance since analysts predicted the lower returns in advance and that information about poor governance was impounded in advance into the stock price. It is conceivable that bad businessmen both make poor decisions as to how to govern themselves and how to do business (Core et. al. 2004).

[23] Concern today with the chain reaction of bank failures, caused by the failure of a foreign bank, should be significantly reduced as compared with earlier periods. One link in a possible chain is interbank credit, but bank regulators can place limits on such credit, as under Section 308 of the FDIC Improvement Act of 1991. The chain-reaction risk arising from bilateral credit exposures from overnight fed funds transactions in the US are quite low – losses would not exceed 1 percent of total commercial

the 1991 failure of BCCI. That case demonstrated that the failure of the bank in its home country necessarily entails the failure of its foreign branches, and may affect as well the solvency of its foreign subsidiaries and affiliates (Scott 1992).

Apart from systemic risk, the second major concern in cross-border banking is competition, as foreign firms compete with domestic firms for business. There is a concern that more light regulation – particularly with respect to capital – may give foreign firms an 'unfair' advantage. A major objective of the Basel Capital Accord of 1988 was to ensure an even playing field between US and Japanese banks (the latter having lower capital requirements at that time).

Keeping these regulatory concerns in mind, we shall examine the application of home and host country rules in the cross-border banking context (Scott and Key 1991). The focus will be on branching where the most difficult issues arise. When foreign banks operate abroad through subsidiaries the host country can fully regulate the foreign bank's domestic subsidiary in the same way it regulates domestic institutions. The host country may be concerned that it cannot exert the same pressure on a foreign bank holding company, as it can on a domestic bank holding company, to rescue a troubled local subsidiary but this is a much lower order of concern than the host country has with branches of foreign banks. When a foreign bank fails, its branches – part and parcel of the bank – fail with it, and the host country has little control over the regulation of the foreign bank by the home country. And with respect to competition, since both foreign and domestic-owned subsidiaries face the same regulatory regime, there should be little regulatory distortion.

I examine below the following approaches to dealing with the selection of home or host rules for cross-border branch banking: (1) harmonization; (2) mutual recognition of home country rules; and (3) conditional recognition of home country rules combined with self-protection measures. Note that certain

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banking assets when loss rates are kept to historically observed levels. A chain reaction of bank failures can also occur through payment system linkage (Furfine 2003). If one bank fails to settle its position in an end-of-day net settlement system for large value payments, other banks that do not get paid may in turn fail. Many countries have replaced net settlement with gross settlement payment systems, like Fedwire, to avoid this problem. In the US, there is still a net settlement alternative, the Clearing House Interbank Payments System (CHIPS), but its new continuous settlement procedures have all but eliminated the chain-reaction problem. Finally, a chain reaction could occur through imitative runs: depositors withdraw their funds from their own banks because another bank has failed. However, depositors in domestic banks are unlikely to assume that their own banks would fail just because a foreign bank has failed (they are too different). In any event, the Fed stands ready as lender of last resort, at least to domestic banks, to cure such irrational runs.

approaches to securities regulation are omitted – issuer choice is only relevant in transactions and national treatment is impossible to apply to foreign branches because, by necessity, they must generally be regulated by the home country.

One additional point is important in any discussion of home and host country rules for banking – it may not always be clear as to what country is the home country. Is it the country where the bank is incorporated or where the bank has most of its deposits? In the case of the 1991 failure of BCCI, the two failed banks were incorporated in Luxembourg and the Cayman Islands, whereas virtually all of the deposits of these banks (as well as assets) were located in the BCCI foreign branches in other countries. Post-BCCI host countries have required a clear identification of the home country and assurances that this country is capable of effective regulation.

5.2.1. Harmonization The centerpiece of harmonization in banking regulation is the Basel Capital Accord of the Basel Committee on Banking Supervision. In addition, there are the 'core principles' of the Basel Committee implemented through the IMF.

A. THE BASEL CAPITAL ACCORD The Basel Accord of 1988 (Basel I or the Basel Accord) established mandatory capital requirements for banks with significant international operations – 'internationally active banks' – but countries could choose to apply them to all of their banks. Both the US and the EU did so. The Basel Accord, while formulated by a supranational organization, is implemented and enforced at the national level. The Basel Accord is not binding on any of the participants – it rather represents an agreement of the supervisors that are parties to the agreement to implement the agreement nationally. In some cases, as with the EU, this agreement required additional legislation in the form of a Directive, while in other countries, like the US, bank supervisors already had adequate statutory authority to implement the Accord through regulation. The 1988 Accord was substantially revised in 2004 (Basel II).

Banks from about 120 countries have adopted the Basel I rules, far more than the G10 countries that were actually parties to the Accord. Other countries were motivated to do so by a number of considerations. To some extent observance of Basel standards had become a mark of respectability for many developing countries. In addition, the IMF has prodded countries to adopt the Basel standards, and monitors them for compliance. For developed countries outside of the G10, observance of Basel standards is a virtual necessity since many countries, most notably the US, require compliance with Basel as a condition for foreign banks to establish branches.

The Basel Accord had the twin goals of ensuring the safety and soundness

of banks operating across borders and evening the competitive playing field. It is far from clear that either objective was achieved. With respect to safety and soundness, the issue was (and remains under Basel II) whether any standardized capital rules make sense for all banks, particularly those from different countries. The objective of establishing an even playing field across many countries may be thwarted by the many factors that shape international competition. A comparison of Japan and the United States by H. Scott and S. Iwahara (1994) argued that identical rules may have a very different effect in countries with different accounting, tax, legal rules and government safety nets. For example, Scott and Iwahara found that the stronger Japanese safety net had a substantial impact on capital ratios. While the Basel minimum capital ratio was 8 percent, banks in both countries held more capital than the required minimum because the market demanded more. In this sense the 8 percent requirement was not binding. They also found that the capital on the books of the 10 largest Japanese banks in 1993 was substantially lower than that of the top 10 US banks: 9.67 percent and 13.60 percent of assets for Japanese and US banks, respectively. Japanese banks could hold lower levels of capital than US banks because they enjoyed a more ironclad safety net.[24]

One virtue of Basel I was that rigid and relatively simple rules did not permit much distortion by national regulators implementing the Accord. Of course, at the same time this made the Accord less flexible. In Basel II, the rules are far more nuanced and technically complicated, and more discretion is given to regulators in implementing the rules. Indeed, there are three versions of the rules, each applicable to banks of different sophistication. While this might make the rules more useful in principle, they will no longer be as standardized, as regulators implement them in different ways. The progression from Basel I to Basel II indicates the trade-off between flexibility and standardization in using harmonized rules internationally.

The Basel process differs fundamentally from the attempt to achieve harmonized rules in the field of securities regulation. Basel did not set out to harmonize existing national rules, as is the case in securities regulation (particularly with respect to accounting issues). While existing rules informed the Basel process, the G10 supervisors sought to devise what they thought were the best set of rules, international rules, to replace the myriad national rules. Basel's success in adopting these new rules – putting aside their desirability or effectiveness – made this process the crown jewel of international regulation. The process may be breaking down, however.

While Basel II like Basel I was only to be mandatory for internationally active banks, the working assumption was that the standards would be applied

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[24] See also Acharya (2003).

to all banks, at least in the US and EU, as was the case with Basel I. The US decided, however, in 2003, that the standardized Basel II methodology that would apply to most banks was unduly complicated. As a result, the US decided it would only adopt that part of Basel II that was designed for the most sophisticated banks, the top 10 US banks, and perhaps 10 more (Ferguson 2003). The EU, however, will apply Basel II to all of its banks. US regulators further decided to delay even the partial implementation of Basel II due to compressional concerns and their own doubts as to whether the new rules would make too large reductions in the required capital of big banks (Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and Office of Thrift Supervision 2005).

In March 2006, the Federal Reserve Board proposed a new rule for implementing Basel II for the major US international banks.[25] The proposal establishes a system of capital floors to make sure that Basel does not lower bank capital too much. The proposal also makes clear that the current minimum leverage ratio, capital to total average assets (without risk-weighting) of 3 per cent (and at least 5 per cent to be considered well-capitalized) would remain unchanged for all banks, whether or not subject to Basel II. This may be the binding constraint, e.g. the leverage ratio may require more capital than the risk-based requirement. These developments raise serious questions about the viability of future international rulemaking.

One further point about Basel II bears noting. Given that Basel II provides three methodologies for different banks, depending on their sophistication, it is probable that banks in the same holding company, but in different countries, could use different methodologies to calculate their capital. For example, the US subsidiary of a German bank might use the most advanced methodology while the Nigerian subsidiary of the same bank would use the least advanced approach. This will make it difficult for the banks and their supervisors to coordinate these different approaches. In addition, where sophisticated bank subsidiaries in different countries use the same model to calculate their capital, as permitted by Basel II, the question arises as to which supervisor shall take the lead in validating the model. This has been a particularly difficult problem in implementing Basel II even within the EU, as countries are reluctant to defer to other supervisors in validating such models.

The most difficult cross-border issues arise with respect to capital required for operational risk. Basel's most advanced approach to calculating this capi-

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[25] Board of Governors of the Federal Reserve System, Notice of Proposed Rulemaking Implementing New Risk-Based Capital Framework in the United States (March 22, 2006).

tal (the so-called Advanced Management Approach) permits the bank to calculate capital on a consolidated holding company level. However, regulators of particular subsidiaries will be concerned about the capital supporting their particular bank, rather than the holding company as a whole. This follows from the fact that an individual bank within a holding company that fails will not necessarily have a claim on consolidated capital or the capital of other affiliates. The Basel Committee (2004) has proposed[26] that 'significant' subsidiaries should calculate stand-alone operational risk capital requirements while other subsidiaries can use an allocated portion of the group-wide requirements – but supervisors of less 'significant' subsidiaries may not accept this.

The home–host problems with Basel demonstrate that one does not fully eliminate the home–host rule choice problem when one is operating under harmonized international rules. While the rules may be harmonized, they must still be implemented by national regulators. These problems could only be eliminated by delegating implementing powers to a supranational authority, powers that the Basel Committee does not now have.

B. STANDARDS AND PRINCIPLES In April 1997, the Basel Committee on Banking Supervision issued a Consultative Paper on *Core Principles for Effective Banking Supervision*. It formulated 25 general 'Core Principles' under the headings of Licensing and Structure, Prudential Regulations and Requirements, Methods of Ongoing Bank Supervision, Information Requirements, Formal Powers of Supervisors and Cross-Border Banking. The first principle requires, *inter alia*, that supervisors 'should possess operational independence and adequate resources', and 'a suitable legal framework for banking supervision'.

The basic problem with the principles is that they mimic supervisory systems in developed countries, yet are intended to be applied in both developed and developing countries. The standards assume a well-trained body of supervisors and sophisticated bankers, and thus are inappropriate for many countries. Moreover, standards that give government officials such tremendous powers may increase corruption in many countries. It may be far better to design mechanisms that give a bigger role to market discipline, such as disclosure requirements and the facilitation of the entry of foreign banks. These were the findings of a survey of regulatory and supervisory policies in 107 countries (Barth *et al*. 2005).[27]

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[26] These principles were further elaborated in Basel Committee on Banking Supervision 1999.

[27] See also Gros (2003).

While the Basel Committee has taken the lead in promulgating standards, since 1999 the IMF and World Bank have undertaken to assess whether the Basel Core Principles are being complied with. These are called Core Principles Assessments (CPA). These surveys have found a wide range of compliance with particular Core Principles. Performance on standards is taken into account by the Fund in making lending and other decisions regarding country assistance.[28]

The Core Principles were only the beginning. The IMF now also conducts a financial sector adjustment program (FSAP) that assesses compliance with a wider set of standards than just the Basel Core Principles. Codes, formulated by international bodies, now cover 12 areas, including the IMF's Code of Good Practices on Transparency in Monetary and Financial Policies, the Basel Committee's Payment and Settlement Systems' Core Principles for Systematically Important Payment Systems, and insolvency and creditor rights standards developed by the World Bank. Voluntary assessments of member countries' observance of standards and codes are made by member countries in the form of Reports on the Observance of Standards and Codes, or ROSCs.

A basic issue with harmonization through standards and principles is why this kind of harmonization is so necessary for the developing countries at which it is principally aimed. Unlike capital standards, which are mainly concerned with cross-border bank operations of banks from developed countries – where low capital standards of one country can damage another or create unfair competition – these standards and principles are aimed at mostly domestic banking operations. Bank failures in most developing countries will have little impact on other countries, and certainly virtually no impact on the developed countries that are behind the development and implementation of the core principles.

A more likely justification for the application of such standards to some developing countries is that bank failures in some countries may play a critical role in financial crises, as in the case of South Korea in the Asian financial crisis in 1997 or the Turkish financial crisis of 2000. These crises may trigger demands for IMF resources that are funded by developed countries. Thus, better regulated banks may reduce the demands for IMF assistance.

5.2.2. Mutual recognition of home country rules This approach, as with securities regulation, is followed within the European Union. Under the so-called single passport system, banks authorized by a home member state are

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[28] See International Monetary Fund (2000) and International Monetary Fund Financial Sector Assessment Program (FSAP) (2000).

entitled to establish branches in other member states and to offer the same services in these host states as they do in their home states, if such services are on an agreed EU list.[29] This system assumes a high degree of confidence by host states in the adequacy of regulation of the home state. Within the European Union this is assured by active cooperation among banking supervisors, as through the Committee of European Banking Supervisors (CEBS), as well as by the supranational structure of the EU itself. These conditions cannot easily be replicated in the international system as a whole.

Even within the EU, not all regulation of banks has been lodged with the home country. Host states can adopt measures 'in the interest of the general good'. These measures must be equally applicable to domestic and foreign entities. The European Court of Justice, in its landmark decision in *Cassis de Dijon*,[30] held that such clauses did not allow host states to set their own technical or qualitative standards for imported goods where the home states (member states of origin) had already set essential minimum standards. The Commission has tried to constrain general good requirements by host states by formulating the following conditions for their use: (1) the measure must not be discriminatory; (2) the measure must not impose higher requirements than those of a Harmonization Directive covering the subject; (3) the measure must have a general good objective; (4) the general good objective must not already be safeguarded in the country of origin; (5) the measure must be capable of guaranteeing that the objective will be met; and (6) the measure does not go beyond what is necessary to achieve the objective pursued. The last criterion, 'proportionality', may often be the hardest to satisfy.

In October 2004, the European Court of Justice held in *Caixa-Bank France v. Ministére de l'économie* that France was required to allow its banks to pay interest on current accounts despite arguments by France that such measures protected consumers against higher cost accounts and encouraged long-term savings. The Court held that prohibitions on interest payments were a serious obstacle to foreign banks seeking to do business in the French market. It also found that consumers could be protected by being offered a choice between higher cost accounts with interest and lower cost ones without interest. The court further stated that longer-term savings could be encouraged in other ways.[31]

The general point is that the EU mutual recognition system, based on deference to home country rules, still permits host country rules in defined, albeit narrow, circumstances.

[29] The Second Banking Directive, 77/780/EEC, as superseded by Directive 2000/12/EC of March 20, 2000.

[30] Case 120/78, 1979 ECR 649.

[31] Case C-442/02, Judgment of the Court, October 5, 2004.

5.2.3. Conditional recognition of home country rule The dominant approach to the home–host problem in banking is for the host country to recognize home country rules on a conditional basis, which often amounts to an appraisal as to whether the home country rules are equivalent to those of the host country. This contrasts with securities regulation where the dominant approach is national treatment, with some exceptions – the Sarbanes-Oxley approach. The reason for the difference is that broad home country recognition is a matter of necessity if a host country permits a foreign bank to operate in its territory – branches of a foreign bank are part and parcel of the foreign bank and thus regulated by the foreign regulator of the bank.

In order to protect itself from the failure of the foreign bank (and the failure of adequate regulation by foreign regulators), the host country has two principal policy tools. First, it can condition entry of foreign branches, and their continued presence, on certain commitments of the foreign bank and/or foreign bank regulator. Second, the host country can minimize the impact a foreign bank failure might have on its financial system. These protective policies risk being viewed by foreign banks and their regulators as attempts by host countries to protect their banks from foreign competition.

These host country policies are not entirely unconstrained. The Basel Committee has established certain baseline principles for allocating responsibility between home and host countries, the Basel Concordats. The remainder of this section discusses the Concordat approach and then discusses the policies the US uses to minimize the impact in the US of foreign bank failure. The US approach is not unique; most developed countries employ similar policies.

A. THE BASEL CONCORDAT The original Basel Concordat was formulated in 1975, entitled 'Report to the Governors on the Supervision of Banks' Foreign Establishments'. The Concordat was revised in 1983, 'Principles for the Supervision of Banks' Foreign Establishments', and this revision was supplemented in 1990, 'Information Flows Between Banking Supervisory Authorities'. In 1992, following the failure of BCCI, the Basel Committee converted certain of its 1983 principles into minimum standards, 'Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments'[32] (Minimum Standards). The Minimum Standards did not, however, supersede the 1983 Concordat, as they provide that the principles of the 1983 Concordat and its 1990 Supplement 'are still viewed as being sound' and 'certain of these principles have been reformulated as minimum standards . . .'.

The Minimum Standards emerged out of concern with the shortcomings of

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[32] Basel Committee on Banking Supervision 1992.

how the BCCI affair was handled, particularly the use of the so-called 'College of Supervisors' to deal with BCCI. The college had representation from the major countries in which BCCI operated, such as the UK and Pakistan, as well as its home countries, Luxembourg for the holding company and one of its banks, and the Cayman Islands for its other bank. But this college had no clear leadership and had difficulties in cooperating to get complete and consolidated information about the banking organization as a whole. McCarthy (2005b) has suggested the college approach can work if done correctly, pointing to the fact that for Hong Kong Shanghai Bank Corporation (HSBC), now headquartered in the UK, the UK Financial Services Agency now chairs a 'college' for HSBC by bringing regulators together from the US, Canada, Switzerland, Hong Kong, France, and the UK, where HSBC holds 80 percent of its assets. It remains to be seen whether this college can surmount the college problems in BCCI, particularly in a financial crisis.

The four Minimum Standards are:

(1) All international banking groups and international banks should be supervised by a home-country authority that capably performs consolidated supervision;
(2) The creation of a cross-border banking establishment should receive the prior consent of both the host-country supervisory authority and the bank's and, if different, the banking group's home-country supervisory authority;
(3) Supervisory authorities should possess the right to gather information from the cross-border banking establishments of the banks or banking groups for which they are the home-country supervisor; and
(4) If a host-country authority determines that any one of the foregoing minimum standards is not met to its satisfaction, that authority could impose restrictive measures necessary to satisfy its prudential concerns consistent with these minimum standards, including the prohibition of the creation of banking establishments.

These standards are consistent with the needs of the host country, insofar as they insist on adequate home country supervision (Principle 1), the right to approve entry (Principle 2), and the right to impose 'restrictive measures' including prohibition on entry (Principle 4). In addition, the home country is given the right to inspect its foreign branches (Principle 3). This inspection right is important to the home country because its ability to assure the safety and soundness of the entire bank is dependent on its having adequate information about the operations of its branches. US and Japanese supervisors both inspect their foreign branches.

Two matters specifically covered by the 1983 revised Concordat, but not by the Minimum Standards, deserve some comment. The 1983 revised Concordat specifically legitimizes the imposition by host countries of capital requirements on branches – requirements that branches hold a specified percentage of their assets in local liquid assets, thus permitting host countries to use such assets to cover local liabilities in the event the bank fails. The 1983 revised Concordat also points to the joint responsibility of the home and host supervisors to make sure the bank has adequate liquidity. The host authority is to monitor the liquidity of the branches, while the home authority is to monitor the liquidity of the bank as a whole. The Basel Committee is also careful to state that '[r]eferences to supervision of liquidity . . . do not relate to central banks' functions as lender of last resort . . .'. The question of who is the lender of last resort to a multinational bank, a quite important question, has yet to be resolved. Both the host and home countries have an interest in the continued operation of a foreign bank. While, in principle, it should seem that lender of last resort obligations should be lodged with the home country, which is responsible for the safety and soundness of the entire bank, the host country central bank may have to provide liquidity if the home country central bank does not.

However, consider the burden of a small country, e.g. Sweden, whose banks operate throughout Europe and the world. Should or could Sweden, economically or politically, bear the burden of the cost of the failure of a bank throughout Europe? Within Europe, Schoenmaker and Goodhart propose that the burden should be shared among the countries in which the problem bank operates, e.g. in proportion to country assets to total assets.[33]

This approach assumes banking organizations fail as a whole. But as is clear from the case of BCCI, the home country bank can fail without the failure of its subsidiaries (or affiliates). Moreover, this plan leaves the home country with weaker incentives to monitor the bank, since it will not pay the full cost of failure. An improvement on this approach might be to have contributions to the fund based on country assets but ultimately to allocate losses to countries based on an ex-post determination of supervisory responsibility. This inquiry must perforce be conducted after a bailout, as there will be no time to assess blame during a crisis.

The Concordat and the Minimum Standards are noteworthy insofar as they establish an international framework for resolving home–host issues. No such framework exists for securities regulation, where the issues may be more difficult to resolve. McCarthy (2005b) has argued that not all financial services are the same and thus different approaches to the home–host issue are required in

[33] Goodhart and Schoenmaker (2006).

different circumstances, for example, compare the problems of dealing with a foreign bank with a large retail business in the host country with a stock market with operations in two countries (as would happen if the NYSE buys Euronext).

B. US REGULATION OF FOREIGN BANKS

(i) Conditional entry and continued presence In 1991, in the wake of the BCCI scandal, the US Congress enacted the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA), which was designed to strengthen federal supervision, regulation, and examination of foreign bank operations in the United States. FBSEA prohibits a foreign bank from establishing a branch without the prior consent of the Federal Reserve, regardless of whether the branch is chartered under state or federal law. This meant that a foreign bank could no longer avoid federal scrutiny by obtaining a state charter, which is what most foreign banks had done prior to FBSEA.

The Act further provided that the Fed could not approve a foreign branch unless the foreign bank was 'subject to comprehensive supervision and regulation on a consolidated basis' by its home country authorities. The foreign bank must provide the Fed with information necessary to make this assessment. FBSEA also established additional discretionary standards that the Fed may take into account when assessing an application. These include the consent of the home country supervisor, the nature of the cooperative relationship between the Fed and the home country regulator as to sharing of material information, various assurances of the foreign bank, compliance with US laws, the needs of the community, and the relative size of the bank in its home country. The Fed may impose additional conditions on its approval, as it deems necessary (for example, cessation or restriction of certain activities).

FBSEA places the ultimate regulatory sanction of an organizational 'death sentence' (termination) in the hands of the Fed. The Fed may order a foreign bank operating a state chartered branch to cease operations if the foreign bank is not subject to 'comprehensive supervision or regulation on a consolidated basis' by its home country authorities. In addition, there may be reason to believe that the foreign bank has violated the law or engages in an 'unsafe or unsound banking practice'. The Fed may also recommend to the Office of the Comptroller (OCC), the chartering authority for federal branches, that it revoke the license of a federal branch, if the Fed has reason to believe that such foreign bank or any affiliate has engaged in conduct for which the activities of any state branch or agency may be terminated. Finally, the Act gives the Fed authority to examine all US branches of foreign banks – this supplemented the existing authority of the OCC and state chartering authorities to examine the branches they had chartered.

A striking application of the 'death sentence' authority occurred in 1996 when it was discovered that the state-chartered New York branch of Daiwa Bank of Japan, then the world's 19th largest bank, lost $1.1 billion from trading US treasuries between 1984 and 1995. When the bank's management discovered the losses in July 1995, they did not promptly report them to US bank regulators (the Federal Reserve and New York State Banking Department). In addition, it appears that in 1992 and 1993 Daiwa management falsely assured Federal Reserve Board examiners that trading and custody had been split (this reduces the possibility of concealed losses), whereas they had in fact both remained under the control of Mr Iguchi, the trader responsible for the losses. There was no threat to Daiwa's solvency from the losses, as the bank had more than a sufficient amount of capital.

As a result, Daiwa's branch license and other US banking operations were terminated by consent orders effective February 2, 1996 (Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and New York State Banking Department 1995). Daiwa also faced US criminal charges, brought on November 2, 1996, and entered into a plea bargain under which it pled guilty and was fined $340 million. Daiwa also suffered consequences in Japan. In September 2000, a Japanese court ordered the executives and former executives of Daiwa to pay $775 million to the bank for the losses caused by the New York branch management. This was then the highest damage award in the history of Japan (BNA Banking Report 2000).

Before Daiwa, the Japanese neither examined nor required audits of the foreign branches of their banks. The Japanese Ministry of Finance (MOF) announced in December 1995 that overseas branches of Japanese banks would be encouraged to obtain external audits and that the Bank of Japan would inspect branches in New York and London

The Daiwa case indicates the delicate balance between home and host country authority over branches of foreign banks. One can legitimately ask whether the Federal Reserve Board and the US government overreacted to Daiwa. No US depositor lost any money because Daiwa honored all of its debts – it was not insolvent. The bank did violate US law by apparently lying to regulators but did the punishment fit the crime? The MOF did not protest (at least openly) Daiwa's expulsion, perhaps, some thought, because MOF was complicit in the cover-up of the losses.

It is interesting to compare the US treatment of Daiwa with the Japanese treatment of US banks that have violated Japanese law. The Japanese have generally not imposed death sentences but rather have temporarily suspended business operations, as in the case of Credit Suisse First Boston (CSFB), which assisted Japanese banks in covering up bad Japanese loans. These CSFB actions resulted in much larger losses than did the Daiwa case. CSFB's 'structured finance' assistance prevented timely action from being taken to

avoid even greater future losses, and the losses that were incurred were paid for by the public when it became necessary to inject capital into failing Japanese banks.

The Japanese did impose a partial death sentence in 2004, however, when the Financial Services Agency (FSA, the successor bank regulator to MOF) ordered Citibank to close its private-banking operations in Japan. The regulators accused Citibank of failing to prevent transactions that may have been linked to money laundering or stock manipulation, and for failing to make adequate disclosure to its clients of the risk of investments. FSA also accused Citibank officials of trying to obstruct its investigations (Financial Services Authority (UK) 2004, Securities and Exchange Surveillance Commission (Japan) 2004, and Citigroup, Inc. 2004). In April 2005, the FSA ordered Cititrust Banking Corp., the Japanese trust unit of Citigroup, to suspend indefinitely all new business operations effective May 2, following Cititrust's failure to comply with Japanese mutual fund registration requirements. But these regulatory actions, serious as they may have been, did not suspend or terminate all of Citigroup's Japanese operations, as did the US in the case of Daiwa.

(ii) Minimizing the impact of failure There are three principal ways in which US regulators seek to limit the impact of the failure of a foreign bank. First, branches of foreign banks are prohibited from taking insured deposits, deposits under $100,000. Second, as specifically permitted by the Concordat, branches of foreign banks are required to back-up their deposits by liquid assets. Third, in the event of failure, the US 'ring-fences' the assets of the foreign branches and uses the proceeds of their sale to pay off US creditors.

PROHIBITION ON BRANCHES OF FOREIGN BANKS TAKING INSURED DEPOSITS Prior to 1978, deposits in branches of foreign banks were not insured by the Federal Deposit Insurance Corporation (FDIC).[34] While this protected the FDIC insurance fund from the failure of foreign banks, depositors who chose to put deposits in these branches were fully exposed to losses – an exposure that could lead the Federal Reserve Board to become a lender of last resort to the foreign bank or the United States to bail out the US depositors after the fact. Also, the unavailability of FDIC insurance arguably made the branches of foreign banks less competitive with US banks.

This approach was reversed under the International Banking Act of 1978 (IBA)[35] that required branches of foreign banks taking deposits of $100,000 or less to be insured. The major rationale for the change was to provide

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[34] This is the current system in Japan.
[35] 12 USC §3101 et. seq.

competitive equality for the branches of foreign banks. Ironically, all but a very few branches of foreign banks remained uninsured even after the change – limiting their deposits to over $100,000. If foreign banks had chosen the insurance option, they would have had to pay for the insurance by premium contributions to the FDIC fund, a cost that would largely have been passed on to depositors in the form of lower interest. Large depositors were more interested in having higher interest rates than having the first $100,000 of their deposits insured.

US policy changed once again in 1991 with the enactment of the FDIC Improvement Act (FDICIA), again in the wake of BCCI. FDICIA prohibited foreign banks from taking any deposits below $100,000 – all such deposits in the future would have to be taken through US subsidiaries. Existing insured branches, of which there were only 52 in 1991, were grandfathered. The rationale for this approach was to avoid putting the FDIC fund at risk from the failure of foreign banks and the inadequacies of their foreign regulators. While this approach, in principle, limited the competitiveness of foreign banks in US markets, the experience with IBA suggested that foreign banks did not really want to take insured deposits through their US branches.

One could take another approach to deposit insurance – allow deposits in a branch of a foreign bank to be insured under the deposit protection scheme of the home country. This would have the advantage of having the insuring country bear the risk for its own supervisory shortcomings. However, this might be thought to introduce an issue of consumer confusion. Deposits in domestic banks would be insured similarly but deposits in the branches of foreign banks would be insured differently, according to the various schemes in place in the home countries of these banks. One might, however, see this as a virtue, as it provides the bank depositor with more choice about the level of insurance protection. A major drawback of the home country deposit insurance system is that the host country is at risk from the failure of the home country's deposit insurance system – when claims on the home country's insurance fund exceed the fund's assets. Deposit insurance funds can become insolvent as occurred in the US thrift crisis in the late 1980s, and during the Japanese financial crisis in the 1990s, albeit in both cases the injection of public funds averted defaults on the funds' obligations.

The EU adopts still another approach. The EU provides that depositors in branches of all foreign banks within the EU must be provided a minimum insurance of €20,000 by their home country. It also permits, but does not require, a bank from an EU home country with limits below the host's country to top up its insurance by joining the host country's scheme. However, a foreign bank cannot provide a higher level of insurance than available in the host country.

Here is an example of how this works. Suppose Country X, the host coun-

try of a branch of a bank from Country Y, had an insurance scheme at the level of €40,000, while home Country Y had a scheme at the level of €30,000. The Country Y bank would have two options. It could either furnish the lower €30,000 deposit insurance of its home country Y or join Country X's scheme and offer €40,000. This system has the advantage of generally placing the deposit insurance with the home country (the regulating country). However, by allowing the foreign bank to provide the same level of insurance as the host country by joining the host country scheme, it puts the host country at risk for the regulatory failures of the home country. This result is clearly more acceptable within the EU than internationally. Note that the EU does not seem bothered by the fact that foreign banks may have a lower level of insurance protection than a domestic bank (if it does not top-up) but it does not permit a foreign bank to have a higher level of insurance than a host country bank, a result that seems protective of the competitive position of banks in countries with low levels of insurance protection.

QUASI-CAPITAL REQUIREMENTS FOR BRANCHES OF FOREIGN BANKS Under the IBA, foreign banks with insured federally chartered branches are required to pledge assets equal to 10 percent of the average of the insured branch's liabilities. Qualifying assets consist of a variety of interest-bearing obligations issued by banks, corporations, governmental entities and certain international organizations. State-chartered branches are subject to similar requirements. In addition, the FDIC requires that all insured branches (federal and state-chartered) maintain eligible assets (generally safe and liquid) payable in US dollars in an amount at least equal in book value to the amount of the branch's liabilities. These requirements once again raise competitive concerns insofar as foreign banks are subject to more onerous capital requirements than domestic banks.[36]

RING-FENCING Ring-fencing of the assets of a branch of a failed foreign bank, to cover its liabilities to host country depositors, is another important self-protection mechanism for host countries. The major policy question is whether these branch assets should more properly be part of a consolidated bankruptcy of the entire bank under the control of the bank's home country receiver. This issue arose in the failure of BCCI.

When BCCI failed, its US agencies (the only offices it had in the US),

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[36] One other way the US protects itself from the failure of a foreign bank is by limiting a foreign bank's daylight overdraft capacity on Fedwire. Whereas US banks' daylight overdraft capacity is a multiple of their entire worldwide capital, the capacity for foreign banks is limited to a fraction of their worldwide capital, at most 35 percent. Board of the Governors of the Federal Reserve System, Policy Statement, 66 Fed. Reg. 64419 (December 13, 2001).

offices that took uninsured deposits over $100,000, failed with it. While BCCI agencies in New York and California were legally prohibited from taking deposits from individual US citizens or residents, it appears that the BCCI agencies did so anyway. The US assets of the failed BCCI banks, estimated at $550 million, consisted only in minor part of the agencies' assets. Far more important were their alleged stockholdings in several US banks and correspondent accounts at the Bank of America and other banks. Claims against US assets included less than $20 million owed by the agencies to third parties (non-BCCI entities), as well as a $200 million fine which the Federal Reserve Board levied against BCCI for illegally acquiring certain US banks. There was also the prospect of additional fines as a result of criminal prosecutions by federal and state authorities.

The liquidators of the BCCI Luxembourg holding company and its two subsidiary banks, incorporated in Luxembourg and the Cayman Islands, first sought to consolidate these assets as part of the foreign insolvency proceedings, pursuant to Section 304 of the US Bankruptcy Code.[37] However, US bank bankruptcies are not subject to the general bankruptcy laws so it was unlikely that this attempt would have been successful. In any event, a settlement was reached under which the US bank liquidators agreed to remit any surplus remaining, after the satisfaction of US claims, to the US bankruptcy court for the benefit of the foreign liquidators.

The net effect of the United States proceedings was that $275 million in US assets was not consolidated with the worldwide receivership assets of the BCCI banks in the Luxembourg and Caymans proceedings and thus was not available to creditors of those banks. It appeared that the US creditors of the BCCI agencies received full payment of their claims.

If US or other country assets of failed foreign banks are not fully consolidated in home-country foreign insolvency proceedings, and such assets are substantial, the ability of a foreign receiver to reorganize a failed bank will be severely limited. While this was not a practical alternative in the BCCI case – earlier efforts to reorganize the bank with an infusion of capital from Abu Dhabi had foundered – it could be a problem in future bankruptcies of multinational banks. Indeed, the possible need to reorganize a failed company is a significant rationale for the US Bankruptcy Code's section 304 proceeding. In fact, it was this concern that was behind the decision of US authorities to assert jurisdiction over the London branch assets of Franklin National Bank when that bank was in danger of failing in 1974. The fact that the US authorities had control over all of Franklin's assets was an important factor in their ability to sell the troubled bank to European American Bank.

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[37] 15 USC §304

The failure to consolidate may also result in the inability of non-US creditors to obtain recovery of the same pro rata share of all of the bank's assets that they would have obtained if the assets were consolidated. While the creditors of BCCI's US agencies were fully paid off, creditors in the foreign insolvency procedures were not.

Apart from the difficulties of preferring some creditors of a bank at the expense of others, the assets of an agency or branch of a foreign bank may have little to do with its actual business activities in the host country. For example, it appears that the BCCI banks shifted assets among branches to avoid detection of insolvency. The difficulty of properly sorting out assets between various offices of a bank may argue for the need for a consolidated bankruptcy proceeding. A further complication arises insofar as the host country asserts jurisdiction over assets of a failed foreign bank that are within its jurisdiction but are not assets of the entities (an agency or branch) operating in its country. For example, part of the US assets of the BCCI banks reportedly consisted of $85 million of deposits of the Tokyo branch of BCCI Luxembourg in US banks. There is no clear rationale for using these assets to satisfy claims of US creditors of US agencies rather than using them to satisfy the claims of Japanese creditors against the Tokyo branch or the claims of worldwide creditors against the entire bank.

The strongest argument for the host country to preserve the assets of a branch or agency of a failed foreign bank for local creditors is that the host country is at risk for the supervisory failures of the home country. This rationale is much stronger when the host country insures local depositors than when it merely seeks to protect their uninsured interests, as in the case of the US agencies of BCCI. Under present law, as discussed above, the US does not insure the branches of foreign banks, so the case for ring-fencing is weak.[38]

C. THE EUROPEAN LEAD SUPERVISOR DEBATE Many European financial service firms would like to see the EU adopt a lead supervisor approach to regulation of EU financial firms (European Financial Services Roundtable 2005). Under this approach one supervisor would be the lead among all supervisors that regulated any entity of a financial firm. This would go beyond the Concordat approach where authority is divided between home and host countries in different ways for branches and subsidiaries.

Under the lead supervisor approach the home country of the holding company or bank could become the lead supervisor for the entire banking organization. Under current EU practices, the home country supervisor of a

[38] For a recent defense of ring-fencing, see Baxter et al. (2004). Thomas Baxter, Jr. is the general counsel of the New York Federal Reserve Bank.

bank rather than of the banking organization, is usually the effective supervisor. For example, under the lead supervisor approach, if a bank in France had an Italian subsidiary, France would be the lead supervisor for the Italian subsidiary as well as the French bank – while today France would be the effective supervisor for the French bank and Italy would be the effective supervisor of the Italian bank. Calls for lead supervisors reflect the desire of the banking industry to achieve more harmonization in supervision (failing the creation of a European supervisor) through extension of the home country principle. Banks believe a lead supervisor would reduce complexity by subjecting a banking organization to only one set of supervisory rules. Regulators that lose power under such a regime are likely to oppose it, and call for added cooperation under the existing regime. Callum McCarthy, the head of the Financial Services Agency in the UK, many of whose regulatees are subsidiaries of foreign banks, has already opposed this approach largely on the ground that host countries cannot politically accept leaving to foreign regulators matters that can seriously affect their economies and citizens (McCarthy 2005a, 2005b).

5.3. Sovereign debt

5.3.1. Background Emerging market debt with over one year maturity increased from $46.2 billion to $1.5 trillion from 1970 to 2003. The composition of this debt changed significantly over this period. In 1970 bank debt was $3.6 billion as compared to bond debt of $1.8 billion, whereas in 2000, bond debt was $368.4 billion as compared to bank debt of $157.8 billion. In addition, the amount of funding from governments also increased. IMF debt outstanding increased from $800 million in 1970 to $108.7 billion in 2003 and other multilateral debt, for example of the World Bank, increased from $7.3 billion to $374.7 billion. Bilateral government debt increased from $25.8 billion to $430.7 billion over this period. Despite the growth of all government debt, private debt grew faster, rising from 26 percent of all debt in 1970 to 41 percent by 2003 (World Bank 2004). In 2005–2006, two major creditors of the IMF, Brazil and Argentina, repaid their IMF debt, reflecting a significant improvement in the economies of these two countries.

Beginning with the Mexican default of 1982, the world has experienced a number of debt defaults by emerging market country borrowers. This was largely a result of the fact that these countries had over-borrowed and could not continue to service their foreign debt, at least not without unacceptable domestic political consequences. Between August 1982 and October 1983, 28 countries including Mexico rescheduled their debt. Sixteen were Latin American. And these countries continually rescheduled new and old rescheduled debt during the 1980s.

The response to these problems was international. The IMF transformed itself from an institution created to maintain fixed exchange rates into a lender of last resort. Banks created the London Club, a forum housed in London, to help private banks reschedule their loans. These negotiations took place alongside negotiations in the Paris Club about rescheduling official credit (credit from one sovereign to another).

A new approach to the sovereign debt problem was undertaken after the first Bush Administration took office in 1989. The idea was to bring permanent debt relief to borrowing countries by reducing and securitizing their debt, combined with the adoption of domestic economic reforms. The governments of the debtor countries issued so-called Brady Bonds (named after the Secretary of the Treasury) in exchange for outstanding debt in arrears to banks, at a negotiated discount to the face value of the debt or at below-market interest rates, secured by zero-coupon US Treasury bonds. The Brady Bonds did substantially reduce the emerging market debt burden but this salutary effect was only temporary.

Not all holders of bank debt tendered it for discounted bond debt. Four months after the government of Peru announced its Brady Bond package in 1995, LP Elliott Associates paid two banks $11.4 million for loans guaranteed by the government of Peru in 1983 with a face value of $20.7 million. Elliott rejected the Brady offers, and then sued Peru and the borrower in New York, asserting that New York law, which governed the bank loans, required full payment of the entire debt plus accrued interest.

Peru was not protected by sovereign immunity. Under US law, there is a commercial activity exception to sovereign immunity, and under *Republic of Argentina v. Weltover*,[39] issuing bonds is regarded as a commercial activity (Gulati and Klee 2001). Elliott obtained an injunction in the US restraining Chase Bank, the agent for the Brady Bonds, from using any funds it received from Peru to service the Brady Bond debt.[40]

Rather than transfer funds to Chase in New York, Peru tried to service the debt through Euroclear (a clearing and settlement system) in Belgium. The Belgian Court of Appeals restrained JPMorgan as operator of Euroclear, from either accepting the money or paying it to creditors.[41] Elliott successfully argued that the *pari passu* clause in the loan agreement required the debtor to

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[39] (1992) 504 US 607. Such rulings are now routine. In *EM Ltd. v. The Republic of Argentina,* the US Second Circuit affirmed a $740 million judgment against Argentina due to its 2001 bond default, 382 F.3d 291 (2004).

[40] US Second Circuit, *Elliott Associates v. Banco de la Nacion and the Republic of Peru*, 194 F.3d 363 (1999).

[41] Court of Appeals of Belgium (2000), LP Elliott Associates, Petitioner, General Docket No. 2000/QR/92, September 26, 2000.

pay all creditors, including Elliott, pro rata. Elliott subsequently settled the case with Peru.

Financial crises continued into the 1990s and beyond, the most important of which were the Asian and Russian crises of 1997 and 1998, respectively. Many of the 1990s crises were triggered, if not caused, by rapid foreign exchange rate depreciations and involved defaults on bonds as well as bank loans.

Argentina captured the title for the largest sovereign default when it defaulted on its $141 billion external debt in late December 2001 which included more than 90 financial instruments and millions of retail investors, many of which were Italian and Japanese. During the two years leading up to the crisis, the IMF repeatedly loaned Argentina funds.

In June 2004, Argentina announced its intention to make an exchange offer for $102 billion of its defaulted debt, $82 billion in principal and $20 billion in past due interest. At the time the exchange was completed, this represented about 34 cents on the dollar.

There was widespread creditor dissatisfaction with the terms of the offer, particularly given the improvement in the Argentine economy. Its real GDP grew by 7 percent in 2004 and inflation was below 5 percent. Furthermore, Argentina generated revenue from a tax on exports designed to capture 'windfalls' from the devaluation.

The exchange was deemed a success by Argentina in March 2005, when bondholders with 76 percent of the old bonds accepted the exchange by tendering their new bonds. Holdout creditors owed $361 million (principal plus interest), for which they paid $114 million in the secondary market, sought an attachment of $7 billion of the old bonds that had been tendered to Argentina in the debt exchange – the $7 billion figure assumed that the old bonds were worth 5 percent of their face value.

The court denied the creditors relief. While the court appeared to accept the argument that Argentina had a property right in the bonds, it stated that part of Argentina's rights to the bonds included its right to cancel the bonds, which the attaching creditors would obviously not do. The failure of Argentina to achieve cancellation of its old debt would lead Argentina to pull out of the exchange entirely, which it would have a right to do under the circumstances.[42] The Second Circuit affirmed the District Court's denial of the attachment order on May 13, 2005 in a summary order.[43] The court stated that

[42] US District Court, S.D. New York, *NML Capital Ltd. v. Republic of Argentina*, 2005 US Dist. LEXIS 5387 (March 29, 2005).

[43] US Second Circuit, *EM Ltd. v. Republic of Argentina*, 131 Fed. Appx. 745 (2005).

the District Court had provided a sufficient and dispositive reason for vacating the attachment, quoting the lower court: 'If these attachments [and restraints] are still in effect, we throw into doubt, to say the least, the conclusion of the exchange offer'. The Second Circuit also noted that the grant of attachment orders was largely a matter of discretion of the District Court and it had not abused its discretion.

5.3.2. Reform of the Sovereign Debt Process The sovereign debt process is primarily international. It is dominated by an international organization, the IMF, with the G7 operating in the background. The sovereign debt problem is quite different than the issues of banking and securities regulation, which principally involve the issue of the allocation between countries of regulatory authority for private cross-border transactions between private parties. In some cases, like Basel capital requirements, international rules are adopted by international institutions, but the much more common situation has been the use of home or host country rules.

Home or host country choices are largely irrelevant for sovereign debt. The home country is the debtor, which if left to its own devices, might not honor its debt at all or do so only at deep discounts. Host countries are obviously not prepared to leave restructuring rules to the home country, and there is no single host country to turn to since the debt is multilateral. The closest parallel in the private sector is the regulation of international banks like BCCI, where a college of supervisors approach was adopted (albeit with much disagreement about how the college should operate). In the case of sovereign debt, the IMF is a permanent college with financial resources – there is no need to invent another one. Furthermore, the Paris Club, another international institution, stands ready to deal with the restructuring of debt issued by one sovereign to another.

Thus, most of the important issues of sovereign debt reform involve how to change the international approach to the problem, as by reforming the IMF's role or designing a new sovereign debt restructuring mechanism. However, an important part of the system design is the extent to which private debt contracts should be enforced, both by countries and the international system as a whole, when defaults occur. In other words, to what extent should contract rather than international regulation determine how sovereign defaults should be dealt with. We now turn to these issues.

A. THE ROLE OF THE IMF The central issue about the IMF is whether constraints should be put on its lending because of the concern with creditor moral hazard. The International Financial Institutions Advisory Commission, dubbed the Meltzer Commission for its Chairman, Allan Meltzer, recommended in March 2000 that the IMF lend only to countries meeting minimum

prudential standards, that its lending not be tied to policy reforms, and that it should be limited to illiquid not insolvent borrowers. A later study of the Council of Foreign Relations proposed placing softer constraints on IMF lending.

In March 2003, the IMF Board formulated specific criteria that must be met before the IMF engages in large-scale lending: (1) balance of payments pressures on capital account, (2) high probability of debt sustainability, (3) good prospects of regaining access to private markets so that IMF financing provides a bridge, and (4) good economic policies in place. In addition the IMF Board adopted the requirement that, in cases of exceptional access, a new exceptional access report has to be prepared and published by the IMF management.[44] These are very soft constraints, however. It is difficult, for example, to see how some of these criteria were satisfied in connection with the subsequent $3.1 billion rollover of IMF debt to Argentina.

B. THE MODIFICATION OF BOND CLAUSES Another important issue in the reform debate is whether so-called collective action clauses (CACs) should be required in sovereign bonds to facilitate rescheduling. CACs permit a supermajority of creditors to change the financial and other terms of sovereign bonds in a restructuring. Sovereign bonds issued under US law traditionally required creditor unanimity to change payment terms. Restrictions on changing bond terms spring from a concern that a majority of creditors can abuse a minority. This fear was reflected in the enactment in 1939 of the Trust Indenture Act (TIA) restricting the use of majority action clauses in corporate issues. Although the TIA applies only to corporate and not sovereign bonds, US contracting practice for sovereign bonds has followed the statutory requirements for corporate bonds.

Due largely to the urging of the US Treasury, emerging countries have increasingly adopted bonds with CACs. Mexico adopted a 75 percent CAC (of all bonds outstanding) in a $1 billion bond offering in February 2003 and Brazil followed by issuing $1 billion of bonds with CACs in April 2003, using an 85 percent requirement. The consensus seems to be that there was no additional cost to countries of issuing bonds with CACs. One would think there would be some price effect – depending on whether the market viewed easier restructuring as positive or negative. If restructurings were to be more expensive for creditors, they should increase in price; if less expensive, they should decrease. Perhaps there was no price effect because the market thought they would have no impact, either because they would never really be used, for

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[44] IMF Executive Board Concludes Discussion on Access Policy in the Context of Capital Account Crises, March 21, 2003.

example there would continue to be bailouts, or because they would be difficult to use (Weinschelbaum and Wynne 2005).

The CAC solution will not work across different credit instruments. Even if the same CAC were inserted in all sovereign bonds, other major debt that would be simultaneously subject to restructuring negotiations, like syndicated bank debt or trade credit, would not have such clauses. It is also a heroic assumption to think that all bonds would have the same CACs; some might have a 75 percent requirement, others 90 percent.

This raises a very fundamental point. The very existence of corporate bankruptcy laws responds to the collective action problem of providing for a bankruptcy process through private contract. Private contract cannot itself deal with bankruptcy because different creditors, not in privity, interact with debtors over time and establish different terms in their contractual documentation for the resolution of disputes.

C. AN INTERNATIONAL BANKRUPTCY SYSTEM FOR SOVEREIGNS In November 2001, Anne Krueger, the then First Deputy Managing Director of the IMF, proposed adoption of a bankruptcy system for sovereign defaulters (the sovereign debt restructuring mechanism, SDRM) (IMF 2001), refining the proposal some four months later (IMF 2002). The proposal died on the vine after the US Treasury announced its opposition, after intense lobbying by creditors who believed the SDRM would make it too easy for sovereigns to default and scale down their debt.

The IMF proposal envisions that at the debtor's request a super-majority of creditors could impose a standstill on payments and a stay on creditor litigation for a fixed duration of time that was potentially renewable. The proposal also contemplates that a super-majority of creditors supplying new financing during the SDRM could subordinate existing claims, modeled on debtor-in-possession (DIP) financing in corporate bankruptcy. Multilaterals like the IMF and the World Bank would not be subject to SDRM.

A restructuring plan, as under CACs, could be approved by a super-majority of creditors in each class. The final IMF plan contemplated a 75 percent requirement (by value). The approval of the plan, however, would have to be informed by the IMF's view as to whether the remaining debt level was sustainable. The SDRM could be terminated, without a plan, upon the vote of 40 percent (by value) of the outstanding verified debt holders. An independent tribunal, perhaps a quasi-judicial organ, would adjudicate issues like lack of equitable treatment or valuation of claims.

A major drawback of SDRM is that it significantly increases the power of the IMF. The IMF continues its lending, plus is heavily involved in the SDRM mechanism. As a major 'priority' lender, it has an obvious interest in seeing that its own debt is repaid which may color its decisions on other issues. It is

rather clear, however, that some central authority would be necessary to administer SDRM. This then raises the problem of finding an alternative to the IMF.

D. STRENGTHENING CREDITOR RIGHTS As has been noted earlier, bond debt obligations are not normally protected in foreign courts by sovereign immunity as the issuance of such debt is regarded as a commercial activity, and commercial activities are outside the protection of sovereign immunity. Sovereigns normally waive sovereign immunity (Russia is a notable exception) in international debt instruments, so their assets in the US, in principle, are subject to attachment (28 USC §1610(a)(1)). This is true in many other countries as well.

Pursuit of court remedies will only be effective if there are assets, outside of the jurisdiction of the debtor country to satisfy court judgments.[45] The extent of such assets has been subject to much debate, given that most sovereign assets are within their borders and effectively immune from seizure. However, there may be significant assets available for attachment abroad. Cross-border foreign payments, whether on restructured bonds, other debt, or even for the importation or export of goods and services, may be fair game for attachment by creditors.[46] There may also be other significant assets abroad, like foreign bank and security custody accounts. Countries hold foreign bank accounts to make and receive payments and as a store of value. They also have foreign securities in custody abroad, often in connection with central bank reserve holdings.

The FSIA of the United States and similar laws in other countries, however, shelter key debtor assets from possible seizure. This is probably done for political reasons – developed countries may seek to accommodate the interests of developing countries, and all sovereigns may share a common interest in protecting their assets from seizure. After all, historically, all kinds of countries have defaulted on debts. Even the United States refused to honor the gold clauses in its bonds after the Depression. Nonetheless, sheltering government assets from seizures seems incompatible with the fundamental principle that countries are responsible for honoring their debts and creates a significant

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[45] Of course, one should not automatically assume that local courts would protect local assets from seizure where a foreign judgment was being enforced. This would depend on whether the laws of the debtor's country shielded the sovereign from such enforcement actions and whether local courts would, in fact, respect such laws in the face of sovereign pressure.

[46] Export receipts or import payments in connection with trade by the sovereign could be attachable, and the sovereign could lose access to short-term trade financing (Bratton and Gulati 2003).

debtor moral hazard problem. If developed countries want the market to play more of a role in limiting emerging market borrowing, they could expose sovereigns to the threat of the same creditor rights to which private borrowers are exposed. This would have to be combined with some kind of coordinated bankruptcy process to avoid races to the courthouse.

Central bank reserves are the principal liquid asset of most countries but under the US Foreign Sovereign Immunities Act, property of a foreign central bank 'held for its own account' is immune from attachment.[47] It is unclear how necessary such assets are for countries to pursue public policy concerns, particularly with countries that have, or should have, flexible exchange rates. There is also the distinct possibility that central bank reserves can be used to shelter commercial assets of the government or of influential individuals, including heads of state. In *Birch Shipping Co. v. United Republic of Tanzania*, the court held that Tanzania could not shelter commercial assets from execution by commingling them in an immune embassy account.[48] And in *Weston Compagnie de Finance et D'Investissement, S.A. v. La Republica del Ecuador*, the court indicated that funds in a central bank account used to finance commercial transactions of private parties would not be immune since these were not funds 'held for its account'.[49]

The possibility that central bank accounts in the United States might be attachable in some case, has led sovereigns to hold these accounts elsewhere, or to remove funds from US accounts once litigation is threatened. The preferred place to hold such funds is at the Bank for International Settlements (BIS). Article 10 of the Constituent Charter of the BIS provides: 'The Bank, its property and assets and all deposits entrusted to it shall be immune in time of peace and in time of war from any measure such as expropriation, requisition, seizure, confiscation, prohibition or restrictions of gold or currency export or import, and any other similar measures'.[50] So the major countries of

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[47] 28 USC §1611(b)(1). This immunity can be waived but only with respect to post-judgment attachment (attachments in aid of execution). This allows the debtor to withdraw assets from the US once litigation is brought. A useful addition to creditor rights would be to allow waiver of pre-judgment attachments.

[48] US District Court for the District of Columbia, *Birch Shipping Co. v. United Republic of Tanzania*, 507 F. Supp. 311 (DDC 1980).

[49] US District Court, S. D. New York, *Weston Compagnie de Finance et D'Investissement, S.A. v. La Republica del Ecuador*, 823 F. Supp. 1066 (1993).

[50] 104 League of Nations Treaty Series 441 (including Constituent Charter and Statutes); Compendium of Swiss laws (Recueil systématique); 0.192.122.971 (including Constituent Charter). In addition, there is a so-called 'Headquarters Agreement' between the BIS and the Swiss government entered into on February 10, 1987, which provides in Article 4.4 that all deposits entrusted to the Bank are 'immune from any measure of execution (including seizure, attachment, freeze or any other measure of

the world through the BIS Charter have given all countries' central banks a complete safe haven for all of their liquid assets, whatever the purpose for which they are held. Creditor rights could be enhanced by eliminating or narrowing such protections.

Two specific areas of creditor rights also deserve special mention, the use of the *pari passu* clause and the ability to seize assets of state-owned enterprises (SOEs). As concerns *pari passu,* we have already discussed the use of this clause in the *Elliott* case in Peru. Holdout creditors were able to attach payments to Brady bondholders in satisfaction of Peru's obligations on outstanding syndicated loans. In principle, this right could be made clear in law and extended to other dollar payments made by the sovereign, as for imports or payments to other trade creditors. In fact, the world seems to be moving in the opposite direction. Belgium recently amended its law to explicitly provide that no funds to be credited to a Euroclear account can be attached.[51]

A second area of interest is the possible seizure of the assets of SOEs in satisfaction of debts owed by sovereigns. While the doctrine of separateness would protect SOEs from being liable for the debts of their owners, assuming separateness was respected in the management of an SOE, creditors of the sovereign would still be entitled to become the owners of the SOE, since the sovereign's stock in the SOE is an asset of the sovereign. Under the Foreign Sovereign Immunities Act (FSIA), a US court cannot attach or garnish sovereign assets located outside the United States.[52] This is not true in the case of private debtors (Loeb 2004). FSIA could be changed to provide that US courts could attach or garnish stock even though the stock was outside the US. If the sovereign or the garnishee failed to deliver the stock, the Court could assign ownership of SOE assets, at least those in the United States, to the private

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execution, enforcement or sequestration, and in particular of attachment within the meaning of Swiss law'.

[51] The new law modifies the Belgian Act of April 28, 1999, which was the Belgian implementation of the EU's Settlement Finality Directive. The amended law provides (with changes in italics): 'No cash settlement account with a settlement system operator or agent, *nor any transfer of money to be credited to such cash settlement account, via a Belgian or foreign credit institution,* may in any manner whatsoever be attached, put under trusteeship or blocked by a participant (other than the settlement system operator or agent), a counterparty or a third party'.

[52] California Court of Appeals (1990), *Philippine Export and Foreign Loan Guarantee Corp v. Chuidian*, 267 Cal. Rept. 457; US District Court, S. D. New York, *Fidelity Partners, Inc. v. Philippine Export & Loan Guarantee Corp.*, 921 F. Supp. 1113 (1996). The idea in these cases is that while the Act specifically permits waiver of sovereign immunity for assets in the United States, its failure to provide for a waiver of sovereign immunity for assets outside the United States means such assets are protected by an unwaivable sovereign immunity.

creditors. One would then have to work out the priority issue as between the creditors of the sovereign and of the SOE.[53]

6. Conclusion

In my view, there is an inexorable pressure to harmonize the rules of international finance, and to increasingly delegate power to international organizations to formulate and enforce such rules, due to concerns with international stability, economic efficiency and the drawbacks of alternative approaches. It is clear that harmonization and supranational authority have greatly increased since the end of World War II. Sovereign debt has been the leading edge of this trend, with the central role of the IMF, and banking has followed behind with the work of the Basel Committee, and the ancillary role of the IMF and World Bank in monitoring and enforcing banking standards in the developing world. Securities regulation has trailed these two other areas due to the relative absence of systemic risk concerns, but the potential efficiency savings in this area are substantial. Even with securities regulation, one can point to the work of IOSCO on disclosure standards. These trends toward harmonization and supranational authority are taking place at an accelerated pace in the European Union because of the political framework and the commitment to a single market, but portend the longer-term future for the rest of the developed world. The creation of the Financial Stability Forum to coordinate the work of various global regulators is itself a testament to the trend.

The various alternative means of allocating authority between home and host countries have proved wanting in terms of the twin objectives of financial stability and efficiency. In a globally integrated world regulation itself must be global.

This is a prediction not an endorsement. There are obviously many significant costs to harmonization and increased supranational authority, primarily the surrender of sovereignty and the absence of regulatory competition. And the trends I outline are not without bumps on the road, as illustrated by the current tribulations of the Basel Accord and the debate over the IMF's role in sovereign debt. This vision of the future will not materialize over night. We will not wake up tomorrow to find that the US office of the Basel Committee has replaced US regulators in regulating and enforcing capital standards for banks in the US. But that is where I believe we are headed.

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[53] The SOEs' own assets are protected under the FSIA, 28 USC §1603(a), because an SOE may be considered an 'agency' of a foreign state if it is either an 'organ' of a foreign state or a majority of its shares are owned by a foreign state. There is a split in the circuits as to whether such immunity applies to indirectly owned SOEs, for example lower-tier subsidiaries. See *Filler v. Hanvit*, 378 F. 3d 213 (2nd Cir. 2004)

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10. International competition law

Andrew T. Guzman

1. Introduction

The phrase 'international competition law' is something of a misnomer. There is no supranational authority charged with generating, applying, or enforcing competition law, there are almost no binding international agreements on the subject, and there are no international requirements with respect to substantive or procedural rules. Indeed, there is not even a forum from which one can imagine a coherent transnational policy on competition emerging.

There is, of course, plenty of business activity that is transnational in scope, and this activity is regulated by competition laws, but for better or worse, only by domestic competition laws.[1] Because these domestic laws operate almost entirely independently of one another, firms engaged in cross-border activities must determine which domestic laws apply to their activities, what those laws require, and how to comply. Depending on how aggressively domestic regimes apply their own laws beyond their borders, firms may find themselves simultaneously subject to numerous competition laws. Furthermore, because the costs and benefits of regulation may fall in different countries, domestic lawmakers may face incentives to alter their domestic laws in an attempt to extract the largest possible gain for their own residents at the expense of foreigners.

This chapter describes the modest state of current cooperative efforts, the ways in which domestic competition laws and international business interact, and some of the possible options for the international community as it moves forward.

2. The regulation of international competition

When domestic laws regulate international activity there is always a question about which laws apply to which activity. It is the task of jurisdictional

[1] For the purposes of this chapter I will refer to EU competition policy as a 'domestic' or 'national' policy. Though not wholly accurate, it is appropriate in this context because legal policy is set through a formal legislative process (as opposed to a treaty process) at the European level.

rules to sort out this question, and so the jurisdictional reach of domestic laws plays a critical role in determining how international business activity is regulated. These rules are also the central policy tool relevant to discussions of international competition policy. This chapter begins with a brief history of approaches used in the two most important jurisdictions, the United States and the European Union. It begins with the United States, which was the first, and for many years the only, country to apply its laws extraterritorially.

2.1. *Jurisdictional approaches*

2.1.1. United States Rules The American position on jurisdiction in competition policy was first laid out in the 1909 case, *American Banana Co. v. United Fruit Co.*[2] The US Supreme Court, in an opinion by Justice Holmes, held that the American defendant's conduct was beyond the reach of the Sherman Act because the alleged conduct took place in Panama and Costa Rica. In upholding a purely territorial jurisdictional approach, Holmes wrote that 'the character of an act as lawful or unlawful must be determined wholly by the law of the country where the act is done'. Under this holding, domestic law extends to the geographic borders of a country and only acts that take place within its borders are subject to local law.

In the decades that followed the *American Banana* case, the Supreme Court heard a series of antitrust cases in which it gradually moved away from a strictly territorialist approach and focused more on the domestic effects of foreign acts.[3] The fatal blow to territorialism came in *United States v. Aluminum Co. of America*[4] (*Alcoa*). The Second Circuit, hearing the case in lieu of the Supreme Court, formally held that the jurisdictional reach of American competition law extended beyond the borders of the country. Judge Learned Hand stated that it '[is] settled law . . . that any state may impose liabilities, even upon persons not within its allegiance, for conduct outside its borders that has consequences within its borders which the state reprehends'.[5] The *Alcoa* case adopted a new 'effects test' that allowed the exercise of jurisdiction over extraterritorial activities 'if they were intended to affect imports and did affect them'.[6] Following the *Alcoa* decisions,

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[2] 213 US 347 (1909).

[3] See *United States v. Sisal Sales Corp.*, 274 US 268 (1927); *Thomsen v. Cayser*, 243 US 66 (1917); *United States v. Pacific & Arctic Ry. & Nav. Co.*, 228 US 87 (1913).

[4] 148 F.2d 416 (2d Cir. 1945).

[5] *United States v. Aluminum Co. of Am.*, 148 F.2d 416, 443 (2d Cir. 1945).

[6] Id. at 444. Although the *Alcoa* case was decided by the Second Circuit, it had

American authorities began a long period of aggressive extraterritorial enforcement of antitrust laws (Wood 1992). The basic effects test was reaffirmed by the Supreme Court in *Hartford Fire Insurance Co. v. California*,[7] where it was stated that 'the Sherman Act applies to foreign conduct that was meant to produce and did in fact produce some substantial effect in the United States'.[8]

Some American courts eventually sought to soften the application of the effects test (Swain 2001), in particular when foreign states had an interest in the disputes. The most important case in this effort was *Timberlane Lumber Co*.[9] In that case, American and Honduran defendants allegedly conspired with Honduran officials to prevent an American company from milling Honduran lumber and exporting it to the United States.[10] Although the plaintiffs had demonstrated the requisite effects of the anticompetitive conduct, the Ninth Circuit adopted a test that sought to take into account the interests of foreign states and criticized the lower court for 'fail[ing] to consider other nations' interests'.[11] The court held that conflicts of law principles in customary international law required the weighing of foreign and domestic interests affected by the exercise of jurisdiction.[12] The court concluded that 'it is evident that at some point the interests of the United States are too weak and the foreign harmony incentive for restraint too strong to justify an extraterritorial assertion of jurisdiction. What that point is, or how it is determined, is not defined by international law'.[13]

The Supreme Court had an opportunity to address the *Timberlane* balancing test and the Alcoa effects test in the early 1990s when it heard *Hartford Fire Insurance Co. v. California*.[14] The plaintiffs in *Hartford Fire*, nineteen

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the standing of Supreme Court jurisprudence because the Circuit court was acting in lieu of the Supreme Court (due to a lack of quorum among Supreme Court Justices). Nevertheless, it is worth mentioning that the Supreme Court itself adopted the Alcoa standard in *Continental Ore Co. v. Union Carbide & Carbon Corp*., 370 US 690, 704 (1962).

[7] 509 US 764 (1993).

[8] Id. at 796. See also US Department of Justice and Federal Trade Commission, *Antitrust Enforcement Guidelines for International Operations*, §3.1 (April 1995).

[9] *Timberlane Lumber Co. v. Bank of America Nat'l Trust & Sav. Ass'n*, 549 F.2d 597 (9th Cir. 1976).

[10] Id. at 603-4.

[11] *Timberlane*, 549 F.2d at 611–12.

[12] Id.

[13] *Timberlane*, 549 F.2d at 609. The Ninth Circuit eventually dismissed the complaint, mainly due to the conflict between the US law and the Honduran law regarding the anticompetitive conduct. *Timberlane Lumber Co. v. Bank of America*, 749 F.2d 1378, 1384 (9th Cir. 1984) (*Timberlane II*), *cert. denied*, 472 US 1032 (1985).

[14] 509 US 764 (1993).

states and a number of private parties, alleged that the defendants, who included certain London reinsurers, had violated the Sherman Act.[15] The defendants argued that the Court should decline jurisdiction on international comity grounds.[16] This jurisdictional conflict was critical because the laws of the United Kingdom permitted the alleged anticompetitive activities while the laws of the United States prohibited them.[17]

The *Hartford Fire* case seemed to offer the Supreme Court an opportunity to establish how comity should be used in the event of a conflict between legal systems. Rather than doing so, however, the Court narrowed the application of comity in such a way as to exclude its use in the case. It held that the principles of international comity should only be applied in the case of a 'true conflict' between American and foreign law, and that a true conflict does not exist if a 'person subject to regulation by two states can comply with the laws of both'.[18] Absent a true conflict, the Court held that the *Alcoa* 'intended effects' test applied.[19]

Though this ruling allowed the Court to avoid the difficult question of how comity should be applied, it also increased the potential for tension among national regulators. If the laws of the United States and those of another country (assuming both are applying the *Hartford Fire* rule) regulate the same activity, both legal regimes can assert jurisdiction, meaning that the stricter of the laws will govern. To appreciate the full implications of *Hartford Fire*, imagine a situation where almost all the plaintiffs and defendants are British and only a few plaintiffs are American. Even though the Americans make up a small part of the market, the Court's holding would require that the defendants comply with both countries' laws. Because the American law is stricter, it would govern the case.

The Supreme Court returned to the question of extraterritorial application of antitrust laws in *F. Hoffman-La Roche Ltd. v. Empagran S.A.*,[20] a case in which comity was again relevant. In *Empagran*, vitamin purchasers filed a class action alleging that vitamin manufacturers and distributors had engaged in a price-fixing conspiracy, raising vitamin prices in the United States and foreign countries in violation of the Sherman and Clayton Acts.

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15 See *Hartford Fire*, 509 US at 769.

16 See *Hartford Fire*, 509 at 797.

17 See id. 798–99.

18 See *Hartford Fire*, 509 US at 799.

19 See id. at 796–7; see also US Department of Justice and Federal Trade Commission, *Antitrust Enforcement Guidelines for International Operations*, April 1995, at 24 ('[T]he Sherman Act applies to foreign conduct that was meant to produce and did in fact produce some substantial effect in the United States.').

20 124 S. Ct. 2359 (2004).

At the heart of the jurisdictional issue was the reach of the Foreign Trade Antitrust Improvements Act of 1982 (FTAIA).[21] The FTAIA excludes from the Sherman Act's reach most anticompetitive conduct that causes only foreign injury, with the exception of conduct that significantly harms imports, domestic commerce, or American exporters.[22] The particular activity in question was a price-fixing scheme that caused domestic injury sufficient for jurisdiction. The same activity also caused injuries to foreigners abroad, but this injury was not related to any injury within the United States. Appealing in part to notions of comity, the Supreme Court held that where a plaintiff's claim rests entirely on a foreign injury that is independent from any domestic harm, there is no jurisdiction under the FTAIA.[23]

2.1.2. European Union For several decades after the *Alcoa* case, the European Union and its member states refused to apply their own competition laws extraterritorially, despite the American practice of doing so (Stevens 2002). It was not until 1985, in the *Wood Pulp* case,[24] that the European Court of Justice (ECJ) first applied a jurisdictional test that lead to the extraterritorial application of laws. In that case, forty-one producers and two trade associations were accused of having implemented an illegal pricing agreement. The ECJ applied what it called an 'implementation test', under which the territorial scope of Article 85 included not only the place where the parties formed an agreement, but also the place of implementation of the anticompetitive agreement or concerted practice (see Breibart 1989).[25] To meet the jurisdictional test under *Wood Pulp*, there must be (i) an agreement, decision or concerted practice entered into by two or more undertakings; and (ii) the actual implementation within the EU of that agreement, decision or concerted practice.[26]

In addition to Article 85, the Commission's authority to regulate concentrations is based on Council Regulation 4064, which gives the Commission authority to review all concentrations that have any impact on the EU. The concentration is deemed to impact the EU if the companies involved have combined worldwide sales of ECU 5 billion or if at least two of the companies involved each have sales in the EU of ECU 250 million. Even if the

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21 Id. at 2363.

22 Id.

23 The Court wrote that 'this Court ordinarily construes ambiguous statutes to avoid unreasonable interference with the sovereign authority of other nations' id. at 2366.

24 In *re Wood Pulp Cartel*, 1985 OJ (L 85) 1, [1985] 3 CMLR 474 (1985).

25 Id.

26 See id. at 166.

concentration does not meet one of these two tests, the EU may still exercise jurisdiction if the concentration passes one of several supplementary tests (Fiebig 1998).[27] The Commission has exercised jurisdiction over the acquisition of joint control over a non-EU firm by an EU firm and a non-EU firm,[28] the acquisition of sole control of a non-EU firm by a non-EU firm,[29] the acquisition of joint control over a non-EU firm by a non-EU firm,[30] and the merger of two non-EU firms.[31]

2.2. Current cooperation

Though there have been a number of past efforts to achieve more substantial cooperation with regard to competition policy, there has been little movement in that direction. The stillborn International Trade Organization (ITO)

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[27] Supplementary tests include (i) the combined aggregate worldwide sales of all the undertakings concerned are more that ECU 2.5 billions; (ii) in each of at least three Member States, the combined aggregate sales of all the undertakings concerned are more than ECU 100 million; (iii) in each of these three Member States, the aggregate sales of each of at least two of the undertakings concerned are more than ECU 25 million; (iv) the aggregate Community-wide sales of at least two of the undertakings concerned are more than ECU 100 million. Id.

[28] See, for example, Commission Decision 97/26/EC, 1997 OJ (L 11) 30, Case IV/M.619 (LEXIS, Eurcom Library, Legis. File) (Gencor/Lonrho); see also Commission Decisions of July 8, 1992, 1992 OJ (C 201) 26, Case IV/M.236 (LEXIS) (Ericsson/Ascom); November 27, 1995, 1995 OJ (C 330) 9, Case IV/M.648 (LEXIS) (McDermott/ETPM).

[29] See, for example, Commission Decision of 30 July 1997 Declaring a Concentration Compatible with the Common Market and the Functioning of the EEA Agreement, art. 5(8), 1997 OJ (L 336) 16 (Boeing/McDonnell Douglas); see also Commission Decisions of: March 23, 1998, 1998 OJ (C 128) 21, Case IV/M.1120 (LEXIS, Eurcom Library, Legis. File) (Compaq/Digital); July 6, 1998, 1998 OJ (C 267) 18, Case IV/M.1207 (LEXIS) (Dana/Echlin); March 7, 1991, 1991 OJ (C 66) 13, Case IV/M.069 (LEXIS) (Kyowa/Saitama Banks); August 11, 1997, 1997 OJ (C 283) 13, Case IV/M.963 (LEXIS) (Compaq/Tandem); September 8, 1997, 1997 OJ (C 305) 6, Case IV/M.977 (LEXIS) (Fujitsu/Amdahl); October 24, 1997, 1997 OJ (C 378) 3, Case IV/M.1011 (LEXIS) (Ingersoll-Rand/Thermo King); February 20, 1997, 1997 O. (C 120) 6, Case IV/M.882 (LEXIS) (Archer-Daniels-Midland/Grace Cocoa).

[30] See, for example, Commission Decisions of October 24, 1997, 1998 OJ (C 6) 2, Case IV/M.994 (LEXIS, Eurcom Library, Legis. File) (DuPont/Hitachi); Commission Decisions of July 20, 1998, 1998 OJ (C 280) 4, Case IV/M.1224 (LEXIS, Eurcom Library, Legis. File) (TPM/Wood Group); June 30, 1993, 1993 OJ (C 219) 10, Case IV/M.346 (LEXIS) (JCSAT/SAJAC); June 1, 1995, 1995 OJ (C 201) 3, Case IV/M.583 (LEXIS) (Inchcape/Gestetner).

[31] See, for example, Commissions Decision of April 2, 1998, 1998 OJ (C 144) 4, Case IV/M.1138 (LEXIS, Eurcom Library, Legis.) (Royal Bank of Canada/Bank of Montreal); October 15, 1997, 1997 OJ (C 341) 8, Case IV/M.985 (LEXIS) (Credit Suisse/Winterthur); October 26, 1995, 1996 OJ (C 33) 7, Case IV/M.642 (LEXIS) (Chase Manhattan/Chemical Banking).

made the first significant effort to establish an international framework for competition policy in its proposed Havana Charter shortly after World War II.[32] The US Congress rejected the ITO's proposed charter, effectively preventing the organization from coming into being, in part due to objections to the antitrust provisions. In the early 1950s, the United States similarly rejected an attempt by the Economic and Social Council (ECOSOC) of the United Nations to formulate an international antitrust policy.

In 1993, a group of antitrust scholars met in Munich, Germany and drafted an International Antitrust Code, which they proposed as a GATT-MTO-Plurilateral Trade Agreement (Gifford 1997).[33] This proposal represented an attempt at true international cooperation on substantive competition issues. For example, Article 4 of the Code was to govern horizontal agreements. It defined some that were per se illegal, and others that were to be treated under a rule of reason approach.[34] Similar substantive provisions were present with respect to vertical restraints (Article 5), mergers (Article 11), abuse of dominant position (Article 14), and so on. The Draft Code was intended to be a true source of international competition law and, perhaps for this reason, was never adopted.

The WTO's Doha Round negotiations saw the most recent attempt at international cooperation.[35] The agenda established for the Doha Round (the 'Doha Declaration') stated that 'further work in the Working Group on the Interaction between Trade and Competition Policy will focus on the clarification of: core principles, including transparency, non-discrimination and procedural fairness, and provisions on hardcore cartels; modalities for voluntary cooperation; and support for progressive reinforcement of competition institutions in developing countries through capacity building'.[36] Notice that this charge does not indicate an intention to carry out negotiations between member states during the round of trade talks, and there is no indication that any such discussions took place.

The current state of international competition law reflects the failure of

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[32] See US Department of State, Pub. No. 3206, Havana Charter for an International Trade Organization 114 (1948).

[33] Draft International Antitrust Code as a GATT-MTO-Plurilateral Trade Agreement (International Antitrust Code Working Group Proposed Draft 1993), published and released July 10, 1993, 64 Antitrust & Trade Reg. Rep. (BNA) No. 1628 (August 19, 1993) (Special Supp.) [hereinafter Draft Antitrust Code].

[34] Draft Antitrust Code, supra note 31, art. 4, s 1, at S-11.

[35] World Trade Organization, Doha WTO Ministerial Declaration, 9–14 November 2001, WT/MIN(01)/DEC/1, available at http://www.wto.org/english/thewto_e/minist_e/min01_e/mindecl_e.htm (last visited September 27, 2004).

[36] Doha Declaration, WTO Ministerial Decalration, November 14, 2001, available at http://www.wto.org/english/thewto_e/minist_e/min01_e/mindecl_e.htm.

these past efforts at cooperation. There is no significant international agreement that requires cooperation by states in the identification or prosecution of conduct that violates competition laws.[37] What exists is a variety of informal agreements among regulators. The most common form of cooperation is the bilateral agreement. By mid-2000, for example, the United States had entered into bilateral competition agreements with Germany,[38] Australia,[39] Canada,[40] Brazil,[41] Israel,[42] Japan,[43] Mexico,[44] and the European Union.[45] Though there are differences among the agreements, they tend to have certain common features, as illustrated in the EC–US agreement.

The EC–US agreement provides notification provisions that call on each party to notify the other when its enforcement activities 'may affect important interests of the other Party'.[46] The agreement also seeks to facilitate information sharing, and provides that the officials of the parties should meet at least twice a year (unless otherwise agreed) to '(a) exchange information on their current enforcement activities and priorities, (b) exchange information on economic sectors of common interest, (c) discuss policy

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37 This excludes the EU. See *supra* note 1.

38 Agreement Relating to Cooperation on Antitrust Matters, June 29, 1982, US–Austl, 34 UST 388, reprinted in 4 Trade Reg. Rep. (CCH) ¶ 13,502 (1999), and available at http://www.usdoj.gov/atr/public/internaitonal/docs/germany.us.txt.

39 Agreement Relating to Mutual Cooperation Regarding Restrictive Business Practices, June 23, 1976, US-FRG, 27 UST 1956, reprinted in 4 Trade Reg. Rep. (CCH) ¶ 13,503 (2000), and available at http://www.usdoj.gov/atr/public/internaitonal/docs/usaus7.htm.

40 Agreement Regarding the Application of Competition and Deceptive Marketing Practice Laws, August 3, 1995, US–Can., reprinted in 4 Trade Reg. Rep. (CCH) ¶ 13,503 (1997), and available at http://www.usdoj.gov/atr/public/internaitonal/docs/uscan721.pdf.

41 Agreement Regarding Cooperation between Competition Authorities in the Enforcement of Competition Laws, October 26, 1999, US–Braz., reprinted in 4 Trade Reg. Rep (CCH) ¶ 13,508 (1999), and available at http://www.usdoj.gov/atr/public/internaitonal/3376.pdf.

42 Agreement Regarding the Application of Competition Laws, March 15, 1999, US–Isr., reprinted in 4 Trade Reg. Rep (CCH) ¶ 13,506 (1999), and available at http://www.usdoj.gov/atr/public/internaitonal/2296.htm.

43 Agreement Concerning Cooperation on Anticompetitive Activities, October 7, 1999, US–Japan, reprinted in 4 Trade Reg. Rep (CCH) ¶ 13,507 (1999), and available at http://www.usdoj.gov/atr/public/internaitonal/doc/3740.pdf.

44 Agreement Regarding the Application of Competition Laws, July 11, 2000, US–Mex., available at http://www.usdoj.gov/atr/icpac/5145.pdf.

45 Agreement Between the Government of the United States of America and the Commission of the European Communities Regarding the Application of Their Competition Laws, September 23, 1991, US–EU, reprinted in 4 Trade Reg. Rep. (CCH) ¶ 13, 504.

46 Id. art. II.1.

changes which they are considering, and (d) discuss other matters of mutual interest'.[47] Some limited information sharing intended to assist in enforcement is also provided. Article III.4 states that the parties will provide relevant information within their possession that is relevant to an enforcement activity.[48] Either party may refuse to provide information, however, if that information is 'incompatible with the important interests of the Party possessing the information'.[49] With respect to cooperation in enforcement, the agreement merely provides that the parties 'may agree that it is in their mutual interest to coordinate their enforcement efforts',[50] but there is no requirement that either side cooperate. Should one party believe that activities taking place within the border of the other party are adversely affecting the former's important interests, it may request that the latter initiate enforcement proceedings, but '[n]othing in this Article limits the discretion of the notified Party . . . as to whether or not to undertake enforcement activities'.[51]

This form of agreement and the information sharing it provides is clearly of use to competition authorities. At a minimum it improves the channels of communication between regulators, lowers the cost of obtaining and sharing information, and provides guidelines with respect to how regulators from different jurisdictions will interact. Without denying the relevance of information sharing, however, it is important to note that the EC–US agreement and most other bilateral agreements are almost entirely limited to that function. They provide very little access to information about a firm or business activity that could not otherwise be obtained by foreign competition authorities, and confidential business information is not shared without the consent of the relevant firm.

Consider what is omitted from these agreements. There is no compromise of domestic control over enforcement, no binding commitment to share information, no commitment to cooperate in any particular instance, no coordination of substantive laws, no establishment of minimum standards, and no accounting for the impact of local laws on other states.[52] Ultimately,

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47 Id. art. III.2.
48 Id. art. III.4
49 Id. art. VIII.1.
50 Id. art. IV.2.
51 Id. art. V.4.
52 There are two notable exceptions of which I am aware. First, Canada and the United States have entered into The Treaty on Mutual Legal Assistance in Criminal Matters, March 18, 1985, Can.–US, 24 ILM 1092 (1985), which provides for the use of compulsory powers to gather evidence in criminal antitrust cases, though this is limited to criminal cases and gives each country the right to refuse cooperation on national interest grounds. The United States has also entered into an agreement with

these agreements are useful but extremely limited tools that facilitate the sharing of information that both parties wish to share.

One might wonder why states that seem to want to cooperate would not prefer a deeper form of commitment. The most likely answer is that what we observe in bilateral agreements is largely what one would expect from bureaucrats and regulators trying to protect their authority. As international activities grow in frequency and importance, the task of ensuring compliance with domestic antitrust laws becomes more challenging. Without some minimal level of cooperation, much of the information and evidence needed to investigate and prosecute a case may be outside the reach of domestic authorities. And what is true of evidence is also true of individuals – those suspected of having violated local laws may be beyond the subpoena power of officials. As international activities reduce the ability of competition officials to enforce their laws, cooperation with foreign enforcement agencies represents a way to protect their power.

Notice, for example, that there is generally no commitment to provide any specific form of cooperation. Each set of domestic regulators retains the discretion to refuse cooperation in a particular case or to decide the extent and form of the cooperation that is provided. Notice also that there is a heavy emphasis on exchanging information about policies, generally getting to know one another, and keeping one another informed of one's own activities.[53] This commitment does not entail any compromise of control, but it does facilitate coordination and cooperation between the competition authorities so that cooperation can take place when it suits all sides.

In terms of the functioning of the international system, there is little indication that existing cooperation represents an effort to construct a sensible international approach to competition issues or address the ways in which domestic laws interact. It is true that bilateral agreements often call on states to take into account the impact of anticompetitive conduct on the other party to the agreement, but there is no explanation of how this sort of consideration should be carried out, no sanction for a failure to consider the interests of other states and no discussion of how foreign interests should be weighed against domestic ones. All of this means that it is almost certainly a mistake to view existing agreements as the beginning of a trend toward cooperation. It is more accurate to describe these agreements as the effort of domestic authorities to adapt to an internationalizing environment. As such, they

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Australia under the International Antitrust Enforcement Assistance Act of 1994, Pub. L. No. 103-438, codified at 15 USC §§ 6201–12, which is discussed briefly later in this chapter.

[53] For example, the US–EC agreement calls for twice yearly meetings to discuss policy issues.

represent neither a hopeful sign of future agreement nor an indication that states are interested in further cooperation.

There are a very small number of more substantive agreements in existence, and this chapter will mention one to give a sense of what is possible. In 1994 the United States enacted legislation to permit the negotiation of international agreements that would permit the sharing of confidential information and allow the US to use its domestic tools of compulsory process to assist foreign governments in the gathering of information.[54] In the more than a decade since that law was established, however, only one such agreement has been reached (with Australia) and there is little evidence that others will be forthcoming.[55]

One additional form of international cooperation is worth mentioning. Recently, competition authorities from a number of countries have established the 'International Competition Network' (ICN). This network has as its stated purpose the facilitation of 'procedural and substantive convergence in antitrust enforcement through a results-oriented agenda and informal, project-driven organization'.[56] Despite this ambitious statement of purpose, the ICN is not, and is not intended to be, a forum in which binding agreements are reached. Rather its intention is to try to reach consensus on recommendations or best practices for domestic authorities. It is then up to those domestic authorities to implement the recommendations if they choose or to pursue international agreements of some sort. Once again the focus is on low levels of cooperation and information sharing.

3. The costs of non-cooperation

The failure to achieve meaningful cooperation in the regulation of competition generates costs for consumers and firms alike. These include the bureaucratic costs of coming into compliance with multiple jurisdictional requirements, the risk of biased prosecutions by domestic authorities, and distortion of the substantive rules put in place by domestic authorities. In this section I discuss each of these costs in turn.

3.1. Costs of ensuring compliance with multiple laws

The most obvious cost associated with non-cooperation is simply the cost of ensuring compliance with the various requirements of multiple regimes. The most dramatic example of how non-cooperation can increase the costs of

[54] International Antitrust Enforcement Assistance Act, 15 USC 6201 (1994).

[55] Agreement on Mutual Antitrust Enforcement Assistance, April 27, 1999, US–Austl., 39 ILM 1501.

[56] ICN website, http://www.internationalcompetitionnetwork.org/.

ensuring compliance is in the merger area. Firms planning to merge face three major categories of costs: (1) the direct and indirect costs of determining whether notification to the state is required, including legal fees, management and employee time and possibly fees for an economic expert; (2) direct and indirect costs of filing, which again include legal fees, filing fees and document production costs and possibly translation fees; and (3) costs that arise from the filing and review requirements when they cause delays in implementing the transaction.[57] These costs increase, and will continue to increase as more jurisdictions enact antitrust regulation, because firms must hire legal representation in each jurisdiction to meet the diverse reporting and disclosure requirements of each state. Even if the legal obligations do not vary across countries, redundant filing obligations generate duplicative costs and wasted time. In addition to these costs, the need to satisfy multiple, independent regulators results in costly delay. Furthermore, the regulatory agencies themselves are engaged in redundant reviews of the activity, further increasing the waste caused by the failure of cooperation.

3.2. Regulatory bias

Because cross-border transactions require the authorities to monitor the activities of both domestic and foreign firms there is a real danger that local firms will be favored over foreign ones, and that discretion in the hands of regulators will be used to apply the law more aggressively to the latter than the former. Indeed, even a totally unbiased regulatory structure may create the perception of bias. This perception is costly because if foreign firms and their governments believe that locals are favored over foreigners, their behavior may be affected. They may be reluctant to take certain actions or enter into certain dealings out of a fear that they face a higher level of scrutiny than do locals.

There is no shortage of evidence that states do, in fact, apply their competition policy prejudicially. The best example of this is the common use of export cartel exemptions.[58] Other examples include industry-level exemp-

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[57] See Notification & Procedures Subgroup, International Competition Network [ICN], Report on the Costs and Burdens of Multijurisdictional Merger Review 10–12 (2000), available at http://www.internationalcompetitionnetwork.org/costburd.pdf.

[58] The Webb-Pomerene Act, Pub. L. No. 65-126, 40 Stat. 516 (1918) (codified at 15 USC §§ 61–6 (1994)) creates an exemption from the Sherman Act and from section 7 of the Clayton Act for export associations that register with the Federal Trade Commission, are formed for the sole purposes of engaging in export trade, and actually engaged solely in such export trade. This exemption does not include export activity that has anticompetitive effects within the United States. When it became evident that exporters were no longer using the Webb-Pomerene Act and therefore

tions from competition laws. In the United States, for example, firms in the following industries enjoy such exemptions: international aviation, international energy, international ocean shipping, and international communications. When local firms benefit from such exemptions they enjoy an advantage that their foreign rivals do not.

Despite these examples, it is true that the bulk of competition laws do not explicitly discriminate based on nationality. But the problem remains because even facially neutral laws can be applied in a discriminatory way by regulators. In fact, one would expect that in most political systems there would be a tendency to favor local firms over foreign competitors. Whether this is because the individuals charged with enforcing competition policy are themselves more favorably disposed to local firms or because political leaders respond to the efforts of local interest groups by putting pressure on these individuals to favor influential locals, there is no reason to think that the administration of competition laws takes place without a national bias.

3.3. Distorted domestic laws

The absence of cooperation in international competition policy also has an effect on the substantive laws adopted by policy makers. To demonstrate, suppose that a country exports virtually all of its production in imperfectly competitive industries. (Only imperfectly competitive industries are of concern here because firms in competitive industries are not problematic from a competition perspective.) When domestic firms engage in activities that might be considered anticompetitive, the great majority of the harm is felt by foreigners, while the benefits are enjoyed by local firms. Policy makers, looking only to local costs and benefits, will take into account all of the resulting benefits enjoyed by firms, but will consider only that fraction of the harm that is felt by local consumers.

A government designing a competition policy in this context would, therefore, favor the interests of producers over those of consumers. Note that this effect is in addition to any preference for one group or the other gener-

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rendering it ineffective, Congress enacted the Export Trading Company Act of 1982, Pub. L. No. 97-290, 96 Stat. 1233-45 (codified at 15 USC §§4001–21 (1994)), and the Foreign Trade Antitrust Improvement Act of 1982, Pub. L. No. 97-290, 96 Stat. 1246–47 (codified at 15 USC §§6a, 45(a)(3)(1994)). The Export Trading Company Act allows a firm to apply for and receive a Certificate of Review from the Secretary of Commerce by demonstrating that its activities will not have harmful effects in the United States. The Certificate allows for immunity from treble damage awards and criminal liability, as well as establishing a presumption of legality, for any activity that is covered by the Certificate. The Foreign Trade Act, on the other hand, exempts from prosecution export cartels that do not have a 'direct, substantial, and reasonably foreseeable' effect on American commerce. 15 USC §6a (1994).

ated by domestic political concerns. One way to think about this is to imagine that the policy maker adjusts the payoffs to local consumers and producers to reflect the relative weights or priorities that he assigns to each. In contrast to local interests, foreign interests are not considered at all – they receive a weight of zero. Thus, in our hypothetical, trade causes the country to favor producers over consumers more than would be the case in the absence of international trade.

To illustrate, imagine that a state favors firm interests over consumer interests. If the country is a closed economy, it will adopt policies that favor firms but, in evaluating policy options, will give consumer interests at least some weight. Now consider a country with the same political economy, but that exports most of the production of its imperfectly competitive industries. Because the political economy favors firms, the interests of domestic producers are still weighted more heavily than those of domestic consumers. In addition to this effect, the impact of the competition regime on consumers is underestimated because foreign consumers receive zero weight in the government's calculus. This generates policies that are still more favorable to firms, at the expense of consumers, than was the case absent trade.

There are a number of strategies available to governments who wish to favor firms over consumers. The easiest of these is the already-discussed export cartel exemption. An exemption of this sort, however, is a relatively crude instrument because it only applies if all of a firm's production is exported. A more nuanced strategy is to change the state's substantive laws. This benefits all firms, including those that sell some of their goods domestically. Returning to the example of a country that exports most but not all of its production in imperfectly competitive industries, the government could react to this pattern of trade by weakening its competition laws. This strategy opens the door to more anticompetitive activity by local firms than would be the case in the absence of trade, yet retains some limits on conduct to protect local consumers.

Imports generate a distortion analogous to the above export distortion. If a country is able to regulate extraterritorially, it has an incentive to tighten its policy (relative to what a closed economy would do) in response to the importation of goods in imperfectly competitive markets. In the case of imports, the full amount of harm suffered by local residents is included in the policy calculus while only the benefits to local firms are considered. As with imports, this generates a predictable distortion regardless of how policy makers weigh the interests of firms and consumers (Guzman 1998).

The combination of trade and consumption patterns in imperfectly competitive markets suggests how a rational state's competition policy will differ from what it would adopt if it had a closed economy.[59] Assume that

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[59] For simplicity, it is assumed here that the impact on a country's firms is

there are two kinds of goods: those that trade in competitive markets and those that trade in imperfectly competitive markets. Firms whose goods trade in competitive markets have no market power and, therefore, cannot engage in conduct that raises competition policy concerns. Firms whose goods trade in imperfectly competitive markets, on the other hand, enjoy market power and states attempt to regulate these firms through the use of competition laws. If a country's firms are responsible for x% of global production of imperfectly competitive goods, it is assumed that those same firms enjoy x% of the monopoly rents generated by the sale of those goods. The government of that country, then, will take into account x% of the producer surplus generated by a change in its policies. Thus, for example, if a country relaxes its competition policies, this might lead to an increase in producer surplus. But since some of that surplus is felt outside the country, the government ignores it. If the same country's consumers account for y% of global consumption of goods sold in imperfectly competitive markets, then the government will take into account y% of the global effect of their policies on consumers.

The net effect of trade, then, depends on the ratio of a country's global share of production to its global share of consumption of imperfectly competitive goods. Notice that a closed economy would be one in which these are equal ($x = 100 = y$). If a country is a net exporter (meaning that its share of global production exceeds its share of consumption, $x > y$) then the country will take into account a larger portion of its policy's impact on producers than on consumers. Relative to what it would do if it were a closed economy, then, the country will favor the interests of producers, yielding a more permissive competition policy regime. If a country is a net importer of these goods ($x < y$), the opposite is true – the preferred policy is stricter than would be the case in a closed economy.

The presence of international activity, then, causes a state's domestic competition laws to deviate in systematic and predictable ways from what the state would choose if it had a closed economy. These deviations represent attempts to externalize the costs and internalize the benefits of the exercise of market power across borders.

proportional to the number of firms in the country, and the impact on consumers is proportional to the amount of local consumption. I will also assume here that all imperfectly competitive goods are equally monopolistic and that monopoly rents are distributed proportionately to the volume of sales of imperfectly competitive goods. These assumptions are not necessary, but greatly simplify the presentation.

4. The de facto global regime

4.1. The problem of excessive regulation

Firms doing business in states that apply their laws extraterritorially have an increased burden because regulations are not identical across jurisdictions. When firms must follow several sets of legal rules at once, the de facto international regime is one that consists of the most stringent elements of each national regime and that is likely to be more restrictive than any individual state would choose for itself. For example, imagine a firm subject to the competition laws of countries A and B. Assume that country A has a more restrictive antitrust policy than country B with respect to horizontal restraints of trade, but a more permissive policy with respect to vertical restraints. Country A believes that this combination represents the optimal competition policy. Country B, on the other hand, believes its regime of permissive policies with respect to horizontal restraints but restrictive policies with respect to vertical restraints is the optimal policy. Firms subject to the jurisdiction of both countries A and B face a de facto regime that includes the strict horizontal restraint regulations of country A and the strict vertical restraint regulations of country B. Neither country A nor country B believes that a competition policy should be this strict.

Nor is it only differences between legal regimes that influence the effective level of regulation. The mere fact that a firm is subject to the regulation of two or more countries increases the regulatory burden. This is most obvious in the merger context where pre-approval of a transaction is often required. Imagine a merger of two or more firms doing business in both the United States and the EU, and subject to merger review in both jurisdictions.[60] Assume further (and counter-factually) that the substantive rules in the two jurisdictions are identical. Being subject to review in both jurisdictions means, in practice, that the merger can only go forward if it is approved by both regulatory authorities. The assumption that the substantive rules are identical makes it more likely that the US and EU authorities will reach the same conclusion, but certainly does not guarantee that outcome. This is so because merger review (or any other form of competition policy review) is carried out by humans with different backgrounds, different interpretations of existing rules, and different attitudes about potentially anticompetitive activity. Furthermore, the reviewing agencies in different countries have

[60] In the US, companies considering a merger must comply with the Sherman and Clayton Acts as well as US Department of Justice and Federal Trade Commission Horizontal Merger Guidelines (1992), and in the EU, the same companies must comply with the Council Regulation 4064/89, known as the Merger Control Regulation.

different cultures, different political climates, and different biases. In addition there is the possibility that reviewing agencies are biased in favor of locals and against foreigners, in which case the application of the law depends on the identity of the firm. Even with identical substantive laws, then, a proposed merger may be approved in one jurisdiction and not in the other. The requirement that the merger be approved by both jurisdictions amounts to an increase in the effective level of regulation.

In short, firms that have to submit to jurisdiction in two or more countries face a more burdensome international competition policy regime than what is applied by either country on its own, and probably more restrictive than any one of those states would choose if either were a closed economy.

One country's extraterritorial application of competition law can also undermine enforcement efforts in other countries. This is most easily seen in leniency programs used by several jurisdictions, including the United States. These programs provide leniency to corporations reporting their illegal activity at an early stage. The primary appeal of such programs is that they encourage parties to come forward with information that may assist authorities to prosecute other parties. But taking advantage of, for example, the leniency program in the United States would not shield a firm from prosecution in another jurisdiction. Indeed, taking advantage of a leniency program in one state may increase the firm's risk of prosecution in another state because the firm will lose control over relevant information. For a firm subject to jurisdiction in many states, then, the incentive to come forward and take advantage of a leniency program may be undercut by the risk of prosecution elsewhere.[61]

Prohibiting extraterritorial assertion of jurisdiction would prevent such overregulation, but this prohibition would have its own costs. Alternatively, the countries could prevent overregulation by entering into some form of cooperative policymaking.

4.2. The problem of too little regulation

Although some jurisdictions, such as the United States and the EU, assert their jurisdictions extraterritorially, many countries (including most developing states) either do not have effective antitrust laws or do not apply those laws extraterritorially. Because the extraterritorial application of laws increases the set of policies available to a state, the decision to not apply

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[61] A variation on this problem was present in *Empagran v. Hofman-LaRoche*, 315 F.3d 338 (DC Cir. 2003). In that case the concern was that allowing foreign private plaintiffs to file complaints would undermine leniency programs. See Brief for the Government of Canada as Amicus Curiae Supporting Reversal of February 3, 2004, Empagran, available at 2004 WL 226389; Mehra (2004).

one's laws in this way requires explanation. Though there may once have been a norm against such application, that is no longer the case. With the United States and Europe (among others) both applying their laws extraterritorially it is hard to imagine that there is some form of informal sanction imposed on countries that follow suit. A better explanation is that the decision to not apply one's laws extraterritorially is a pragmatic one reflecting the fact that a state lacks the power to enforce its laws abroad or the capacity to pursue cases that involved events outside the country. Firms doing business in these jurisdictions face an accidental international competition policy, but its contours are more complex than the regime faced by businesses operating in the United States and the EU.

Consider first the effect of international trade on the domestic competition policy of a country that does not apply that policy beyond its borders. With respect to imports, the country cannot prevent anticompetitive activity by foreign producers. With this in mind when creating substantive competition policy, the policy makers will only consider the effect of the law on domestic production. In other words, because domestic competition policy will have no impact on the behavior of foreign firms, the optimal policy for the state is the same as it would be if there were no imports. Because restrictive antitrust laws affect both producers and consumers, as long as domestic firms export some of their products, the state has a motivation to adopt more permissive competition laws than would be the case in a closed economy. (If local producers in imperfectly competitive markets only sell domestically, the local competition policy will be the same as it would be in a closed economy.) This is so because the benefits of a tougher competition policy flow to consumers. If some of the consumers of a good are located abroad, the policy maker ignores that portion of the benefit that is enjoyed by foreign consumers. In selecting an optimal policy the decision maker takes into account all the costs of tougher policies, but only a fraction of the benefits – leading to more permissive laws.

This analysis predicts that small, open economies, where firms export a high percentage of production and consumers import a high percentage of consumption, will have weak or ineffective antitrust laws. The fact that small states rarely have substantial antitrust laws is fully consistent with this prediction. The EU experience is similarly consistent with the theory. When the EU's competition policy moved from the national level to the regional level (and extraterritoriality came into practice), the relevant policy went from being relatively permissive to relatively restrictive.

The analysis of states that do not apply their laws extraterritorially does not end here, however. Though the domestic laws adopted by these states are likely to be weaker than would be the case in the absence of trade, the de facto regime for many firms doing business in such countries is affected by other states that apply their laws extraterritorially.

For instance, firms which conduct business in the United States and the EU are potentially subject to the laws of both jurisdictions. Consider the example of two or more passenger aircraft producers that wish to merge. Assume that the merged firm will have increased market power, increased prices, and earn higher profits. A territorialist state can only reach the proposed merger if one of the firms is located within its borders, and even then it can only hope to prevent the local firm from participating. However, both the United States and the EU will have jurisdiction over the proposed merger and either state can block it. If the EU or the United States blocks the merger, this action will affect all states. The competition policies of states that apply their laws extraterritorially, therefore, can influence economic activity in other states. In particular, states without extraterritorial jurisdiction are able to free ride on the regulatory supervision of those countries that do apply their laws in this way. Free riding is especially effective for countries that engage in a great deal of trade. Local firms with market power will be disciplined by international firms, and international firms are likely to do business in the EU, the US, or both – meaning that they will be subject to competition policy in those jurisdictions.

Although states that do not apply their laws extraterritorially can substitute free riding for a domestic competition policy, that strategy falls short of a fully effective legal regime. First, the EU and the United States may not bother to pursue a case that only minimally impacts them, even if it has a major impact on the free-riding state. The costs and benefits of an activity are obviously not the same in all countries, especially when comparing developing countries to developed ones. For example, anticompetitive conduct in the market for pharmaceuticals that treat tropical diseases may be enormously costly for some developing countries, but may not attract the attention of US or EU regulators.

Second, free riding is only effective to the extent that the firms in question are doing business in the US or the EU. Regional anticompetitive activities (such as regional periodicals) may not trigger jurisdiction in the US or the EU, and yet may impose significant costs on states.

An additional problem with free riding is that strong and effective enforcement of US and EU antitrust laws in those countries will not prevent firms from engaging in anticompetitive activities in other countries, outside the reach of the United States and the EU. Firms do not need to have a uniform pricing model for all the countries where they do business; they only have to restrain their anticompetitive activities in countries with effective competition policies. The United States and the EU have no reason to pursue a firm as long as it abides by their policies in their respective countries. Therefore, those countries whose laws cannot reach the firm cannot depend on free riding on the competition laws of the EU and the United

States. The empirical evidence suggests that exactly this sort of market segmentation and price discrimination has taken place (Levenstein and Suslow 2001; O'Connor 2001; White 2001; Clarke and Evenett 2002).

In conclusion, the de facto competition policy regime that exists in countries that do not apply their laws outside their borders is one created by a combination of overregulation (from markets where the EU or the US laws apply) and underregulation (where those laws do not apply). Cooperation could bring the regulation to a more optimal level.

5. Options for cooperation

The case for cooperation laid out above turns on the argument that the failure to cooperate generates unnecessary costs. This is, of course, only half the story because cooperation may also be costly. In this section I discuss the costs associated with several alternative forms of cooperation. In considering these different cooperative strategies, it is useful to remember that as we move to higher levels of cooperation, the associated costs increase. Greater cooperation moves decisions and policies further from individual citizens and the conventional domestic political process, and gives greater authority to domestic and, potentially, international bureaucracies. Greater cooperation also raises enforcement problems both because states may fail to comply with their commitments and because a truly international enforcement strategy may require some new form of cooperative transnational enforcement authority, which at the moment is difficult to imagine. Finally, cooperation is costly because the negotiation and maintenance of international cooperative agreements consume resources. The negotiation of agreements is time consuming and politically difficult, as is the establishment of new institutions, and the need for unanimity with respect to changes in agreements generates a powerful status quo bias that can prevent a cooperative regime from adapting to changes in the world.

Where possible, states should avoid these costs. This counsels for the lowest level of cooperation possible, consistent with an effort to avoid the major costs of non-cooperation (Guzman 2002). With this in mind, I turn to consider the three general forms of cooperation that might be envisioned for competition policy: the status quo of information sharing, agreement on choice of law rules, and cooperation on substantive laws.

5.1. Information sharing

As already discussed, current cooperation is almost entirely limited to voluntary information-sharing agreements. This minimal level of cooperation is required for regulators to successfully prosecute international firms doing business in their countries. If prosecutors could not seek help outside their borders, there is little to stop firms from violating the law, residing in a

foreign jurisdiction, and simply keeping important documents and meetings pertaining to the violative activity offshore. It is hardly surprising, then, that competition policy authorities have achieved this modest level of cooperation.

The information-sharing agreements that currently exist are a relevant and important tool in the international regulation of competition. They are not, however, sufficient to address the regulatory challenge of regulating international business activity with domestic laws. Without any compromise of domestic authority, coordination of jurisdictional reach, or agreement on minimum standards, information sharing cannot address the main costs of non-cooperation discussed in this chapter.

5.2. Choice of law

States could engage in a higher level of cooperation without surrendering any control of domestic substantive laws by agreeing to some coherent system of choice of law rules for competition policy. There are standard touchstones that one could use to determine the applicable law, including the location of the anticompetitive activity, the location of the most significant effects, the principal place of business of the firm, and so on. All of these pose problems in application, and one would have to decide whether the goal is to assign jurisdiction exclusively to one state or to some larger number, but despite these problems at least some activities and transactions could be addressed through an agreement on choice of law rules.

Unless a choice-of-law system were able to establish exclusive jurisdiction in most cases, however, it could not resolve the problem, already discussed, of overlapping jurisdiction. Firms that do business in both the EU and the US will continue to face excessive regulation as long as both states exercise jurisdiction over the activities and transactions of these firms. Nor can choice-of-law rules discourage states from distorting their substantive laws in an attempt to favor local firms. A choice-of-law system that assigns jurisdiction to more than one state will lead to overregulation and a system that assigned jurisdiction to a single state will lead to underregulation. Furthermore, a choice-of-law system cannot resolve the problem of local bias and trade-induced distortions of national substantive policies.

Theoretically, the problem of underregulation in states that cannot extend their laws extraterritorially could be addressed through a choice-of-law rule that grants standing to plaintiffs if the relevant firm activity took place within the jurisdiction, even if the injuries occurred abroad. (An even more aggressive rule would grant standing to any plaintiff regardless of where the conduct took place.) This rule would give injured plaintiffs a remedy against the actions of foreign firms that target states whose laws do not apply extraterritorially, as long as the conduct was within a state with effective

antitrust rules. Such a rule would at a minimum ensure that western firms faced some regulation when selling into countries without extraterritorial reach. The justification for this rule is essentially the same as the justification for eliminating export cartel exemptions: it requires states to regulate some anticompetitive behavior even when it benefits local firms and harms foreign consumers. This arrangement would obviously be a dramatic change from the status quo, and implementation would face numerous difficulties. If one concludes (as is almost surely correct) that the adoption and operation of such a rule in the current context is unrealistic, the lesson is that deeper cooperation is needed.

5.3. Substantive cooperation

The inability of either information sharing or choice-of-law rules to resolve the problems of international competition policy leads us to consider more substantive cooperation. By substantive cooperation I mean cooperation that deals with the content of the actual antitrust rules governing transactions. Cooperation at this level is necessary if international competition is to be regulated in a sensible and effective way.

At this point it is appropriate to address a source of confusion that exists in the international competition literature. When one discusses cooperation in competition policy, some observers immediately assume that what is being proposed is the harmonization of domestic laws. This need not be the case, however, and many forms of cooperation short of harmonization are possible. That said, it is also true that virtually any cooperation involves the surrender of some level of domestic control. Suppose, for example, that the US and the EC were to enter into an agreement that places an obligation on the competition authorities to share information with one another under certain conditions. If this agreement is effective, it will make it easier, for example, for EU authorities to pursue a case against American firms.[62] This represents a de facto increase in the regulatory burden on those US firms. The agreement in question is far from a rule of harmonization, but it increases the reach of both states' laws and, therefore, makes it more likely that a firm must satisfy both sets of laws. For firms subject to the laws of both jurisdictions, then, there is a de facto harmonization – regardless of where they are from, they face a regulatory system that includes the laws of both systems.

The history of attempts at cooperation as well as the theory of international cooperation in the area tell us that achieving cooperation on substantive issues

[62] In fact, even the current system of informal cooperation could lead to this result as voluntary information sharing can increase the effective reach of domestic authorities.

is difficult (Guzman 1998). It is difficult because of differences in priorities, perceptions, and legal culture across countries, but also because different states are in different positions. As discussed in Section 3.3, the domestic policies chosen by states and the global policies preferred by states depend on the pattern of trade in imperfectly competitive markets. States that are net importers of such goods will prefer a strict policy and states that are net exporters will prefer a weak policy, relative to what each state would prefer absent this distortion. This problem, along with others already mentioned, suggests that the best strategy for cooperation is to start small.

The most realistic area in which agreement might be reached is a non-discrimination principle, including both national treatment and most favored nation elements (McGinnis 2004; Trebilcock and Iacobbucci 2004; Guzman 2001). Non-discrimination is attractive because it is consistent with basic notions of fairness and with established rules in international trade. It would also address at least one problem – the use of export cartels. A national treatment obligation may also be of some use in addressing discrimination in application, though one wonders how successful that would be. Even if one imagines using some form of dispute resolution to determine if a state has complied with a non-discrimination requirement, experience at the WTO suggests that it is difficult to monitor discrimination of this sort. This is especially true because comparisons across transactions are difficult in this area. An alleged price-fixing scheme at the international level, for example, cannot easily be compared to some domestic analog to determine if both were treated in the same way by regulators.

Beyond a non-discrimination agreement, states could consider the WTO's proposed 'core principles, including transparency, non-discrimination and procedural fairness, and provisions on hardcore cartels; [and] modalities for voluntary cooperation'.[63] This more ambitious set of issues is still rather modest and focuses on issues that have widespread agreement – the need for transparency, non-discrimination, and the need to address hardcore cartels.

Whatever form of cooperation one envisions, there remains the question of where negotiations should take place. This is more than simply a detail because the forum in which negotiation takes place is likely to affect the chance of an agreement. I have argued that the WTO provides the most proper forum for these negotiations (Guzman 2003). Some commentators disagree and believe that WTO business and negotiations on antitrust policy should not mix (Fox 1999; Tarullo 2000). Furthermore, Michael Trebilcock

[63] WTO Ministerial Declaration, Doha Ministerial Conference Fourth Session, WTO Doc. WT/MIN(01)/DEC/1 (November 20, 2001), ¶ 25.

and Edward Iacobbucci argue that the failure of the members to come to an agreement during the Doha Round, and the EU's subsequent proposal at Cancun in September 2001 to withdraw competition policy from the WTO's negotiating agenda due to sharp opposition from developing countries, demonstrates that the WTO is not the ideal forum to negotiate cooperation (Trebilcock and Iacobucci 2004).

The advantage of negotiating at the WTO is that doing so provides a setting where many issues can be negotiated at once, and therefore allows for concessions in one area in exchange for agreement in another. This ability to negotiate across a range of topics is crucial in achieving an international antitrust agreement because it reduces transaction costs which, in turn, increases the likelihood that the parties will reach the optimal result.

The WTO's dispute settlement system provides an additional advantage to using this forum. Without enforcement procedures, parties to an agreement have little incentive to honor their commitments. Though the dispute settlement system within the WTO is imperfect, it currently provides the best mechanism for ensuring compliance with an antitrust agreement. Additional advantages offered by the WTO include universal membership, relatively transparent procedures, and experience managing the negotiation and implementation of international agreements.

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11. Intellectual property rights in world trade

Frederick M. Abbott

Technology has always played a significant role in economic development and the shifting fortunes of nations. Yet when the GATT was established in 1947, very limited attention was paid to 'intellectual property'. This is largely explained by the evolution of an international system for the regulation of intellectual property (IP) under the auspices of what today is known as the World Intellectual Property Organization (WIPO). As a subject of international regulation, intellectual property had not been overlooked. In fact, it was perhaps the first element of world trade subject to truly multilateral discipline with the Paris Convention for the Protection of Industrial Property of 1883 and the Berne Convention for the Protection of Literary and Artistic Work of 1886.

IP is regulated at the multilateral, regional, bilateral, national and subnational levels. This chapter focuses on the multilateral regulatory system largely concentrated at the WTO and WIPO, but also refers to regulation at other levels of governance.

The forms of intellectual property

Intellectual property is a defined set of the intangible products of human creative activity.[1] Unlike real property and personal property which is often protected by means of physical security devices (such as fences and other enclosures), intellectual property is mainly protected by sets of enforceable legal rights granted to 'owners' or 'holders'.[2] These legal rights are intended to solve the economic problem described by Kenneth Arrow as the 'incomplete appropriability of knowledge'.[3] Because intellectual property is intangible and typically easy to copy and transport, it is difficult for business enterprises to capture the full value of investments in it (i.e., competitors can easily appropriate it.). Intellectual property rights ('IPRs') are an effort to solve this inappropriability problem.

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[1] For a detailed technical discussion of intellectual property rights, see Frederick Abbott et al. (1999).

[2] Some intellectual property rights holders attempt to protect their interests through security devices, such as data encryption or software anticopy protections. See discussion of encryption technologies in Barlow (1994).

[3] Arrow (1962).

Intellectual property is usually referred to by the form of 'right' (or IPR) granted to the holder. So, for example, a 'patent' is a set of legal rights granted to an inventor. It is not the invention itself. Historically, the patent and trademark were referred to as 'industrial property rights' while the copyright and related rights were referred to as 'authors' and artists' rights'. However, with the advent of the protection of computer software by copyright, the line between industrial property rights and authors' and artists' rights blurred and this distinction is no longer particularly relevant.

Patent

The 'patent' is a set of rights granted to the inventor of a product or process which is 'new' (or 'novel'), involves an 'inventive step' (or is 'nonobvious') and is 'capable of industrial application' (or 'useful').[4] The inventor must disclose the invention in the patent application in a way that enables others to make the invention without undue experimentation. The minimum term of a patent under the TRIPS Agreement is 20 years from the filing of the application. The holder of a patent may prevent others from making, using, offering for sale, selling or importing the invention during the patent term. As with other IPRs, the rights of the patent holder are qualified by certain important exceptions. The patent is typically referred to as a 'hard' form of intellectual property because it excludes another person from using the invention without the consent of the patent holder even if the other person independently found the same invention.

The patent is intended to perform three functions: (1) to stimulate inventive activity; (2) to encourage investment in the products of inventive activity, and (3) to disseminate technical information to the public.[5] The extent to which the patent effectively performs these functions has been the subject of long debate. The principal alternative to using patents to stimulate inventive activity is government subsidy. Economists generally believe that patents are a more efficient policy instrument than government subsidies for promoting investment in innovation, while allowing that in certain circumstances subsidies can be more effective.[6] There is recent concern that an over-proliferation of

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[4] The criteria of patentability are referred to by different words in European and American law. European law refers to new, involving an inventive step and capable of industrial application, while American law refers to novel, nonobvious and useful.

[5] These functions are elaborated in Fritz Machlup (1958), *An Economic Review of the Patent System*, Subcomm. on Patents, Trademarks and Copyrights, of the Committee on the Judiciary, 85th Congress, 2d Sess. (excerpts reprinted in Abbott et al. (1999), at 224–46).

[6] See Nordhaus (1969).

patents may impede inventive activity, at least in certain fields, as a 'patent thicket' grows.[7]

Patents have a cost to society in terms of allowing higher than competitive prices to be charged to consumers, and this cost must be weighed against their positive invention-encouraging effects. In some areas, the social cost of allowing market exclusivity may be quite high. By way of illustration, allowing the inventor of a new cancer drug to prevent others from making it may significantly increase its price and reduce patient access to it. Policy-makers have justified the social cost as necessary to provide an incentive and reward for the innovator. However, the patent term is limited. After some years, generic producers are allowed to copy the drug and enter the market providing enhanced access to patients. The social benefits and costs of patenting inventions in different fields of technology differ. High-definition television and cancer treatment serve different social functions, and limiting consumer access to these products has different social effects.

Trademark

The 'trademark' is a sign or symbol that distinguishes the goods or services of one enterprise from another in commerce. Trademarks may consist of virtually any form of sign, including letters and words, designs, colors, shapes, sounds and scents.[8] A trademark allows its holder to prevent others from using an identical or confusingly similar sign to identify its goods or services in commerce where such use would result in a likelihood of confusion. Trademark rights may last as long as the right holder continues to use the mark in commerce. In civil law jurisdictions, trademark rights are typically based on registration. In common-law jurisdictions, trademark rights may be based either on registration or on use in commerce (the latter referred to as 'common law' trademarks). In some jurisdictions, trademark rights may extend beyond the prevention of consumer confusion to encompass the prevention of 'dilution' of the trademark holder's interests, i.e., third parties may be prevented from 'tarnishing' or 'blurring' the trademark.

It is generally believed that trademarks serve an efficiency-enhancing function by providing consumers with an easy way to identify products with preferred qualities or characteristics.[9] Consumers come to identify certain 'brands' which they prefer, and make purchasing decisions based on brand-identification (as a substitute for more costly and time-consuming case-by-

[7] See US Federal Trade Commission (2003), at 6–7.

[8] Some jurisdictions impose limitations on the use of single colors as trademarks.

[9] See discussion by the US Supreme Court of economic policies underlying trademark protection in *Qualitex v. Jacobson*, 514 US 159 (1995).

case product analysis and testing). Trademarks also provide a vehicle into which business enterprises can invest advertising dollars, stimulating brand identification and 'goodwill'.[10] Economists are divided as to whether it is useful to encourage investments in goodwill since there is not necessarily a correlation between the usefulness and quality of products and the amount of advertising invested in them. This can lead to market distortions (in which consumers make purchases based on artificially stimulated demand).

Copyright

'Copyright' is granted to authors and artists to protect expressive works against unauthorized reproduction or distribution by third parties. Expressive works are broadly defined, and include such things as books, films, music recordings and computer software. There is, in fact, no express limit on what material might be considered to embody protectable artistic expression. However, copyright does not extend to functional works or ideas.[11] This principle is often referred to as the 'idea-expression dichotomy', with the 'idea' excluded from copyright protection. Under the TRIPS Agreement the minimum term of copyright protection is the life of the author plus 50 years. However, in a number of places, including the United States and European Union, the duration of copyright has been extended to the life of the author plus 70 years. Copyright also extends to the rights of performers in the fixation of their unfixed performances, and to rights of producers of sound recordings and broadcasters. These latter rights traditionally were protected as 'neighboring rights' in European law, but as a consequence of more recent treaty developments are now considered the subject of copyright. Copyright also protects the 'moral' rights of authors and artists, the extent of protection varying among jurisdictions. Moral rights extend at least to the right of the author to be identified with the work, and not to suffer from the mutilation or distortion of the work with which he or she is identified. Copyright is considered a 'soft' form of IPR because it does not preclude independent creation by third parties.

Copyright is intended to benefit the public by encouraging authors and artists to create and disseminate their works.[12] As with other forms of IP, it is not easy to assess the economic effects of copyright protection. It is difficult to measure how much creative expression is gained (or lost) as a result of copyright, and what the economic value of that expression is. While movie

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[10] See McCarthy (2005), at §§2.17–2.30.

[11] See generally *Feist Publications v. Rural Telephone Service*, 499 US 340 (1991).

[12] Id.

and music producing companies routinely offer data regarding losses suffered as a result of inadequate enforcement of copyright protection,[13] the figures typically do not reveal the extent to which the claimed losses – which usually refer to lost opportunity costs – should be offset by the economic and social benefit to consumers of unauthorized copies, or of the economic gains/benefits to 'pirates'.[14] In the well-known Napster court battle between music producers and an online file-sharing service, economists had considerable difficulty estimating what the effect of nonenforcement of copyright protection was on music producers because of difficulties assessing the extent to which losses from uncompensated file-sharing were offset by gains from increased artist exposure and consequent CD sales.[15]

Design protection

Designs are covered by various forms of IPR, including design patent, copyright, trademark and trade dress, and *sui generis* registration systems. The protection of non-utilitarian designs has long been a problematic area for intellectual property law. The traditional 'utility patent' is granted with respect to a useful or functional invention. It is not suited to nonfunctional aesthetic design. In a number of jurisdictions, this led to the creation of a separate 'design patent' specifically granted to nonfunctional product elements. However, design patenting has a number of drawbacks, including that securing protection is time-consuming and costly. Copyright protection covers expressive works and in principle is suitable for design protection, but many designs include potentially functional elements, resulting in uncertainty at the enforcement stage. Trademark and trade dress also protect design. The design or shape of a product or its packaging may be distinctive and associated with a particular enterprise. However, as with copyright, trademark and trade dress offer protection only for nonfunctional design, and this aspect also creates enforcement uncertainty. To overcome problems with design protection by traditional forms of IP, jurisdictions such as the European Union have established design registration systems with somewhat more flexible standards than those associated with the traditional IPRs.

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[13] See, for example, presentations by C.K. Chow, Eric Smith and James M. Zimmerman at Congressional-Executive Commission on China, Roundtable on 'Intellectual Property Protection as Economic Policy: Will China Ever Enforce its IP Laws?', May 16, 2005, available at http://www.cecc.gov/pages/roundtables/051605/index.php?PHPSESSID=4646c4dfd4ea4de24988b5b9d47a3d02.

[14] Of course, music and film producers are not concerned with 'global economic welfare effects'. They are concerned with how gains are allocated, i.e., their profitability.

[15] *A&M Records v. Napster*, 114 F. Supp. 2d 896 (ND Cal. 2000), subsequent history in *A&M Records v. Napster*, 239 F.3d 1004(9th Cir. 2001).

One of the industries most concerned with design protection is the textile or clothing industry. In this sector consumer preferences change very rapidly and an expensive time-consuming process for securing protection would not be particularly helpful to the industry. The TRIPS Agreement acknowledges this and obligates Members not to impede the grant of protection by costly, examination or publication requirements. The major economic issues associated with design protection arise when industries blur the line between form and function. For example, the most controversial issue in European design protection is the treatment of automobile spare parts, including body panels and motor parts. In its 2001 Design Regulation, the EC excluded engine components from design protection and put off for future negotiation a decision on whether automobile body parts were covered.[16]

Geographical indication

Geographical indications (or GIs) are identifiers that associate a product with a place based on the quality or characteristics of the product or goodwill associated with the place.[17] The classic illustrative GI is 'Champagne', i.e. the name of a region in France known for producing quality sparkling wines by a specific method. GIs are protected in a variety of ways in different national jurisdictions. The United States protects them by collective and certification trademarks, as well as by a special labeling system for wines and spirits administered by the Treasury Department. The European Union protects them by special registration systems, which typically include elaborate monitoring of production methods. Many Latin American countries protect 'appellations of origin' separately from trademarks. In addition, geographical indications are also protected by common and civil law unfair competition regimes.

GIs are controversial. The EU has been pressing at the WTO to increase the level of GI protection for agricultural products other than wines and spirits (which already enjoy high protection), but is resisted by the United States, among others. The EU is a high-cost producer of specialized agricultural products and is seeking higher prices for those products based on GI protection. The United States is a low-cost producer of bulk agricultural products and is concerned about potential market access restrictions from stronger GI protection. Whether other countries support one or the other 'camp' in this GIs debate largely depends on whether they are efficient large-scale agricultural producers, on one hand, or are producers of specialized niche products, on the other.

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[16] Council Regulation (EC) No. 6/2002 of 12 December 2001 on Community designs, at recitals 12–13.

[17] A geographical indication is distinguished from a 'mark of origin' which merely identifies the place where a good is produced. The latter is not intended to denote characteristics.

Protection of layout design of integrated circuits

Integrated circuits (or semiconductors) are produced on the basis of three-dimensional maps or 'mask works' that are used to direct sophisticated equipment that etches circuits on semiconductor materials. In the 1980s, it was unclear whether such mask works could be protected by copyright (since they perform a function), and patent protection is often unsuitable to incremental innovations in IC design. *Sui generis* (or unique) systems of IC lay out protection were developed. Such systems can be given effect either through registration or automatic protection. There has been little enforcement activity based on *sui generis* IC layout-design protection, but it is the subject of TRIPS Agreement rules.

Protection of undisclosed information

Undisclosed information is generally protectable if it is commercially valuable, undisclosed and the business claiming rights takes reasonable steps to protect it. Protection of undisclosed information is generally (but not exclusively) synonymous with 'trade secret' protection. Such protection is provided in a variety of ways, including by specific statute or by unfair competition law. Trade secret protection generally lasts as long as the relevant information remains secret. The TRIPS Agreement specifically requires protection of undisclosed data with respect to new chemical entities in pharmaceutical and agricultural chemical products that is submitted for government regulatory purposes, requiring protection against 'unfair commercial use'.

Trade secret protection enables businesses to develop and maintain production processes, customer lists, recipes and other valuable information that provide advantages over competitors.[18] Allowing businesses to protect such information encourages competition and is generally thought to be healthy from an economic standpoint. Trade secret protection is controversial principally when it is abused, such as when businesses demand payment for information which is in the public domain as a condition to providing necessary products or services. The scope of protection of data submitted for regulatory purposes in the pharmaceutical and agricultural sector is highly controversial because the extent of protection helps to determine the speed at which copies (or 'generic' versions of 'originator' products) can be granted regulatory approval and brought to market.

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[18] See discussion of economic policies underlying trade secret protection in *Kewanee Oil v. Bicron*, 416 US 470 (1974).

Multilateral regulation of IP

The early multilateral regulatory system

As noted in the introduction, some of the earliest efforts toward the multilateral regulation of economic activity were directed at intellectual property. The Paris Convention was concluded in 1883 and the Berne Convention was concluded in 1886. The Paris Convention established rules with respect to patents, trademarks and unfair competition. During negotiation of the Paris Convention, proposals were made to create harmonized international patent law. However, these efforts were unsuccessful owing, among other things, to wide variations in the way patents were regulated in different countries. The Berne Convention addressed copyright.

The Paris Convention establishes three basic principles. These are national treatment, right of priority and independence of patents. 'National treatment' is a principle well-known to trade lawyers. In the patent and trademark context, it means that foreign patent and trademark applicants must be treated equivalently with national applicants, and foreign holders of patent or trademark rights within the national territory should not be discriminated against on the basis of nationality. 'Right of priority' allows patent and trademark applicants a period in which they can file abroad without fear of pre-emption. A patent applicant in any Paris Convention country has a period of one year following its first filing to file within all other Paris Convention countries. During this 'priority period', acts which might otherwise defeat patentability (such as the publication of new 'art', or the third-party filing of an application for the same invention) will not have adverse effect. For trademarks the priority period is six months. The principle of 'independence of patents' means that acts taken by authorities with respect to a patent or trademark in one Paris Convention country will not affect the status of equivalent patents or trademarks in other Paris Convention countries. So, for example, if a court in one Paris country determines that a patent is invalid and orders it canceled, this does not affect the validity of patents on the same invention in other Paris countries. This rule reflects the fact that governments are distrustful of the possible motives of other governments in acting against their inventors.

By the late 1970s, from the standpoint of industrialized country patent holders, the Paris Convention was most notable for what it does not do. The Paris Convention does not define a patent or what criteria are used for granting it. It does not prescribe subject matter coverage, it does not set a minimum (or maximum) term of a patent, it does not define the rights of patent holders, and it was perceived as having a weak dispute settlement mechanism (which provides for recourse to the International Court of Justice). In addition, the Paris Convention includes liberal rules on compulsory licensing of patents.

The Berne Convention is a more complete legal instrument. It very broadly

defines the subject matter scope of copyright protection, it sets a minimum term of copyright (generally, the life of the author plus 50 years) and it prescribes rights that are accorded to copyright holders. In addition, it provides that copyright is established automatically on the creation of an expressive work, and precludes countries from making registration or notice a condition to copyright protection.

From the standpoint of the expressive industries, the major drawbacks of the Berne Convention are that it does not cover so-called 'neighboring rights' such as performances (which are addressed by other international agreements) and it employs the same arguably weak enforcement mechanism (the ICJ) as the Paris Convention.

Perceived weaknesses in the Paris and Berne Conventions, combined with the increasing importance of the intellectual property component of goods and services, generated demands for substantial changes to the international intellectual property system.

From WIPO to the GATT and WTO

By the late 1970s, industrialists in the United States had grown concerned with what they considered an inadequate attention to the protection of their intellectual property assets, particularly in developing and newly industrializing countries.[19] These concerns were spread across various industry sectors. Makers of 'brand name' goods were concerned over trademark counterfeiting. Recording companies and film studios were increasingly anxious about copyright piracy. Pharmaceutical and agricultural chemical producers were dissatisfied with the protection given to their innovations.

The concern of industry coincided with a movement among developing countries in favor of a 'New International Economic Order' (NIEO). That movement was centered in the Group of 77 and in multilateral bodies such as the United Nations Conference on Trade and Development (UNCTAD), and emphasized the imbalance in economic welfare between developed and developing countries. It advocated control by developing countries over their own resources, and demanded transfer of technology from North to South to remedy imbalances in development. The NIEO sought at WIPO to relax protection of IP, such as by providing more flexible rules for the compulsory licensing of patents.

In the mid-1980s WIPO was affected by a fundamental clash of interests and values. In negotiations for revision to the Paris Convention, the United

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[19] On the background of the TRIPS Agreement and the transition from WIPO to the GATT and WTO, see generally, Abbott (1989), and Abbott (1997a, 1997b). On the political dimension, *see* Sell (2003).

States and other developed countries, including those of the European Community and Japan, demanded stronger protection of intellectual property rights (IPRs). Developing countries demanded more flexible rules. The negotiations failed, and as a consequence the United States, EC and Japan shifted focus to the GATT. Developing countries depended on GATT rules for exports to developed country markets for, among others, their agriculture and textile products. Developed countries had much greater leverage at the GATT as compared to WIPO. Thus was born the GATT Uruguay Round negotiations on the subject of 'Trade-Related Aspects of Intellectual Property Rights' or 'TRIPS'.

The TRIPS negotiations were among the most controversial aspects of the Uruguay Round. Developing countries, led by Argentina, Brazil and India, believed that agreeing to higher standards of IPRs protection at the GATT would have negative consequences, at least in the short term, by increasing their 'rent payments' to the developed countries for technology and expression. They were not persuaded that such protection would provide them with 'dynamic' innovation benefits that would offset increased rent outflows. Developing countries with an interest in adopting higher standards of IP protection could, of course, choose to do this outside the GATT.

The United States used a 'carrot and stick' approach to accomplishing its objectives on TRIPS. On the carrot side, it offered to reduce textile quotas and to help obtain concessions from the EC on agricultural export subsidies, each of which was of considerable interest to developing countries. On the stick side, it used its domestic Special Section 301 authority to threaten and impose trade sanctions on countries that failed to meet US standards of IPRs protection, making clear that it would not be satisfied to continue with the status quo at the GATT. Developing countries reluctantly agreed to the Agreement on Trade-Related Aspects of Intellectual Property Rights or TRIPS Agreement as one of the three pillars of the Uruguay Round (along with the GATT 1994 and the General Agreement on Trade in Services).

The entry into force of the TRIPS Agreement on January 1, 1995 as part of the new WTO created a situation in which two multilateral institutions share responsibility for regulation of the international IPRs system.[20] While the TRIPS Agreement, as discussed below, incorporates the provisions of various WIPO-administered agreements, there is no well-defined hierarchy or relationship between the rules and authority of the WTO and WIPO. A major distinction between the two, however, is that the TRIPS Agreement incorporates the WTO dispute settlement system, allowing for trade-based enforcement of its rules. Several of the WIPO Conventions permit recourse to the

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20 See Abbott (2000a).

International Court of Justice (ICJ), but no case has been brought before the ICJ on the basis of such a convention.

The TRIPS Agreement
The TRIPS Agreement consists of a preamble and seven (7) parts.[21] The first part defines the relationship between the TRIPS Agreement and national law, and between the TRIPS Agreement and certain WIPO Conventions. It includes the core national and most favored nation (MFN) treatment provisions. The second part incorporates the substantive rules applicable to different forms of IP. The third part sets out enforcement obligations of WTO Members. The fourth part addresses the acquisition and maintenance of protection. The fifth part concerns dispute settlement, the sixth part transitional arrangements, and the seventh part institutional matters.

Principles
The national treatment provision of the TRIPS Agreement obligates each Member to treat nationals of other Members on at least as favorable a basis as its own nationals with respect to the protection of IP.[22] National treatment is a common feature of international IP agreements, including WIPO Conventions, predating the TRIPS Agreement. The most favored nation treatment (MFN) provision obligates each Member to extend the same IP privileges and immunities granted to nationals of one Member to nationals of all other Members.[23] Prior to the TRIPS Agreement, MFN was not included in international IP agreements largely because it did not appear likely that a country would grant to any foreigners IP privileges more extensive than it granted to its own nationals. Thus, national treatment would be an adequate standard for all treaty partners. However, the United States in the early 1990s negotiated some agreements which appeared to give rights to US nationals that were not enjoyed by the nationals of its treaty partners, and other countries began to see MFN as necessary in the multilateral context. The Appellate Body has identified national treatment and MFN as fundamental principles of the TRIPS Agreement.[24]

The TRIPS Agreement left each Member to decide on its own policy with respect to the exhaustion of rights.[25] The point at which IPRs are 'exhausted'

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21 For a complete technical analysis of the TRIPS Agreement on an article by article basis, including its negotiating history, see UNCTAD/ICTSD (2005), available at hppt://www.iprsonline.org.

22 Article 3, TRIPS Agreement.

23 Article 4, *id*.

24 See United States – Section 211 Omnibus Appropriations Act of 1998, WT/DS176 ('US – Havana Club').

25 Article 6, TRIPS Agreement.

determines when the holders of rights cease to control the movement of goods or services in commerce.[26] From an international trade standpoint, this is typically referred to as the 'parallel imports' issue because the rule of exhaustion adopted by each country determines whether goods first placed on the market under a 'parallel' IPR outside the country may be imported notwithstanding the presence of an IPR within the country.

There are several alternative approaches to exhaustion that countries may adopt, including national, regional and international exhaustion. And, different exhaustion rules may be adopted with respect to different IPRs by the same country.[27] When a country adopts a rule of international exhaustion, the rights of the IPR holder are exhausted when the good or service is first sold or placed on the market anywhere in the world. Assume that South Africa adopts a rule of international exhaustion of patent rights. If a product is first sold in India where there is a local patent, it may be imported into South Africa where the patent holder also controls a parallel patent. The patent holder for South Africa may not block the importation because its rights were exhausted when the product was first placed on the market in India.

Under a regional exhaustion approach, the holder's rights are exhausted when the good or service is placed on the market within the region. So, for example, the European Union has adopted an intra-union exhaustion doctrine. It provides that goods first placed on the market anywhere in the EU under an IPR may be imported into any other EU country. The importation may not be blocked by an economically linked holder of a parallel IPR in any other EU country. However, this rule does not extend to goods first placed on the market outside the EU. So, while an IPR-protected product placed on the market in France may be parallel imported into Germany, an IPR-protected product placed on the market in India may not be parallel imported into Germany or any other EU country.

Under a national exhaustion approach, exhaustion takes place only when goods or services are placed on the market within the territory of the subject country. A country may thus adopt a rule that when products are placed on the market within that country, the rights of IPRs holders are exhausted. Resales within the country may not be prevented. But holders of parallel IPRs may block the importation of products first placed on the market outside the country.

The rule of exhaustion has received quite a bit of attention in the case of

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[26] See Abbott (1998).

[27] This is, for example, the case with respect to the United States which has different exhaustion rules for patents and trademarks, with the rule on copyright yet to be fully defined by the Supreme Court.

pharmaceutical products. Should a consumer in the United States be able to purchase and import a drug first sold by the patent holder in Canada or Europe at a lower price than is available in the United States? Consumers argue they should be entitled to seek the best price available for their medicines, wherever those medicines are placed on the market. Presumably pharmaceutical companies are making a profit wherever they are selling their products. Pharmaceutical companies, on the other side, argue that they are subject to different regulatory conditions in different countries and they should not be bound to prices that may be artificially established by regulatory authorities in any particular country.

The parallel imports debate has another dimension with respect to so-called 'differential' or 'equity' pricing strategies.[28] Some argue that pharmaceutical companies should be able to sell their products to poorer developing countries at low prices while charging higher prices in developed countries, and further argue that rules allowing parallel importation will prevent them from using such strategies.[29] They contend that arbitragers will buy drugs sold cheaply in developing countries and export them to wealthier markets. Others argue that exhaustion rules do not prevent companies from using differential pricing because national governments can control whether differentially priced products are exported and imported. They suggest that the pharmaceutical companies are using this argument as a way to prevent parallel importation which the companies oppose because it interferes with their optimal pricing strategies.[30]

The Doha Declaration on the TRIPS Agreement and Public Health, discussed later on, confirmed the right of WTO Members to decide on their own policies with respect to exhaustion.[31]

The TRIPS Agreement also includes principles confirming the importance of encouraging the transfer of technology to promote development,[32] and recognizing the right of Members to adopt measures consistent with the Agreement to protect public health and nutrition, as well as to control anti-competitive practices.[33]

WTO Members are required to give effect to the TRIPS Agreement in

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[28] See discussion and references in Abbott (2005a).

[29] See, for example, Danzon and Towse(2005), at 438–52.

[30] See Abbott (2005a).

[31] Ministerial Conference, Declaration on the TRIPS Agreement and Public Health, adopted November 14, 2001, WT/MIN(01)/DEC/2, November 20, 2001, para. 5(d).

[32] Article 7, TRIPS Agreement. For a discussion of TRIPS Agreement rules and the transfer of technology, see Correa (2005).

[33] Article 8, *id*.

national law, but the agreement leaves to each Member the precise means for doing so.[34]

The substantive rules

The TRIPS Agreement identifies certain intellectual property subject matter as being subject to its rules.[35] The boundary lines of this identification are shaded because the Agreement incorporates provisions of WIPO Conventions that refer to subject matter not expressly addressed in the TRIPS Agreement (for example, trade names). Also, in some areas discretion on the scope of subject matter is left to Members.[36] Taking this shading into account, the TRIPS Agreement still does not apply to all subject matter that might come within the concept of IP as broadly defined, but rather it applies to subject matter that is addressed by the Agreement.

The broad categories of IP addressed by the Agreement are copyright, trademark, geographical indication, industrial design, patent, layout design of integrated circuit and protection of undisclosed information.

Copyright

For copyright, the TRIPS Agreement largely relies on the substantive rules of the Berne Convention which are incorporated by reference.[37] The Berne Convention includes a broad and flexible scope of copyright subject matter coverage. The term of protection prescribed by the Berne Convention at the time of adoption of the TRIPS Agreement was consistent with that of most developed countries.[38] The TRIPS Agreement adds rules clarifying that computer software and compilations of data (based on the creative activity

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[34] There is no explicit statement as to whether the agreement is intended to have 'self-executing' or 'direct effect' in national law. Since the substantive rules are comparatively precise, there is no strong reason why a Member could not choose to give it direct effect, though it appears that most countries have elected to implement TRIPS Agreement requirements through the adoption of amendments to IPRs legislation.

In Article 1.1, the TRIPS Agreement recognizes that each Member has the flexibility to choose the method of implementation within its own legal system and practice, signaling a certain level of flexibility.

[35] Article 1.2, TRIPS Agreement.

[36] The effect of the cross-reference to the Paris Convention in the coverage of trade names was the subject of an Appellate Body decision, US – Havana Club, discussed *infra*. The AB noted that obligations with respect to the scope of patent protection are the subject of some discretion on the part of Members.

[37] Article 9.1, TRIPS Agreement.

[38] The Berne Convention generally provides a term of the life of the author plus 50 years. Since the TRIPS Agreement was adopted, a number of countries including the United States and European Union have extended the term of copyright to life of the author plus 70 years.

involved in their assembly) are copyrightable subject matter.[39] The TRIPS Agreement also extends copyright to certain rights of performers in their unfixed performances,[40] and to certain rights of producers of phonograms and of broadcast organizations. The Agreement sets out a general provision on 'limitations and exceptions' to copyright, which is largely coextensive with a corresponding provision in the Berne Convention.[41] By incorporating relevant provisions of the Berne Convention, the TRIPS Agreement includes other exception provisions, for example, with respect to fair use.[42]

Trademark

The Paris Convention includes rules governing trademarks, but it does not define what a trademark is. The TRIPS Agreement provides a broad definition of trademark subject matter.[43] The TRIPS Agreement also makes service marks subject to an equivalent level of protection with trademarks on goods.[44] Trademark protection extends as long as the trademark holder continues to use the mark, subject to applicable requirements with respect to renewal of registration.[45] A minimum trademark renewal term of seven years is established.[46] Trademark holders are accorded the right to prevent third parties from using marks in a way that would result in a likelihood of confusion,[47] a standard familiar to common law and civil lawyers. The TRIPS Agreement extends rights with regard to so-called 'well known' marks, clarifying that the well-known character of a mark is determined by reference to the 'relevant sector of the public', and that rights in well-known marks extend to dissimilar goods or services where a connection with the trademark holder would be expected.[48] The Agreement limits conditions that can be attached to the use of marks.[49] The rules also include exceptions for fair use of marks.[50]

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[39] Article 10, TRIPS Agreement.

[40] Prior to the TRIPS Agreement, performers in the United States did not have the right to prevent the recording of their performances.

[41] Article 13, TRIPS Agreement, Article 9(2), Berne Convention.

[42] See also Articles 10 and 10*bis*, Berne Convention.

[43] Article 15.1, TRIPS Agreement.

[44] *Id.*

[45] The United States and the Commonwealth countries generally allow for common law rights in trademarks so that registration is not always required. For most civil law countries, trademarks are based solely on registration. The TRIPS Agreement does not affect this distinction.

[46] Article 18, TRIPS Agreement.

[47] Article 16.1, *id.*

[48] Article 16.2–3, *id.*

[49] Article 20, *id.*

[50] Article 17, *id.*

There was relatively little controversy about incorporation of trademark protection in the TRIPS Agreement.[51] At the time of its adoption, trademark registration was common throughout the world. Under the TRIPS Agreement trademarks are essentially of indefinite duration; the owner does not lose protection for as long as it continues using its trademark on its goods or services.

Geographical indication

As noted earlier, a geographical indication is an identifier that associates a product with a place based on the quality or characteristics of the product or associated goodwill.[52] The TRIPS Agreement obligates Members to protect GIs based on rules derived from WIPO Conventions,[53] but provides relatively limited guidance as to how protection is to be afforded, leaving much of the work for future negotiations (which as of late 2006 is ongoing). However, the TRIPS Agreement provides additional specificity on the subject of wines and spirits, including a provision calling for negotiations to establish a register of geographical indications for wines for countries participating in the system.[54]

Industrial design

The TRIPS Agreement obligates Members to provide 10 years of protection to industrial designs, but does not prescribe a specific way to accomplish this.[55] The methods for protecting industrial design have traditionally included copyright, trademark and trade dress, design patent and *sui generis* design registration systems. The Agreement obligates Members to ensure that procedures and costs for the protection of textile designs do not unreasonably interfere with the opportunities to obtain protection.[56] Textile designs get special mention because of the large number of designs that producers seek to protect and the often short life cycle of such designs.[57]

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[51] Trademarks help consumers make purchasing decisions based on their accumulated knowledge about products and producers, and provide the vehicle by which companies promote their goods. There is a limited social cost to allowing a company to reserve a particular brand name for its own use, and a benefit to consumers from being able to associate products with producers.

[52] Article 22.1, *id.*

[53] Article 22.2, *id.*

[54] Article 23, *id.*

[55] Article 25, *id.*

[56] Article 25.2, *id.*

[57] A clothing producer may put a large number of new designs into production each year and without a firm basis for predicting the success of any particular design. Clothing fashions change rapidly, and if procedures for securing protection are time-consuming the result may not be useful.

Patent

The most significant changes to the international IP regulatory system brought about by the TRIPS Agreement were in the field of patents. The Paris Convention provides rules regarding the mechanisms by which patents are granted, and prescribes national treatment. It does not, however, define the subject matter scope of patent protection, the criteria of patentability or the term of patent protection. It includes a limited set of rules applicable to the compulsory licensing of patents.

The TRIPS Agreement provides that patents should be available for products and processes in all fields of technology on the basis of the criteria of novelty, inventive step and capability of industrial application.[58] It also provides for sufficiency of disclosure.[59] Taken together, these criteria reflect the basic rules of developed country patent systems. The Agreement provides that patents rights shall be available and enjoyed without discrimination based on place of invention, field of technology, and whether products are imported or locally produced.[60] The TRIPS Agreement prescribes a minimum 20-year term of protection counted from the filing of the patent application.[61]

The TRIPS Agreement allows for certain exclusions from patentability, such as for the protection of public order and for diagnostic or therapeutic procedures.[62] It permits Members to refuse patenting of animals and plants, but requires that some form of plant variety protection be provided.[63] This may be through patent or a *sui generis* form of protection. Also, the exclusion for animals and plants does not extend to non-biological and microbiological processes.

The TRIPS Agreement expands upon the compulsory licensing rules found in the Paris Convention, prescribing substantive and procedural conditions for the granting of such licenses.[64] However, it does not limit the grounds upon which compulsory licenses may be granted, and it provides for a waiver of procedural prerequisites in cases of national emergency, extreme urgency, or for public non-commercial use. In addition to the provision on compulsory licensing, the TRIPS Agreement incorporates a general provision concerning exceptions to patent rights.[65] This allows a Member to adopt limited excep-

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[58] Article 27, TRIPS Agreement.
[59] Article 29, *id*.
[60] Article 27, *id*.
[61] Article 33, *id*.
[62] Article 27.2–3(a), *id*.
[63] Article 27.3(b), *id*.
[64] Article 31, *id*.
[65] Article 30, *id*.

tions that do not unreasonably conflict with the normal exploitation of the patent or the legitimate interests of patent holders, taking into account the legitimate interests of third parties. This general exception provision is the subject of an important panel decision to be discussed later.[66]

The requirement that countries subject inventions in all fields of technology to patent protection required a major change to the patent laws of many countries. Developing countries were granted a 10-year transition period in which to provide patent protection for subject matter areas not previously covered.[67] In respect of pharmaceutical and agricultural chemical product patents, special 'mailbox' rules required developing Members to accept applications filed during the transition period and preserve them for review when protection became available. If and when a patent was eventually granted the term would be limited based on the original filing date of the mailbox application.[68] This rather complex system was the subject of the first AB decision concerning TRIPS, and is discussed *infra*.[69] Because the 10-year transition period expired on January 1, 2005, the complex subject of mailbox applications will become a matter largely of historical interest once the complex processing situation in India is completed.[70]

Layout design of integrated circuit

The Treaty on Intellectual Property in Respect of Integrated Circuits (IPIC) was negotiated and signed under the auspices of WIPO, but has not entered into force.[71] The TRIPS Agreement incorporates most of the substantive rules of the IPIC Treaty, but modifies them to extend the term of protection and addresses concerns that had been raised regarding provisions of the treaty dealing with third-party purchasers with notice.[72] TRIPS Agreement provisions require that protection for 'original' mask works be provided for a

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[66] *Canada – Patent Protection of Pharmaceutical Products*, WT/DS114, 17 March 2000 ('Canada – Generic Pharmaceuticals').

[67] The change would have a particularly significant effect in countries which did not provide patent protection for pharmaceutical products since bringing such products under patent protection would affect existing generic producers and almost certainly increase the price of medicines. Article 64.4, TRIPS Agreement.

[68] Article 70.8, TRIPS Agreement.

[69] India – Patent Protection for Pharmaceutical and Agricultural Chemical Products, WT/DS50, 5 September 1997 ('India – Mailbox').

[70] India began to process a large number of mailbox applications as of January 1, 2005, and the extent to which this process generates legal controversy remains to be seen.

[71] This is largely based on objections of the United States and Japan regarding the term of protection and provisions dealing with third-party users with notice.

[72] Article 37, TRIPS Agreement.

minimum of 10 years following registration or first commercial exploitation anywhere in the world.[73] Members need not adopt registration systems.[74]

Protection of undisclosed information

The TRIPS Agreement requires Members to protect confidential commercial information, generally referred to in common law countries as 'trade secrets'. The Agreement accomplishes this by incorporating a provision of the Paris Convention addressing unfair competition and by broadly defining the protectable subject matter.[75] Information will be protected if it is not generally known in its precise configuration by those in the relevant sector, if it has commercial value because it is secret, and if the holder has taken reasonable steps to keep it secret. Members are to provide protection against such information being obtained 'contrary to honest commercial practices'. Trade secret protection is capable of lasting indefinitely, provided that the information remains confidential.

In addition to the general provisions concerning trade secrets, the TRIPS Agreement includes specific rules addressing undisclosed test or other data submitted to regulatory authorities as a condition for obtaining approval for pharmaceutical or agricultural chemical products using 'new chemical entities'.[76] Protection is to be provided against 'unfair commercial use', and the data are to be protected against disclosure except as necessary to protect the public. This is one of the most controversial provisions of the TRIPS Agreement. The United States asserts that it requires Members to provide fixed periods of 'market exclusivity' for innovator products, while many other Members dispute this, pointing to the flexible requirement that protection be provided against 'unfair commercial use' of data.

Competition

There is a very close relationship between laws regulating IP and laws regulating competition.[77] Although IPRs differ markedly in their characteristics, their general effect is to provide a basis for excluding third parties from marketing products under particular conditions. Competition (or antitrust) laws are intended to assure fair access to markets. On a static basis, it may appear that IPRs and competition law are fundamentally in conflict. However, IPRs may promote competition by fostering innovation and creative work,

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[73] Article 38, *id*.

[74] Article 38.2, *id*.

[75] Article 39.1–2, *id.*

[76] Article 39.3, TRIPS Agreement.

[77] See generally, Public Policy and Global Technological Integration, *supra* note 19 (2004).

thereby providing new products and services that challenge existing market participants. In a dynamic sense IPRs may be pro-competitive. Nonetheless, because IPRs provide a legal basis to exclude third parties from the market, it is necessary to be vigilant that such rights not be abused, such as by the imposition of excessively anticompetitive conditions on licensees.

The TRIPS Agreement includes several provisions that recognize the right of Members to police anticompetitive abuse of IPRs. These include a general provision recognizing the right of Members to adopt measures to control abuses of IPRs[78] and a more specific provision addressing restrictive conditions in licensing agreements,[79] as well as encouraging intergovernmental cooperation. In addition, rules on compulsory licensing specially attend to measures taken to address anticompetitive practices.[80] Also, a Member's exhaustion doctrine effectively addresses conditions of competition, and the rule allowing Members to adopt their own policies with respect to exhaustion is inherently a pro-competitive provision.

Enforcement obligations

A significant part of the TRIPS Agreement is devoted to the measures Members are expected to make available for the enforcement of IPRs.[81] It is important to note, however, that the TRIPS Agreement generally establishes a regime under which private IPRs holders are responsible for taking steps to enforce their rights. With limited exception, Members are not obligated to 'police' the private interests of IPRs holders.[82]

The TRIPS Agreement requires Members to establish effective procedures for the enforcement of IPRs, including provision for remedies to prevent further infringement.[83] The procedures must be fair and equitable. When decisions are taken by administrators, they should be subject to review by judicial authority.

Members are obligated to provide IPRs holders with access to civil judicial procedures to enforce their rights.[84] Parties should have adequate opportunity to present evidence.[85]

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78 Article 8.2, TRIPS Agreement.

79 Article 40, *id*.

80 See, *inter alia,* Article 31(k), *id*.

81 Part III, *id*.

82 Article 61, TRIPS Agreement, requires Members to provide for criminal procedures and penalties for trademark counterfeiting and copyright piracy on a commercial scale, and this may be viewed as a policing obligation.

83 Article 41, *id*.

84 Article 42, *id.*

85 Articles 42–3, *id*.

Damages and injunctions should be available.[86] Judges should have the authority to order the destruction of infringing goods.[87] Abuse of legal process should be subject to remedial action.[88]

Procedures for provisional measures to prevent infringement and the destruction of evidence should be available.[89] When provisional measures are granted prior to hearing from an alleged infringer, the accused should be given an opportunity for a prompt review.

Members must provide procedures under which IPRs holders may provide notice to customs authorities of suspected shipments of infringing goods, and make available procedures for the suspension of entry into commerce.[90] Adequate security may be required to protect the importer.[91] The importer shall be notified, and a hearing on the suspension must be convened promptly.[92] The accuser may be required to indemnify the importer for wrongful detention of goods.[93]

Members are required to make available criminal procedures and penalties for willful trademark infringement and copyright piracy on a commercial scale.[94]

Acquisition and maintenance

The TRIPS Agreement includes a provision recognizing that Members may adopt procedures and formalities for the grant and maintenance of IPRs.[95] Members must, however, assure that procedures with respect to the grant of IPRs do not unreasonably curtail the period of protection. Final administrative determinations regarding the grant and maintenance of rights should be subject to judicial review.

Dispute settlement

Dispute settlement under the TRIPS Agreement is undertaken pursuant to the Dispute Settlement Understanding (DSU).[96] There is, however, one unique aspect to TRIPS dispute settlement that remains in effect in 2006. During the Uruguay Round, Members could not agree on whether so-called 'non-

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86 Articles 44–5, *id.*
87 Article 46, *id.*
88 Article 48, *id.*
89 Article 50, *id.*
90 Article 51, *id.*
91 Article 53, *id.*
92 Article 54, *id.*
93 Article 56, *id.*
94 Article 61, *id.*
95 Article 62, *id.*
96 Article 64.1, *id.*

violation nullification or impairment' complaints should be permitted under the TRIPS Agreement.[97] A compromise was adopted which provided for a five-year moratorium on such non-violation complaints,[98] during which time Members were to negotiate on the 'scope and modalities' of such causes of action. Any agreement on scope and modalities, or on extension of the moratorium, would need to be adopted by consensus.[99] The five-year period passed with no action having been taken. At the Doha and subsequent Ministerials (Cancun and Hong Kong), Members agreed to extend the moratorium at least until the Ministerial Conference next following the Hong Kong Ministerial (which took place at the end of 2005).

Non-violation complaints might prove quite problematic under the TRIPS Agreement since there is considerable uncertainty as to what kind of 'market access' benefits a Member might have expected to obtain as a result of the protection of IP.[100]

TRIPS decisions under the DSU are discussed below.

Transitional arrangements

There are different types of transitional arrangements under the TRIPS Agreement.

Developed countries had one year to bring their IP systems into conformity with TRIPS standards.[101] Because developing and least developed Members (as well as Members in transition to market economy) would face adjustment difficulties in conforming to these standards, they were given longer transition periods. In general, developing countries (and Members in transition) had five years (until January 1, 2000) to conform to the TRIPS Agreement.[102] However, for patent subject matter areas which were not previously accorded protection, developing Members could take an additional five years (to January 1, 2005).[103] As noted earlier, if the period for providing pharmaceutical or agricultural chemical patent protection was extended, Members were required to put in place a 'mailbox' system, and provide 'exclusive marketing

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[97] In a non-violation complaint, a Member alleges that while another Member has not acted inconsistently with an agreement, the other Member has acted in a way that deprives the complaining Member of benefits it expected to receive when it entered into the agreement. See Abbott (2000b).

[98] Article 64.2, TRIPS Agreement.

[99] Article 64.3, *id.*

[100] See Abbott (2003).

[101] Article 65.1, *id.*

[102] Article 65.2, TRIPS Agreement. National and MFN treatment provisions took effect for all Members after one year. Article 65.1, *id.*

[103] Article 65.4.

rights' for products meeting certain conditions.[104] In all cases, developing countries could not reduce levels of protection below TRIPS standards during the transition period.[105]

Least developed countries in general had until January 1, 2006 to apply TRIPS standards.[106] There was no rule against reducing levels of protection during the transition for least developed countries. Pursuant to the Doha Declaration on the TRIPS Agreement and Public Health, and implementing decisions, least developed countries have an additional 10-year period (until January 1, 2016) to provide pharmaceutical patent or data protection, and need not enforce patent and data rights that may already have been granted.[107] In December 2005 the general transition period for least developed countries was extended until July 1, 2013. However, other than in respect of pharmaceutical products, developing countries lost the flexibility to reduce levels of protection already in force.[108]

In addition to transition arrangements to take into account different levels of development, the TRIPS Agreement addressed subject matter that existed at the time the Agreement entered into force.[109] In general, if subject matter was capable of protection at the time the agreement became effective, it would benefit from TRIPS rules. There was no general requirement of retroactive protection.

Institutional matters

The WTO Agreement establishes the Council for Trade-Related Aspects of Intellectual Property Rights ('TRIPS Council') to oversee the implementation of the TRIPS Agreement.[110] The TRIPS Council has a number of specific responsibilities under the TRIPS Agreement, including reviewing the laws of Members,[111] periodically reviewing the operation of the TRIPS Agreement, and undertaking further negotiation or review in specific subject matter areas such as geographical indications and patents for living things. In addition, Members may propose additional areas of negotiation.

Pursuant to its internal rules of procedure, the TRIPS Council acts only by

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[104] Article 70.8, *id*.
[105] Article 65.5, *id*.
[106] Article 66.1, *id*.
[107] Doha Declaration, para. 7.
[108] This is a problem for least developed countries because most have strict IP laws put in place by colonial powers which do not reflect specific least developed country interests.
[109] Article 70, TRIPS Agreement.
[110] Article IV:5, WTO Agreement.
[111] Article 71.1, TRIPS Agreement.

consensus.[112] If there is not consensus on a matter, it may be referred to the General Council which, at least in theory, may act under alternative WTO voting rules.

The TRIPS Council is also responsible for coordinating activities with WIPO.[113] A modest cooperation agreement has been concluded between the WTO and WIPO.[114]

TRIPS dispute settlement decisions

There have been a number of cases decided by WTO panels and the Appellate Body under the terms of the TRIPS Agreement. Other dispute settlement claims have been initiated and withdrawn. Below is a summary of the cases decided so far, and a discussion of one important claim that was withdrawn.[115]

India – Mailbox (US)

India – Patent Protection for Pharmaceutical and Agricultural Chemical Products, WT/DS50, 5 September 1997 (‘*India – Mailbox’)* was the first WTO dispute under the TRIPS Agreement that resulted in a decision by a panel, and subsequently by the Appellate Body. The complaining party was the United States, which alleged that India had failed to adequately implement TRIPS Agreement requirements under Articles 70:8 and 70:9 to establish a so-called ‘mailbox’ to receive and preserve patent applications, and to adopt legislation authorizing the granting of exclusive marketing rights (EMRs).

The first part of the decision of the Appellate Body in this dispute concerned a difference over jurisprudence with the Panel. The Panel said that the United States and its patent holders had ‘legitimate expectations’ concerning the implementation by India of a mailbox system that would eliminate ‘any reasonable doubts’ concerning the future grant of patents. The Appellate Body said that the Panel had mistakenly applied the doctrine of non-violation nullification or impairment in formulating its approach to interpretation, and pointed out that non-violation complaints could not yet be brought under the TRIPS Agreement. The Appellate Body said that the proper means for interpreting the TRIPS Agreement was by application of the rules of the Vienna

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[112] Rules of Procedure for Meetings of the Council for TRIPS, IP/C/1, 28 September 1995, Rule 33.

[113] Article 68, *id*.

[114] The organizations, *inter alia*, agreed to the creation of a common register of IP laws, and this has been established at WIPO.

[115] For a more complete discussion *see* Abbott (2004b) The discussion in this section of the chapter first appeared in Chapter 3.14, *TRIPS* – United Nations Conference on Trade and Development (UNCTAD) in *Course on Dispute Settlement in International Trade, Investment and Intellectual Property*, United Nations, 2003.

Convention on the Law of Treaties, which provides that treaties shall be interpreted based on their express terms and context, in light of their object and purpose. India was required to comply with the terms of the TRIPS Agreement, no more, no less. This meant that India would be required to provide a 'sound legal basis' for the treatment of mailbox applications.

The Appellate Body went on to examine India's claim that an administrative order allegedly given by the executive to the patent office was an adequate means to implement the mailbox requirement. India had not furnished the text of such an order to the Panel or Appellate Body. The Indian Patents Act required the patent office to reject applications that concerned subject matter for which patent protection could not be granted, including for pharmaceutical products. There was substantial evidence that under the Indian Constitution, the statutory Patents Act requirement to reject a patent application on subject matter grounds could not be modified by an executive administrative order. The Appellate Body agreed with the Panel that India had in fact failed to provide a sound legal basis for receiving and preserving mailbox applications.

Another aspect of the case involved India's alleged failure to adopt legislation authorizing the grant of EMRs. India argued that since no party had yet to qualify for the grant of EMRs, it had no need for legislative authority which could be provided as the circumstances warranted. The Appellate Body disagreed on the basis of the express text of the TRIPS Agreement which it held to require the adoption of legislation authorizing the grant of EMRs from the entry into force of the agreement.

The Appellate Body also rejected a Panel determination under Article 63 of the TRIPS Agreement that India had failed to comply with transparency obligations. The Appellate Body's rejection was based solely on grounds that the Panel had permitted the United States to add a cause of action to its complaint outside the Panel's terms of reference.

Canada – Generic Pharmaceuticals

Canada – Patent Protection of Pharmaceutical Products, WT/DS114, 17 March 2000 ('*Canada –Generic Pharmaceuticals*') involved a complaint brought by the European Communities (EC) against Canada alleging that provisions of Canadian patent law that allowed the stockpiling of products prior to the expiration of a patent term, and that authorized the use of patented inventions for the purposes of preparing and pursuing regulatory submissions prior to the expiration of a patent term, violated TRIPS obligations. The focus of the EC's complaint was the generic pharmaceutical sector. The EC claimed that the relevant provisions of Canada's Patent Act, when read in connection with its drug regulatory rules, allowed generic producers to obtain approval for and stockpile patented medicines contrary to TRIPS patent rules.

Canada conceded that the relevant provision of its Patent Act contravened

the rights of patent holders under Article 28.1 of the TRIPS Agreement. It invoked Article 30, asserting that it was providing limited exceptions to the rights of patent holders within the scope of that provision.

The Panel devoted a considerable portion of its decision to interpreting the meaning of the three elements of Article 30; that is, 'limited exception', not unreasonably interfering with the normal exploitation of the patent, and not unreasonably prejudicing the interests of the patent holder, taking into account the legitimate interests of third parties. In the Panel's view, a 'limited exception' refers to a narrow derogation, with reference to the range of rights provided to the patent holder. The element of 'normal exploitation' is used to address the way that patents are ordinarily used. The test of the patent holder's interests is used to consider the potential economic impact on the patent holder. The legitimate interests of third parties are not limited to legal interests in the patent relation, but include public social interests.

The Panel determined that Canada's stockpiling exception was not sufficiently 'limited' because it potentially allowed an unlimited quantity of patented products to be made during the patent term. It therefore did not qualify as a limited exception under Article 30. Having made this determination, the Panel did not address the other two elements that must be satisfied to support an Article 30 exception.

Canada's regulatory review exception allows third parties to use patented inventions during the term of the patent to develop submissions for approval, such as in the case of marketing approval for a generic pharmaceutical product. Canada does not extend the term of patents to take into account the period of time during which an invention is subject to regulatory review.

Regarding the first criterion under Article 30, that an exception must be limited, the Panel determined that Canada's regulatory review exception was limited because it addressed only a small part of the patent right, and was reasonably closely circumscribed.

Regarding the second criterion, that there is not unreasonable interference with normal patent exploitation, the Panel found it was not generally accepted that patent rights must be exploited without being subject to limited exceptions, such as use by third parties for regulatory review purposes. It was not an unreasonable interference with the normal exploitation of patents to subject them to this type of exception.

Regarding the third criterion, that there not be unreasonable prejudice to the patent holder (taking into account third-party interests), the Panel considered the EC's argument that Canada's regulatory review exception should have been combined with a 'patent term extension' to take into account the period during which the patent holder awaited marketing approval for its drug. In the EC's view, the failure to provide an extension meant that the patent holder suffered economically because its patent term was effectively reduced by the

period during which it awaited marketing approval, while the generic producer was enabled to begin marketing promptly upon the expiration of the patent. The Panel rejected the EC contention, finding that governments took account of the interests of the patent holder in adopting their regulatory review procedures, and that there was no requirement that the patent holder effectively be compensated because it had to subject its product to regulatory review.

The Panel finally considered whether Canada's regulatory review exception was inconsistent with Article 27.1 of the TRIPS Agreement in the sense of discriminating with respect to field of technology. The Panel began by holding that Article 30 exceptions are subject to Article 27.1, even though there is no language in Article 30 suggesting that exceptions that may be granted are restricted to a certain kind or class. However, it pointed out that Article 27.1 refers to 'discrimination' regarding field of technology, which is a pejorative term. The fact that Members may not 'discriminate' regarding a field of technology does not imply that they may not 'differentiate' among fields of technology for legitimate purposes. Having made these determinations, the Panel found that Canada's patent legislation neither differentiated nor discriminated since it was, by its terms and application, neutral as to field of technology.

US – Copyright Exemption

United States – Section 110(5) of the US Copyright Act, WT/DS160, 15 June 2000 ('*US – Copyright Exemption*') involved a claim by the EC against the United States alleging that exceptions in the US Copyright Act that permitted commercial establishments to provide radio and television entertainment to customers without payment of remuneration to copyright holders was TRIPS-inconsistent. The EC's claims were based on Articles 11*bis* and 11 of the Berne Convention that establish rights in favor of authors and artists with respect to the broadcast and communication to the public of their works. The US defended its exemptions on the basis of Article 13 of the TRIPS Agreement, that largely incorporates the exception provision found in Article 9(2) of the Berne Convention.

The US copyright exemptions basically covered two situations. The first ('homestyle exemption') allowed broadcasts to be received and transmitted to the public by a single apparatus of a kind ordinarily used in private homes, and was not directed to a specific category of establishment. The second ('business exemption') allowed general commercial establishments of a limited size, and bars and restaurants also of a limited (though larger) size, to receive and broadcast to the public through a specified range of equipment.

The Panel found that the US business exemption did not fall within the exception for 'certain special cases' within the meaning of Article 13 of the TRIPS Agreement. The range of establishments was too large, and the commercial significance to copyright holders was too great for this to be

considered a minor exemption. Although it might have stopped here, the Panel went on to complete its analysis of the other exception factors in Article 13 of the TRIPS Agreement so as to provide a factually complete record for the Appellate Body. The Panel found that copyright holders had a normal expectation of compensation for broadcast to the public of their works, and that commercial establishments of a substantial size would reasonably be expected to bear the burden of furnishing compensation to them. Since the business exemption covered a broad range of US commercial establishments, the lack of compensation unreasonably prejudiced the legitimate interests of the copyright holders.

The Panel found that the 'homestyle exemption' was in fact of limited scope, because among other things it had been construed narrowly by US courts. In respect to the normal exploitation of copyrighted works, the Panel found that there was a minimal market for single private receiver broadcasts, in particular since most small shop owners would not be willing to pay for a copyright license. On similar grounds, the Panel found that the legitimate interests of copyright holders were not unreasonably prejudiced.

Canada – Patent Term

Canada – Term of Patent Protection, WT/DS170, 18 September 2000 ('*Canada – Patent Term*') involved a complaint by the United States against Canada for an alleged failure to apply the minimum 20-year patent term requirement of Article 33 of the TRIPS Agreement to patents that were granted under pre-TRIPS Agreement patent legislation. This decision involved the interpretation of Articles 70.1 and 70.2 of the TRIPS Agreement that deal with application of the agreement to subject matter that existed prior to its entry into force.

Canada argued that it was not required to extend the term of patents that had been granted under an act that applied to patents granted up until 1989 (and remained in force when Article 33 became applicable), because Article 70.1 excluded application of the TRIPS Agreement to 'acts' which occurred before the date of application. In Canada's view, the grant of a patent was an 'act' that occurred before Article 33 became applicable. Canada argued that Article 70.2, which establishes obligations regarding 'subject matter existing at the date of application . . . and which is protected in that Member on the said date', referred to patents granted prior to application of the agreement, but did not require Canada specifically to undertake the act of extending the patent term, which was excluded under Article 70.1.

The decision of the Panel and Appellate Body in this case focused on the plain meaning of Articles 70.1 and 70.2. Neither the Panel nor the Appellate Body found Canada's attempt to distinguish the act of setting out a patent term (as within Article 70.1), and the general 'existing' nature of the patented

invention under Article 70.2, persuasive. The Appellate Body found that Article 70.2 required the application of Article 33 to the term of existing patents based on the express language of the TRIPS Agreement.

US – Havana Club

United States – Section 211 Omnibus Appropriations Act of 1998, WT/DS176/AB/R, 2 January 2002 ('*US – Havana Club*'), WT/DS176, involved a claim by the EC against the United States alleging TRIPS Agreement inconsistency of US legislation denying holders of trademarks confiscated by the government of Cuba without compensation the right to enforce those marks in US courts, and denying permission to register those marks at the US Patent and Trademark Office. The case involved a trademark ('Havana Club' for rum) that the government of Cuba took from Cuban national owners following the revolution, and that became the subject of a Cuban-French joint venture some 40 years later. Federal courts in the United States had upheld the validity of the US legislation and its application to the Cuban-French joint venture prior to the EC's initiation of the dispute at the WTO. The EC argued that the US legislation was inconsistent with rules concerning trademark registration of the Paris Convention, interfered with the basic rights of trademark holders under the TRIPS Agreement, and was inconsistent with TRIPS Agreement national and most favoured nation treatment rules.

The Appellate Body decided (confirming the Panel's view) that the obligation in the Paris Convention Article 6*quinquies telle quelle* (or 'as is') rule is addressed to accepting trademarks for registration in the same form, and not to eliminating Member discretion to apply rules concerning other rights in marks. It found that Articles 15 and 16 of the TRIPS Agreement do not prevent each Member from making its own determination regarding the ownership of marks within the boundaries established by the Paris Convention. It decided that Article 42 regarding procedural rights does not obligate a Member to permit adjudication of each substantive claim regarding trademark rights a party might assert, if that party is fairly determined *ab initio* not to be the holder of an interest in the subject mark. In sum, the Appellate Body confirmed the right of the United States to refuse registration and enforcement of trademarks it determines to have been confiscated in violation of strong public policy of the forum state.

The Appellate Body analyzed US law relating to Cuba's alleged confiscation of trademarks in regard to national and most favored nation treatment obligations. It observed that as a matter of WTO law, these obligations are fundamental. It rejected the Panel's determination that, although certain minor discriminatory aspects of the US legislation could be identified, those aspects were unlikely to have a practical effect, and so are not WTO-inconsistent. The

Appellate Body, in a somewhat strained reliance on an earlier GATT panel report (US – Section 337),[116] found that even discriminatory aspects unlikely to have effect in practice were nonetheless inconsistent with the US national treatment and MFN obligations.

The Appellate Body further held, contrary to the Panel, that trade names are within the subject matter scope of the TRIPS Agreement.

Although the Appellate Body identified what it considered to be a minor procedural defect in the mechanism adopted by the US Congress to effectuate its decision regarding the confiscated trademark, the Appellate Body affirmed in its entirety the authority of the Congress and Executive Branch to deny validity to a Cuban-French claim of trademark ownership.

EC – Geographical Indications

In *European Communities – Protection of Trademarks and Geographical Indications for Agricultural Products and Foodstuffs* ('*EC – GIs*'), the United States (WT/DS174/R, 15 March 2005) and Australia (WT/DS290/R, 15 March 2005) each brought claims alleging that the EC's system of protecting geographical indications discriminated against foreign applicants for protection. The EC's regulations required as a condition for granting protection that the home country of a foreign applicant maintain a system of GIs protection equivalent to that of the EC – a so-called 'material reciprocity' requirement. The EC argued its regulations were qualified by reference to international obligations and that this assured WTO consistency. The panel rejected this claim based on its interpretation of the text of the regulations and the way they had been applied by the EC. The EC's material reciprocity requirement was found to derogate from national treatment requirements under Article 3 of the TRIPS Agreement and Article III of the GATT 1994. The panel also found that the EC's requirement that foreign governments make certain certifications on behalf of private applicants for GIs protection, which was not required from EC member states for EC nationals, was inconsistent with the national treatment standard.

The EC regulations permit GIs to be registered notwithstanding prior

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[116] Panel Report, *United States – Section 337 of the Tariff Act of 1930* ('*US – Section 337*'), adopted 7 November 1989, BISD 36S/345. The Appellate Body's reliance is strained because the Panel in the *US – Section 337* case identified a number of differences between rules applicable to patent proceedings involving domestically produced and imported goods, and found only a limited number inconsistent with US national treatment obligations. Those found to constitute discrimination (such as the incapacity of an import-related patent holder to assert counterclaims in a 337 proceeding) were matters that in intellectual property rights enforcement had significant consequences.

conflicting trademark registrations. The US and Australia argued that this was inconsistent with the EC's obligation to allow the registration and effective use of trademarks. The panel agreed that there was an inconsistency, but allowed the EC to maintain its system pursuant to the limited exception provision of Article 17 of the TRIPS Agreement. However, the panel indicated that the limited exception would not extend to linguistic versions of GIs that were not specifically registered.

US Claims regarding Brazil's compulsory licensing legislation

Although a dispute between the United States and Brazil regarding compulsory licensing was settled prior to the convening of a panel, because it raised important issues which may be relevant to future dispute settlement it may usefully be considered. On May 30, 2000, the United States requested consultations with Brazil under the WTO Dispute Settlement Understanding, stating:

> [The United States] request[s] consultations with the Government of Brazil . . . concerning those provisions of Brazil's 1996 industrial property law (Law No. 9,279 of 14 May 1996; effective May 1997) and other related measures, which establish a 'local working' requirement for the enjoyability of exclusive patent rights that can only be satisfied by the local production – and not the importation – of the patented subject matter. Specifically, Brazil's 'local working' requirement stipulates that a patent shall be subject to compulsory licensing if the subject matter of the patent is not 'worked' in the territory of Brazil. Brazil then explicitly defines 'failure to be worked' as 'failure to manufacture or incomplete manufacture of the product', or 'failure to make full use of the patented process'. The United States considers that such a requirement is inconsistent with Brazil's obligations under Articles 27 and 28 of the *TRIPS Agreement*, and Article III of the GATT 1994.

The request for consultations was followed by a US request for establishment of a panel. The United States withdrew its complaint in this matter prior to the submission of written pleadings by either party. However, the request for consultations illustrates that provisions authorizing compulsory licensing for 'non-work' may be subject to a future challenge under Article 27 of the TRIPS Agreement.

The Paris Convention authorizes the grant of compulsory licenses for failure to work a patent. A major issue in a case such as that brought by the United States against Brazil is whether Article 27:1 of the TRIPS Agreement was intended to prohibit WTO Members from adopting and implementing local working requirements, and effectively to supersede the Paris Convention rule. The negotiating history of the TRIPS Agreement indicates that Members differed strongly on the issue of local working. Several delegations favored a direct prohibition of local working requirements, but the TRIPS Agreement did not incorporate a direct prohibition. Instead, it says that patent rights shall

be enjoyable without 'discrimination' as to whether goods are locally produced or imported. Under the jurisprudence of the *Canada-Generic Pharmaceuticals* case, this leaves room for local working requirements adopted for bona fide (i.e., non-discriminatory) purposes. A WTO Member might well argue that requiring production of certain defense-related inventions within the national territory is essential to national security, and therefore justifies a local working requirement. There are no doubt other justifiable grounds for requiring local working of a patent.

The importance of local working was demonstrated in 2005 congressional testimony by US Secretary of Health and Human Services Leavitt regarding US preparation for a potential avian flu pandemic. He said the United States believes that in a pandemic situation, foreign suppliers would divert products to their own markets, and that it was essential that the United States have its own manufacturing facilities for avian flu treatments.

Current and future issues

The role of WIPO

WIPO also continues to play a major role in regulating IP in world trade. First, WIPO administers treaties pursuant to which persons may secure registration of patents and trademarks in many countries, including the Patent Cooperation Treaty (PCT) and Madrid Agreement and Protocol. Administration of the PCT is highly technical work and employs a large staff. Second, WIPO continues to serve as a forum for negotiations on IPRs. Shortly following entry into force of the TRIPS Agreement, the WIPO Copyright Treaty and WIPO Performances and Phonograms Treaty (WPPT) were concluded at WIPO, and have entered into force. Among other things, negotiations on substantive patent law harmonization continue at WIPO, although the pace of these negotiations is slow due to continuing differences in national perceptions concerning the appropriate standards of protection. WIPO is cooperating with the governing body of the Convention on Biological Diversity in the development of rules on the relationship between IPRs and genetic resources, as well as traditional knowledge. Third, WIPO is increasingly assuming a role as forum for alternative dispute resolution with respect to IPRs, including those that protect domain names on the Internet.[117]

The most controversial of the ongoing WIPO negotiations concerns

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[117] The WIPO Arbitration and Mediation Center serves as a dispute settlement service provider under the ICANN Uniform Domain Name Dispute Resolution Policy and routinely appoints panels to resolve disputes between persons claiming rights in trademarks and domain name registrants. Information about the Center can be found at http://www.wipo.int.

substantive patent law harmonization. Recall that the earliest efforts to negotiate the Paris Convention included proposals to create harmonized international patent law. Why is this subject matter so controversial? First, there is a substantial disparity in the capacity of countries to develop new technologies and commercialize them. The vast preponderance of patents is owned by enterprises in the industrialized countries. Developing countries are, on the whole, substantial 'net payers' for technology. While it may seem like a good idea from the standpoint of someone in the United States or Germany to have harmonized worldwide patent standards which would be based on the rules established in the highly industrialized countries, which rules would pave the way for a system in which multinational companies ultimately could apply for a single patent and obtain worldwide monopolies for their new products, this idea is looked at differently from the standpoint of people in countries who mainly pay higher prices for patented products, that is, the net payers.[118] Under the TRIPS Agreement, countries currently have substantial discretion in the way they define the criteria of patentability. This gives them the ability to control how easy or difficult it is to obtain patents. A country which is a net payer for technology may wish to make it more difficult to obtain patents, for example, by imposing a strict standard for inventive step. Also, there is concern among some developing countries that issues of importance to them, such as the protection of biodiverse resources, will not be given enough attention in these negotiations. Finally, but not exhaustively, even among the most highly developed countries like the United States and the EU there remain some significant differences in the way that the patent systems function and on which there is yet to be agreement on harmonization. For all these reasons, the substantive patent law harmonization negotiations at WIPO are contentious. However, the pressures from the industrialized countries to conclude such negotiations are growing ever stronger.

One of the most important policy debates likely to take place over the next several years concerns whether the world community will move toward adoption of an 'international patent' that will be effective for all (or most) countries.[119] Because of the disparate interests of countries at different levels of development, and because the idea of granting effective 'global monopolies' is so important, this idea has so far made limited headway. However, major industrial companies are likely to keep pressing for this as a way to reduce patenting costs and administrative problems.

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[118] In fact, current negotiations for substantive patent law harmonization do not envision a 'single patent', rather uniform rules that must be applied by all countries.

[119] See Barton (2005), 617; and reports of ongoing work on WIPO Patent Agenda at http://www.wipo.int.

Other multilateral organizations and NGOs

While the TRIPS Agreement was negotiated with minimal public attention, the period since its adoption has seen a strong public focus on the role IPRs play in society. A substantial number of multilateral organizations, including the Food and Agricultural Organization (FAO), United Nations Conference on Trade and Development (UNCTAD), World Bank and World Health Organization (WHO), among others, have taken a much more active interest in IPRs-related matters in recent years.

From the standpoint of other multilateral organizations the control over IPRs issues exercised by the WTO raises concern. Do the FAO and WHO have the authority to regulate patents and trademarks in the areas of food products and public health, respectively? How does that authority relate to the authority of the WTO and the rules of the TRIPS Agreement? This is sometimes referred to as the problem of 'coherence'. At the moment, there is limited practical attention being given to this problem.

In addition to the governmental side, civil society through non-governmental organizations (NGOs), including Médecins Sans Frontieres (Doctors without Borders), Oxfam, and others recognize that IPRs may directly affect their capacity to pursue their missions and have become powerful advocates on IPRs issues that affect their work, including work in combating hunger, disease and economic inequity. Should only national governments have a voice at the WTO and other multilateral organizations because those governments are representative of their people? Or, is national representation at the WTO and other multilateral fora skewed in favor of industrial interests so that NGO representation is necessary to provide a counterweight? This is a contentious issue. In recent years NGOs have made it more difficult to conclude trade and IPRs negotiations on terms sought by industry, and industry has sought ways to limit the influence of NGOs, including by shifting negotiations to less transparent forums.

Policy issues

The medicines debate The TRIPS Agreement entered the public spotlight in a major way in the context of a debate concerning the role of patents on medicines.[120] Sharp controversy arose when the major pharmaceutical research companies, backed by the United States and European Union, on the basis of alleged inconsistencies with the TRIPS Agreement challenged legislation that had been adopted in South Africa to improve access to medicines. The TRIPS Agreement did not support or justify the pharmaceutical industry claims.

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120 Compare Abbott (2002) and Sykes (2002).

Industry was ultimately forced to withdraw its claims under intense public pressure reflecting the seriousness of the HIV-AIDS pandemic in Africa. As a result, however, WTO Ministers at the urging of developing countries and NGOs adopted the Doha Declaration on the TRIPS Agreement and Public Health in November 2001, which, among other things, confirmed the right of Members to take advantage of the flexibilities in the TRIPS Agreement.

Paragraph 6 of the Doha Declaration addressed the problem of effective use of compulsory licensing by countries with insufficient manufacturing capacity in the pharmaceutical sector.[121] It instructed the TRIPS Council to make a recommendation on the subject. After nearly two years of negotiation, the TRIPS Council recommended and the General Council adopted the August 30, 2003, Decision on Implementation of Paragraph 6 of the Doha Declaration on the TRIPS Agreement and Public Health, which provides a waiver of certain TRIPS obligations. More specifically, it waives the restriction otherwise imposed by Article 31(f), which limits production under compulsory license to predominant supply of a Member's domestic market, and also limits remuneration to the exporting country. On December 6, 2005, WTO Members adopted a Protocol Amending the TRIPS Agreement that will transform the August 30, 2003 Decision into an amendment of the TRIPS Agreement when it is approved by a sufficient number of Members. The Decision and waiver will continue in effect until the amendment is approved by all WTO Members.

The Decision and Amendment authorizes WTO Members to grant compulsory licenses for export to countries with insufficient manufacturing capacity for particular pharmaceutical products. It establishes procedures and conditions for using the system.[122] The Decision and Amendment are important elements of developing country TRIPS flexibility. In the post-January 1, 2005 environment, few new pharmaceutical products are likely to be available for import in generic versions from traditional suppliers such as India and China.[123] In order to obtain supplies, developing countries without manufacturing capacity may need to request countries with capacity to produce under compulsory license for them.

Paragraph 7 of the Doha Declaration extended until January 1, 2016, the obligation on 'least developed' WTO Members to provide pharmaceutical product patent and data protection, and perhaps more importantly provided that until that date least developed countries could elect not to enforce existing patents and data protection obligations. This decision had very important

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[121] See Abbott (2005c).

[122] Abbott and Puymbroeck (2005).

[123] This is not a foregone conclusion because India and China may choose to issue government use or compulsory licenses to supply their domestic markets, leaving substantial quantities available for export without use of the Decision and Amendment.

consequences for least developed countries. They could import or produce medicines patented within their territories without concern about infringement, and could register treatments without concern about data protection rules, provided only that the government decides to take advantage of WTO-recognized flexibilities. Least developed countries could avoid the procedures and obligations involved in the granting of government use or compulsory licenses, including the obligation to provide adequate remuneration in the circumstances of the case.

Pharmaceutical research and development is necessary for the introduction of new medicines. Patents provide one mechanism to encourage the funding of R&D, and the research-based pharmaceutical industry (Pharma) points to a risk that the weakening of patent protection ultimately will harm global consumers who will have fewer new treatments available.[124]

The problem of funding pharmaceutical R&D is a very complex one. In the United States, a great deal of public money (in each of 2005 and 2006, approximately $28 billion), administered by the National Institutes of Health, is directed to basic pharmaceutical research. A substantial portion of pharmaceutical R&D is accounted for by government subsidy. Only a small portion of global R&D funds is generated by sales in developing countries. The disease burdens in many of these countries, including HIV-AIDS, malaria, and tuberculosis, but also heart disease, diabetes, intestinal and respiratory disease, overwhelms the capacity of the health sector to provide treatment. Whether it is more important to increase patent rents from these countries, or alternatively to allow medicines to be made available at low prices, is a question that policymakers struggle with. The medicines debate will continue.

Protection of biodiverse resources

While the medicines debate has received the most public attention, there are other important policy issues being addressed in the TRIPS Council. These include the relationship between the TRIPS Agreement and the Convention on Biological Diversity (CBD), and whether the patent rules of the TRIPS Agreement should be amended, for example, to require disclosure in patent applications of the source and origin of genetic resources.[125]

The CBD recognizes that states own the genetic resources located within their territories, and requires that persons seeking to bioprospect for and exploit those resources have the 'prior informed consent' of the host country, as well as arrange for the equitable sharing of benefits from exploitation. The

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[124] For support in the academic literature, see DiMasi et al. (2003).

[125] See contributions by Dutfield, Taubman, Cottier and Pannizon and Coombe, all in Maskus and Reichman (2005), at 495–614.

majority of genetic resource stocks are located in so-called 'Megadiverse' countries, and all but one of those is a developing country (the United States is the industrialized Megadiverse country). A number of developing countries have argued in the TRIPS Council and at WIPO that patent applications should include information regarding where genetic resources come from in order to allow them to effectively police their rights under the CBD. Patent applicants may otherwise be able to describe biotechnological inventions without providing information that will let the patent examiner know that information regarding the invention may be available from foreign sources, and without notice to the country which supplied the genetic resources that would allow it to determine whether there was prior informed consent. The United States so far is the country most strongly opposing the effort to require disclosure, arguing that the source and origin of genetic resources is not relevant to patentability and should not be part of the patent application process.

The regulation of IP at the regional and bilateral level

IP is regulated by regional organizations such as the European Union. The EU regional arrangement in many ways seeks to replicate a federal regulatory system, and from the standpoint of trade regulation is largely unique. Given the enlargement of the EU to 25 member states and its importance as a market for goods and services, the details of its IP regulatory system are important to those involved in international business.

There are many regional organizations, including the Andean Community, ASEAN (East Asia), APEC (Asia-Pacific), CARICOM (Caribbean), NAFTA (North America), MERCOSUR/l (South America Southern Cone and Venezuela) and SACU (Southern Africa). Each of these organizations has adopted some form of IP rules.

In recent years, the United States in particular has used regional and bilateral free trade negotiations as a way to obtain concessions from other countries on IPRs matters.[126] In the context of regional and bilateral free trade agreement negotiations, the United States has obtained commitments on standards of patent, copyright and trademark protection substantially higher than those found in the TRIPS Agreement or other multilateral agreements, and has also obtained major commitments for the protection of pharmaceutical products. Developing countries accepting these commitments are effectively agreeing to increase rent payments on medicines to the United States, and there is considerable debate about whether this serves the social welfare interests of these developing countries.

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[126] See discussion and analysis of the phenomenon in Abbott (2005c), 348–58 and Abbott (2005b), 88–98, Drahos (2002); Fink and Reichenmiller (2005); World Bank (2005), chapter 5, at 98-B110.

Continuing tensions

Just as countries have different capacities and comparative advantages in terms of the production of goods and services, so they have different capacities for generating IP and making use of it.[127] A country with a well-developed educational system and research institutions, whether public or private, will have advantages over countries where these resources are lacking. Smaller countries like Switzerland and Singapore may compete with the United States in generating new technologies.[128] The countries with a high capacity for innovation may have a stronger interest in IP protection than countries more likely to be importers of innovation. Some regions, like Europe, with a long history of specialized agricultural production may have stronger interest in protecting geographical indications (like Champagne or Parma ham) than countries whose agricultural producing regions are less well identified with products. Therefore, just as countries differ in respect to their interests in offering and accepting concessions on tariffs and quotas in trade negotiations, they also differ in respect to their interests in offering and accepting concessions in IP. A country that is going to be a 'net payer' for technology, expression or identifiers will likely have a weaker interest in offering higher standards of IP protection.

The TRIPS Agreement effectively mandated universal standards of IP protection. These rules are applicable to countries at widely different stages of economic development, with different political, cultural and educational systems.[129] The balance reflected in the TRIPS Agreement was composed over time in various industrialized countries.[130] Developing countries must accommodate to these rules. In many cases, the infrastructure to do this is lacking. Some developing countries made policy choices that differed substantially from those of the US, EU and Japan. Those choices have now been unwound. The TRIPS Agreement took developmental and policy differences into account by including transition arrangements, but transition periods have

[127] An excellent review of the economic literature concerning the role of IPRs in economic development is Fink and Maskus eds (2005).

[128] If a small country lacks the factors necessary to move new technology into commercial scale production, it may elect to license out innovation to foreign producers.

[129] On differential interests in IPRs, see Maskus (2000), and Abbott (1998a).

[130] In the United States, the Constitution addresses IP. Congress plays an active role in regulating IP. US IP law is adjusted on a more or less regular basis to accommodate changes in technologies and perceptions about the proper balance between the rights that should be accorded to innovators and the access that should be permitted consumers. In areas of high social concern, such as pharmaceuticals, the US Congress has adopted highly complex mechanisms for balancing the interests of innovating companies, generic producers and consumers.

now largely expired. Negotiations on TRIPS subject matter at the WTO and in other fora continue to be a source of controversy. Because of the important and disparate interests at stake, this should not be surprising.

Conclusion

Intellectual property rights perform a variety of functions. They promote innovation and creative expression, and they protect investment. The promotion of innovation and protection of investment are important objectives for the global economy. New products and methods for producing them improve the quality of life and enhance productivity. It is important, however, to bear in mind that IPRs protection also imposes social and economic costs. It restricts the use of knowledge, even if for a limited time. The benefits of IPRs protection are not equitably shared among the richer and poorer nations. Just as national legislators must seek to strike a balance between the interests of various domestic stakeholders in IPRs protection, so must those responsible for negotiations at the multilateral level seek to strike an appropriate balance among industry and consumers, and among the wealthy and the poor. The people of the world are closely linked by new technologies and we share an interest in a stable and prosperous international environment.

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12. Power and cooperation in international environmental law

*Richard H. Steinberg**

This chapter examines international environmental regulation from economic, political, and legal perspectives. Section 1 introduces the economics and politics of international environmental regulation. International agreements on environmental issues are often seen as symmetric contracts among states, solving cooperation problems among states with similar interests, or facilitating side-payments from states that favor environmental regulation to states that would not otherwise support regulation. In contrast, some realist political scientists suggest that when international environmental interests vary across states, international environmental agreements often result from coercion of weaker states by more powerful ones.

With this framework in mind, the bulk of this chapter examines the negotiation and substance of the world's most important international environmental agreements.[1] Section 2 examines the main agreements related to international environmental protection of the oceans, including those concluded to protect fisheries and those intended to reduce land-based marine pollution. Section 3 examines the main agreements relating to global air pollution and climate change – the Montreal Protocol to the Vienna Convention for the Protection of the Ozone Layer (Montreal Protocol)[2] and the Kyoto Protocol to the United Nations Framework Convention on Climate Change (Kyoto Protocol).[3] Section 4 explores the main trade and the environment issues and agreements, including the Basel Convention on the Transboundary Movement of Hazardous Wastes (Basel Convention)[4] and the Convention on

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1 As this suggests, this chapter focuses on understanding commitments to (i.e., not compliance with) international environmental agreements.

2 Montreal Protocol on Substances that Deplete the Ozone Layer, 16 September 1987, 26 ILM 1541.

3 Kyoto Protocol to the FCCC, FCCC Conference of the Parties, 37 ILM 22 (1998).

4 Basel Convention on the Control of Transboundary Movements of Hazardous Wastes and their Disposal, 22 March 1989, 28 ILM 649 (1989).

International Trade in Endangered Species of Wild Fauna and Flora (CITES),[5] as well as environmental issues in the World Trade Organization (WTO), the North American Free Trade Agreement (NAFTA), and European Union (EU).

Section 5 concludes that most effective international environmental agreements have resulted not from symmetrical contracting alone but from negotiations that involve coercion by powerful, greener countries of weaker countries that are generally less interested in international environmental protection. In this sense, international environmental regulation is at least as much political as it is economic.

1. Contracting and coercion: economic and political analysis of international environmental law

International environmental policy questions have both economic and political dimensions.

From an economic perspective, pollution and environmental degradation raise health care costs, as well as the costs of producing some goods and services (e.g., the productivity of fisheries). Moreover, at present and for future generations, environmental degradation diminishes opportunities for recreation and intrinsic enjoyment of nature's beauty (Leopold 1949). At the same time, environmental protection is financially costly for the governments and firms that undertake it. Environmental regulation in one country may also place the firms that are subject to it at a competitive disadvantage vis-à-vis foreign firms that are subject to less stringent environmental regulation. Largely for these reasons, regulation of activities affecting the environment may also be politically costly for policy-makers who choose to engage in it.

Economic reasoning has long offered an important heuristic for analyzing domestic environmental law and policy. Pollution may be considered a negative externality: absent government regulation, the costs of environmental degradation are often not internalized into a producer's cost function. Of course, Coasian contracting may generate a Pareto-efficient reduction of such degradation (Coase 1960). But without an initial governmental assignment of a property right to be free from environmental degradation, the Coasian market-based solution usually entails paying the polluter, a distributive consequence that runs counter to a normative 'polluter pays' preference (Calabresi and Melamed 1972). Moreover, in many instances, Coasian bargaining faces a transaction cost or a collective action problem that undermines a potential solution (Olsen 1971). Some environmental issues, such as overfishing or

[5] Convention on International Trade in Endangered Species of Wild Fauna and Flora, 3 March 1975 (amended 22 June 1979), 12 ILM 1085.

overhunting, may be characterized as a problem of the commons. Hence, government intervention may be justified.

In the international context, where there is no global sovereign, environmental problems are particularly difficult to solve. There, states are the entities that must cooperate to regulate pollution and some states – often poor ones – place little or no value on environmental protection.[6] The states that favor global environmental protection may refuse on principle or be unable to 'pay' poorer states to limit environmental degradation. Moreover, the states that favor global environmental protection may face significant barriers to cooperation. And even if they can cooperate, the absence of a centralized global environmental administrative authority implies that states and non-governmental organizations are the only entities that can gather and disseminate information about the precise sources and consequences of environmentally unfriendly activities (Raustiala 2002). The fundamental international environmental problem is that, unlike the domestic context, where a national government can intervene to solve distributive, cooperation, and information problems, the international system does not have a supranational sovereign. In this sense, the international system is said to be anarchic (Waltz 1979).

Using economic reasoning, some political scientists have shown that international institutions may solve these problems. International institutions may improve information generation and transmission, foster verification of and compliance with commitments, and help solve collective action and other cooperation problems (Keohane 1984). But in the environmental context, successful establishment of such institutions presumes fundamental agreement among states on environmental objectives and willingness to share associated costs. As suggested above, in the international environmental context, there is often fundamental disagreement on these issues between states on the importance of environmental protection and on the willingness to share costs – a fundamental divergence of interests.

Sociological arguments suggest that interests are plastic. Transnational epistemic communities (TECs) of expert professionals may persuade all states of the adverse consequences of environmental degradation, but TECs exist and operate effectively under only restrictive conditions of uncertainty (Haas 1992). Liberal interest group pressures, particularly those exerted by transnational non-governmental organizations (NGOs) and other transnational advocacy networks (TANs) of like-minded activists, could persuade all or most countries that polluters have a duty to diminish environmental degradation

[6] This low value on environmental protection is understandable: whether environmental protection is a normal good or a luxury good, poor states are less likely than rich states to spend money on it.

(Moravcsik 2001; Keck and Sikkink 1998). Some argue that almost all interests are socially constructed and malleable (Wendt 1999). But the reconstitution of interests implicit in these approaches usually takes place over a long time period and is undoubtedly constrained by material factors, such as the financial costs of environmental protection. Empirically, therefore, TANs, TECs, and other liberal pressures have not persuaded all states to support across-the-board global environmental protection. Without broad global convergence on environmental objectives, it is hard to reach consensual Pareto-improving environmental agreements.

Concluding an international agreement through a side-payment offers another form of contracting. States that favor environmental protection may offer a side-payment to other states that otherwise would not support environmental protection or that are unwilling to pay for it. If the side-payment is large enough to induce voluntary agreement, then the arrangement is Pareto-improving, as all parties will be better off. There are, however, a few reasons why side payments might not be favored by states that support environmental protection. First, some states may refuse to pay them out of a sense of the unfairness of doing so. As suggested above, there is a normative current that suggests that polluters ought to pay the costs of not polluting – and that they should not get paid for such behavior. This stance may resonate particularly well in the United States and Europe, two powerful, wealthy regions that might otherwise be in a position to offer a side-payment. Second, if parties' interests are highly divergent, or the costs of complying with an environmental agreement are high, then a side-payment may be too costly to be borne by the parties favoring the agreement.

Third, politics may offer another solution that is less costly than making a side payment. In the absence of a supranational sovereign to impose a solution, or like-minded states that can contract a solution, power offers a means by which environmental arrangements may be established. Technically, legal sovereignty implies that all international agreements are based on state consent; behaviorally, however, weaker states may face insurmountable international political pressure to 'consent' to a particular agreement (Steinberg 2004). An agreement reached through coercion may be seen as asymmetric in the sense that it generates less political support for the state from domestic interests in weaker countries than in powerful ones; at the extreme, a weaker state may be coerced into an agreement that actually runs contrary to domestic political interests. Of course, the source and measure of state power varies across environmental issue areas (Keohane and Nye 1974), and the extent to which power is concentrated varies as well (Steinberg 1997). While richer countries generally prefer more environmental protection than do poorer ones (Wildavsky 1988), in particular environmental issue areas, some rich countries may not support environmental protection or they may disagree among them-

selves about the appropriate extent or means of protection. Where powerful states can not agree, as in the case of climate change, no agreement will be reached or any agreement that is reached will be of limited effectiveness. According to the logic of this realist argument, environment-friendly rules and agreements may be concluded in issue areas where the interests of powerful states are sufficiently convergent, and their combined power is sufficiently substantial, to coerce other countries into joining. Under these conditions, bargaining between powerful and weak countries takes place on the Pareto frontier (Krasner 1991).

Thus, these two approaches – contracting (either between like-minded states or through side-payments) and coercion, one essentially economic, the other political – together denote conditions under which effective international environmental law may be generated. First, economic logic suggests that in those environmental issue areas where states do share similar interests, they may contract to reach an effective and symmetric Pareto-improving international agreement. Alternatively, economic logic suggests the possibility of Pareto-improving contracts concluded through side-payments. Second, realist political logic suggests that when state interests diverge and side-payments can not be made, effective international environmental agreements may be reached only if powerful, greener states coerce weaker states into a particular agreement. Third, it is possible that effective international agreements may be reached from a combination of coercion and side-payments.

2. International environmental agreements on the sea: land-based marine pollution and fisheries

There are two main issue areas in which international environmental agreements have been concluded to protect the sea: those aimed at diminishing land-based marine pollution and those regulating fisheries. These two sets of agreements illustrate the two main means of reaching agreement, contracting and coercion, respectively.

2.1. Land-based marine pollution

Over half of the world's population lives within ten miles of the coast (Hunter et al. 1998, p. 779), so it is not surprising that land-based marine pollution (LBMP),[7] which involves the pollution of maritime zones by land-based

[7] Article 1 of UNCLOS defines marine pollution as: '[T]he introduction by man, directly or indirectly, of substances or energy into the marine environment, including estuaries, which results or is likely to result in such deleterious effects as harm to living resources and marine life, hazards to human health, hindrance to marine activities, including fishing and other legitimate uses of the sea, impairment of quality for use of sea water and reduction of amenities'.

discharges, accounts for approximately 70 per cent of marine pollution (Kiss and Shelton 2004, p. 539). This pollution contaminates and damages fisheries, marine mammals (Hunter et al. 1998, p. 779),[8] coral reefs (Davidson 2002, p. 502), and other aspects of the marine environment.[9] Although the cumulative consequences of marine pollution are greater than any single oil spill (Wolfrum et al. 2000, p. 252), the international community has yet to develop a comprehensive and enforceable global approach to the problem. However, several regional agreements have been reached among like-minded countries.

The unsuccessful pursuit of effective global commitments The past three decades are littered with global agreements containing hortatory provisions relating to LBMP, but the international community has not established a mandatory and enforceable global regime to regulate LBMP.

The doctrine of *sic utere tuo ut alienum non laedes* (use your property not to injure that of another) has served as a customary international law justification for regulating the discharge of land-based pollution (Guruswamy et al. 1999, p. 598). The 1972 Stockholm Conference (the results of which were non-binding 'soft law') codified this notion in Principle 7 which provides that 'states shall take all possible steps to prevent pollution of the seas by substances' (Guruswamy et al. 1999, p. 598). In 1973, the General Assembly established the United Nations Environment Programme (UNEP) to implement the provisions of the Stockholm Convention (Mensah 1999, p. 299). In 1974, the UNEP devised the Regional Seas Programme built on a regional control strategy consisting of four objectives, the conclusion or provision at the regional level of: (1) action plans for research, assessment, and monitoring of land-based sources of marine pollution; (2) legally binding conventions; (3) technical protocols and annexes tailored to address particular threats; and (4) financial and institutional support to enforce the first three provisions (Hunter et al. 1998, p. 788).

In 1982, the international community touched upon LBMP in the United Nations Convention on the Law of the Sea (UNCLOS), but the relevant provisions are hortatory or so vague as to be ineffective. Article 194 obligates states to 'take, individually, or as appropriate, jointly, all measures that are necessary

[8] Toxic chemicals in LBMP tend to remain in the tissues of marine mammals and compromise their immune systems. These concentrations are often 'bio-accumulative', which means that they increase as one advances through the food chain (Hunter et al. 1998, p. 779).

[9] Coral reefs harbor many fish. More than one billion people in Asia depend on coral reefs as a source of food (Davidson 2002, p. 502). Besides food, coral reefs can serve as a source of tourism and protect shorelines from hurricanes (Davidson 2002, p. 502).

to prevent, reduce and control pollution from any source' (Wolfrum et al. 2000, p. 252). Article 207 refers directly to the LBMP problem, providing that states must 'prevent, reduce, and control pollution of the marine environment from land-based sources' (Sands 2003, p. 429). In order to meet this aim, member-states must take 'internationally agreed rules, standards, and recommended practices and procedures' into account (Sands 2003, p. 429). Article 213 stipulates that states must enforce international as well as national environmental laws (Wolfrum et al. 2000, p. 252).

After conclusion of the UNCLOS, the international community again addressed LBMP through the UNEP's Montreal Guidelines. The Guidelines, which the UNEP adopted in 1984, constituted the first comprehensive attempt to regulate LBMP (Mensah 1999, pp. 302–3). However, the resulting 19 recommendations and three Annexes are so broad and non-binding that they have not required implementation (Hunter et al. 1998, p. 784).

Two scientific reports subsequently provided additional impetus to reach a more substantive global agreement on LBMP. In 1987, the 'Brundtland Commission' (the World Commission on Environment and Development) published a report entitled, *Our Common Future*. The Commission encouraged international cooperation to combat the growing threats that pollution and land-based development posed to the living resources of the sea. In 1990, the Group of Scientific Experts on Marine Pollution (GESAMP) completed the first comprehensive study on the effects of marine pollution, concluding that land-based activities bore responsibility for the majority of marine pollution (Mensah 1999, p. 297).

In 1995, 108 states and the European Union gathered in Washington, DC to conclude an agreement calling for a global program of action to restrict LBMP emissions (Sands 2003, p. 429). This conference produced two agreements, the Washington Declaration on the Protection of the Marine Environment from Land-Based Sources (Washington Declaration) and the Global Programme of Action for the Protection of the Marine Environment from Land-Based Activities (GPA) (Mensah 1999, p. 307). In the Washington Declaration, participants announced their intentions to take action to combat LBMP (Hunter et al. 1998, p. 785). In the GPA, participants specified four fields of action, including a call for a binding instrument dealing with some of the more dangerous pollutants (Sands 2003, p. 430).[10] Yet the GPA failed to

[10] These four areas are: (1) measures to ensure periodic assessment of the current state of the coastal environment on both the global and regional levels; (2) methods to facilitate information exchange; (3) a mechanism to coordinate activities of organizations devoted to issues concerning LBMP; and (4) the establishment of an intergovernmental mechanism to evaluate the progress in implementing LBMP (Mensah 1999, p. 308). Point 17 urged the ban of at least a dozen bio-accumulative

include any mention of target reductions or timetables (Wolfrum et al. 2000, p. 253). Rather than forming an organ to ensure implementation, the GPA requests states themselves to 'take the necessary measures for the implementation of the GPA at the national, regional, and international level' (Wolfrum et al. 2000, p. 253).

The GPA has yet to develop a globally binding instrument, as countries are reluctant to cede any sovereignty over activities within their territories (Mensah 1999, p. 312). Both developing and developed countries seem uninterested in pursuing a mandatory and enforceable global LBMP regime. Some developing countries fear that these environmental measures will curb economic development (Ring 1997, p. 69). At the same time, developed countries have been unwilling to offer financial assistance to developing countries to reduce LBMP (Ring 1997, p. 129). But most importantly, many studies, including the one by GESAMP in 1990, have concluded that LBMP has yet to make a significant impact outside of coastal waters (Mensah 1999, p. 312).

Regional approaches The generally concentrated and localized nature of LBMP impacts explains why it has been easier to reach effective regional than global agreement on the regulation of LBMP. States have signed several binding agreements concerning LBMP at the regional level.

European states adopted two regional agreements that were the first to effectively address LBMP (Mensah 1999, p. 300). The first such agreement was the Paris Convention for the Prevention of Marine Pollution from Land-Based Sources in 1974. The signatories, all of whom were Western European states, agreed to protect the marine environment in the Atlantic and Arctic Oceans, excluding the Baltic and Mediterranean Seas (Hunter et al. 1998, p. 789). Articles 4(1)(a) and 4(2)(a) required the elimination of land-based marine pollution caused by particular substances listed in Part I of Annex A (Sands 2003, p. 431).[11] These same articles also required the minimization of the discharge of substances listed in Part II of Annex A (Sands 2003, p. 431).[12] Articles 4(3) and 4(4) restricted the discharge of radioactive substances by requiring the adoption of 'measures to forestall, and as appropriate, eliminate pollution of the maritime area [of these substances]'. Article 6 required the

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pollutants, including aldrin, dieldrine, chlordane, heptachlor, DDT, dioxins, furans, endrin, hexacholorobenzine, mirex, polychlorinated biphenyls, and toxaphene (Hunter et al. 1998, p. 787).

[11] This list included mercury and mercury compounds, cadmium and cadmium compounds, and persistent oils and hydrocarbons (Sands 2003, p. 431).

[12] These substances were considered less harmful and easier to neutralize through natural processes than the substances in Annex I. Part II included organic compounds of phosphorus, silicon, tin, arsenic, copper, lead, nickel, and zinc (Sands 2003, p. 431).

states to forestall any pollution from land-based sources (Hunter et al. 1998, p. 789). In Article 7, the Convention's administrative organ, which consisted of one representative from each member-state, had the power to adopt certain binding programs, measures, and decisions via unanimous vote (Sands 2003, p. 432).

In 1992, the EC member-states replaced this agreement with the Convention for the Protection of the Marine Environment of the North-East Atlantic. Article 31 of the 1992 Convention ensures that many measures contained in the 1974 Convention remain applicable (Kiss and Shelton 2004, p. 540). The 1992 Convention also calls for the application of the precautionary principle to restrict the emission of LBMP and the obligation to use the 'best available technologies' (BATs) to combat point-source pollution[13] and 'best environmental practices' (BEPs) to combat pollution from diffuse sources (Mensah 1999, p. 319; Kiss and Shelton 2004, p. 540). The 1992 Convention entered into force on 25 March 1998 (Wolfrum et al. 2000, p. 256).[14]

Also in 1974, the states on the Baltic Sea established the Helsinki Convention, another agreement located outside the UNEP program, to address pollution from a variety of sources (Hunter et al. 1998, p. 789). Marine pollution was a particularly acute problem in the Baltic Sea, where it accounted for over 80 per cent of pollution (Hunter et al. 1998, p. 789). Article 6 of the Convention called for a permit system to control substances listed in Annex II; the permit could only be issued upon approval by the designated national authority (Hunter et al. 1998, p. 789). In 1992, the parties adopted a 'new Helsinki Convention', with standards resembling those of the 'new' Paris Convention. The 1992 Helsinki Convention called for states to adopt the precautionary approach to restrict LMBP emissions (Wolfrum et al. 2000, p. 255). The new convention also called for BATs and BEPs (Kiss and Shelton 2004, p. 541). On 17 January 2000, the modified Helsinki Convention entered into force. There are currently ten signatories, including the European Union.[15]

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[13] Point source pollution refers to pollution that emanates from a discrete source, such as discharge from a factory pipeline. That which does not emanate from a discrete source is known as diffuse source pollution. An example of diffuse source pollution would be run-off from agricultural crops which were sprayed with herbicides or pesticides.

[14] Signatories are Belgium, Denmark, the EU, France, Germany, Iceland, Ireland, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom (Wolfrum et al. 2000, p. 256).

[15] In 2005, the parties included: Germany, Latvia, Sweden, Estonia, Finland, Denmark, Lithuania, Poland, Russia, and the European Union.

By 1999, in addition to the foregoing, regional seas agreements had been adopted in nine different regions.[16] Four of these agreements contain only an hortatory provision on LBMP, calling for contracting parties to undertake all appropriate measures to limit land-based pollution from within their own territories (Hunter et al. 1998, p. 788). One other agreement, the Protocol Concerning the Development of the Marine Environment of the Wider Caribbean Region on 6 October 1999, covers 16 states of the Caribbean (including the United States), but it has yet to be ratified by any of the signatories (Kiss and Shelton 2004, p. 543).[17]

However, four of the agreements have entered into force and include mandatory rules and processes regulating land-based pollution: the 1980 Athens Land-Based Sources of Pollution (LBS) Protocol concerning the Mediterranean Sea (the Mediterranean LBS Protocol),[18] the 1983 Quito LBS Protocol concerning the Southeast Pacific region, the 1990 Kuwait LBS Protocol covering the region around Kuwait,[19] and the 1992 Black Sea Protocol (Sands 2003, p. 436). These four agreements require banning the

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[16] The agreements covered the following areas: Mediterranean, Kuwait region, West and Central Africa region, the Southeast Pacific region, the Red Sea and the Gulf of Eden region, the Wider Caribbean region (Hunter et al. 1998, p. 788), the East African Region, the South Pacific region, and the Black Sea (Mensah 1999, p. 299).

[17] The Protocol incorporates GPA principles for the preparation of environmental impact assessments for 'planned land-based activities or planned modifications to such activities which are subject to regulatory control and which are likely to cause substantial pollution of or significant harmful changes to the Convention area' (Kiss and Shelton 2004, p. 543). The agreement also sets forth strict maximum numeric levels for pollution and timetables for compliance which surpass the level of detail in any other LBMP Protocol (Hunter et al. 1998, p. 790).

[18] The Mediterranean LBS Protocol is notable for covering activities within the hydrologic basin of all member-states. The parties to the Mediterranean Protocol defined the hydrologic basin as 'the entire watershed area within [the territories of a member-state] and draining into the Mediterranean Sea'. In 1996, the parties adopted a new protocol that calls for strict regulation of point-source discharges and the releases of materials in the air that may reach the Mediterranean Sea. This agreement has yet to enter into force because it has only been approved by 13 of the 22 signatories to the original convention, leaving it four short of the requirement for approval by 75 per cent of the original signatories. The following parties have ratified the amended protocol: Albania, Cyprus, the European Community, France, Greece, Italy, Malta, Monaco, Morocco, Slovenia, Spain, Tunisia, and Turkey. The following states have not ratified the protocol: Algeria, Bosnia-Herzegovina, Croatia, Egypt, Israel, Lebanon, Libya, Syria and Yugoslavia (Kiss and Shelton 2004, pp. 541–2).

[19] The Kuwait region includes Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates. The Kuwait LBS Protocol is notable for being the first regional protocol to call for environmental impact assessments (Mensah 1999, p. 318).

discharge of substances on their Annex I 'black lists', and require authorization by a designated scientific authority to discharge substances on their Annex II 'gray lists' (Sands 2003, p. 436). All of the protocols call for cooperation to develop standards, provide technical assistance, and establish a system for assessing pollution levels and the effectiveness of measures (Sands 2003, p. 437). These agreements rely on the participation of parties rather than a central secretariat for information gathering, compliance reviews, and consultations in the case of one member-state's LBMP harming the interests of another (Sands 2003, p. 437).

Assessment of LBMP regimes The effects of LBMP are more pronounced regionally than at great distances. And particular LBMP problems vary across regions. As a result, LBMP interests are more salient at a regional than a global level. Hence, there is no global, effective agreement regulating LBMP, but there are several regional ones.

The regional LBMP regimes have been criticized by environmentalists for 'weak standards and weak supervisory institutions' (Hunter et al. 1998, p. 790), being established at the 'lowest common denominator', and accommodating economic and commercial considerations (Mensah 1999, p. 320). Moreover, most regional protocols lack dispute settlement mechanisms[20] and civil liability regimes to punish violations (Mensah 1999, p. 320). Finally, some of the regional regimes have been criticized for lacking a reliable transfer of resources to developing country member-states, which require serious financial assistance to upgrade their institutional capacities (Schumacher et al. 1996, p. 115).

Nonetheless, several regional LBMP regimes are considered effective. Effective, regional LBMP regimes are more likely to be found in wealthy parts of the world than poor ones. As noted above, wealthier countries tend to be greener than poorer ones and more capable of bearing the costs of environmental protection. Moreover, when member-states are uniformly wealthy, the LBMP regime has tended to be more comprehensive. Hence, three of the six effective regional LBMP protocols involve predominantly EU member-states and EU aspirants, and these three EU-centered protocols have been considered 'relative successes' or 'a model' (Mensah 1999, p. 319; Wolfrum et al. 2000, p. 254).[21]

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[20] The Kuwait LBS Protocol does have a judicial commission to rule on disputes between member-states (Mensah 1999, p. 320).

[21] Some have argued that the Mediterranean Protocol has 'achieved a measure of success' in no small part due to the influence of EU environmental legislation (Mensah 1999, pp. 317–18). Since EU states had already ceded some sovereignty on this issue by passing several directives relating to LBMP (Kiss and Shelton 2004 p. 540), they may have been more amenable to comprehensive agreements.

2.2. Fisheries agreements

Renowned law scholar Hugo Grotius re-introduced the Roman concept of freedom of the seas in his 1609 work, *Mare Liberum*.[22] By the 1800s, the legal principle of the freedom to navigate on and fish this unregulated area known as the high seas had gained universal acceptance among the major powers. While customary international law allowed for an extension of a nation's territorial sovereignty over the marine area off its coast not to exceed three miles, activities on the vast expanses of the oceans were free from any sort of regulation (Hunter et al. 1998, pp. 678–9).

This freedom has created a classic 'tragedy of the commons', threatening the long-term viability of fishing on the high seas. Until recently, no institution existed to manage the resource for the benefit of all. In the absence of such an entity, each actor's interest in short-term exploitation of the resource exceeded the perceived long-term benefits of not exploiting the resource. This short-sighted behavior has produced an overexploitation of the resource (Ardia 1998, p. 519). Since fish are the primary source of protein for close to 950 million people and fishing represents up to 80 per cent of the exports in certain developing countries, the current stagnation of fish yields[23] carries significant consequences (Kiss and Shelton 2004, p. 402).

There are two standard alternative solutions to the tragedy of the commons: privatization and regulation. Since the mid-twentieth century, powerful coastal states, led by the United States, have used their naval power to expand territorial waters so as to, in effect, privatize large fisheries. They have subsequently used access to those fisheries as a source of bargaining leverage to coerce weaker fishing states into agreements that regulate stocks of fish that straddle territorial and international waters.

Extensions of coastal sovereignty Following World War II, US President Harry S. Truman issued the first extension of territorial authority past the traditional three-mile zone when he established a fishery conservation zone to protect Alaskan salmon (Picard 1996, p. 319). Although the United States assured other countries that this action would not interfere with their freedom

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[22] In this work, Grotius defended the right of Dutch ships to traverse through areas of the Indian Ocean and Eastern Seas over which England and Spain exercised control. Grotius argued that natural law forbade ownership of the commons; therefore, the rights of navigation and fishing on the high seas were basic rights of all nations (Hunter et al. 1998, p. 678).

[23] Due to persistent overfishing, fish production has stagnated since the 1990s. Overfishing has resulted in a substantial increase in annual yields of fish from 18 million tons in 1950 to 56 million tons by 1970 (Kiss and Shelton 2004, p. 402).

of navigation,[24] the countries that followed suit unilaterally expanded their respective jurisdictions without the attendant assurance of the continuation of the freedom of navigation (Picard 1996, p. 319). By 1958, almost 20 countries had claimed control over their continental shelves (Hunter et al. 1998, p. 679).

The conflict over the high seas led to the first two United Nations Conferences on the Law of the Seas (UNCLOS I and UNCLOS II) in 1958 and 1960, respectively. The tension between coastal states, which asserted an extension of territorial control, and the distant water fishing nations, which desired to minimize national control over the seas' resources, was irreconcilable in those negotiations (Hunter et al. 1998, pp. 679–80) and that tension has since defined all subsequent fisheries negotiations.

The naval force-distance gradient, defined as the degree to which naval and associated political power diminishes as we move away from a home base (Boulding 1963, p. 245), permitted coastal states to continue unilaterally declaring extension of their territorial seas. Hence, the nationalization of the sea continued to the point that by 1973 states had asserted authority over one-third of the ocean territory (Hunter et al. 1998, p. 680).

In 1973, negotiations began on UNCLOS III, which concluded in 1982. UNCLOS III has become a seminal document for the protection of the marine environment. The most notable achievement of UNCLOS III was codification of the nationalization of ocean territories that had already taken place in fact because of the local power of coastal states. According to Article 17, a state exercises control over the territorial waters up to 12 miles from the coast although it has to permit the innocent passage of ships. However, innocent passage does not permit the exploitation of local marine resources. Furthermore, coastal states were granted an exclusive economic zone (EEZ) that extends up to 200 miles from the coast.[25] Articles 61 through 68 permit a coastal state to regulate the marine resources within its EEZ, and these rights include obligations to ensure the conservation of species (Articles 56, 61, and 62). Article 73 grants a coastal state the right to inspect, board, and arrest any vessel within its EEZ. Beyond the EEZ, only the flag state (the state in which the ship is registered) possesses the right to regulate vessel activity. Part XII of UNCLOS III (Articles 192–237) places a duty on states to preserve the habitat of depleted, threatened, or endangered species and other types of marine life. The net result is that over 90 per cent of the world's fisheries

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[24] The Truman Proclamation included a disclaimer that the conservation zones would maintain their 'character as high seas . . . and the right to their free and unimpeded navigation' (Picard 1996, p. 319).

[25] Article 76(1) states that the EEZ covers whichever is larger: the 200 miles from the baseline (the area that covers coast to the harbor walls) or the edge of the continental margin.

reside within EEZs (Hunter et al. 1998, pp. 680–83; Wolfrum et al. 2000, pp. 226–9).

This 'privatization' of coastal fisheries addressed part of the international tragedy of the commons. However, this development has not always led to sustainable management of fish populations within EEZs, largely because of domestic politics. In some cases, the fishing industry dominates the decision-making process for managing fisheries, which has meant that many coastal states continue to engage in EEZ fishing beyond biologically desirable levels (Swing 2003, p. 141).[26] Moreover, some fishing fleets have increased as governments have continued to subsidize the construction of vessels (Carr and Scheiber 2002, p. 56).

Straddling stocks, migratory stocks, and international waters The privatization of coastal waters could not fully solve the international fisheries problem: international waters were still a commons. Straddling stocks (whose range covers both EEZs and the high seas) and migratory stocks of fish do not limit themselves to EEZ boundaries (Picard 1996, p. 329).[27] Together, these fish stocks account for approximately 10 per cent of the world's food supply (Barston 1995, p. 159). In the 1980s, regional organizations such as the International Convention on the Conservation of Atlantic Tunas (ICCAT), the North Atlantic Fisheries Organisation (NAFO), and the Commission for the Conservation of Antarctic Marine Living Resources (CCAMLR) tried but failed to secure the necessary participation among all fishing parties to cooperate in managing high seas fisheries (Carr and Scheiber 2002, p. 52; Warner-Kramer 2004, pp. 511–22). In the same period, many ships re-flagged in states with open registries that were not parties to UNCLOS III in order to avoid control by jurisdictions that subjected their vessels to stricter regulations (Carr and Scheiber 2002, p. 60).[28] These conditions reflected and perpetuated the

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[26] For instance, fishing industry interests serve on regional regulatory councils in which they possess full voting rights (Carr and Scheiber 2002, p. 58). In the United States from 1990–2001, commercial fishing interests constituted 49 per cent of the membership on regional councils, recreation fishing interests constituted 33 per cent, and all other industry interests constituted 17 per cent (Okey 2003, p. 193). In the EU, the fishing industry managed to reduce the scientists' recommended 85 per cent cut in fishing quotas to a much more politically palatable 60 per cent cut (Carr and Sheiber 2002, p. 45).

[27] For instance, the pacific salmon spends most of its formative years within the EEZ and then spends most of its adult life outside the reach of any EEZ, except to reproduce (Ardia 1998, pp. 538–9).

[28] US tuna fishermen escaped restrictions designed to protect dolphins by re-flagging in countries such as Costa Rica, which did not require such measures (Carr and Sheiber 2002, p. 61). Overall, the practice of flag state responsibility and the

pathology in which each state had an interest in extracting as much of the resource as possible.

These emerging problems compelled participants in the 1992 UN Conference on Environment and Development (the Rio Summit) to call for an international conference to address straddling and highly migratory fish stocks in Agenda 21, Chapter 17. A 1994 report of the United Nations Food and Agricultural Organization (FAO) stressed the urgency of the issue, reporting that 14 of the 20 existing stocks of commercial tuna were dangerously depleted and that straddling fish stocks had been decreasing precipitously since 1989 (Vigneron 1998, pp. 582–4).

By the early 1990s, the tension between pro-access deep-water fishing nations and more pro-conservation coastal states resulted in many coastal states taking unilateral actions to restrict access to areas that affected their fish stocks. Canada, Chile, Colombia, Peru, Argentina and Mexico made claims to extend their jurisdiction beyond their UNCLOS III-recognized EEZs (Vigneron 1998, p. 585). These moves signaled that coastal states could further expand their EEZs and further restrict access to their coastal stocks unless fishing nations agreed to regulate the fishing of straddling and migratory stocks in international waters.

On 29 January 1993, the UN General Assembly agreed to convene an intergovernmental conference on straddling and migratory stocks. During the negotiations, the participants divided themselves into two main groups, the coastal states and the distant-water fishing states. Although the United States belonged to the coastal state club, it sought a balance that would advance conservation and protect high-seas fishing interests.

The distant-water fishing states, which had a vested interest in maintaining freedom of the high seas, wanted a non-binding legal instrument with a narrow scope. Many of these states contended that any binding agreement would violate the principle of freedom of the high seas articulated in Article 87 of UNCLOS III. Participants in this group included China, Estonia, Japan, Poland, Thailand, the EU, and the Ukraine (Vigneron 1998, pp. 596–7).

The coastal states consisted of four active subgroups, all of which sought a legally binding agreement to at least better monitor high-seas fishing activities (Vigneron 1998, p. 597). The first active group, the 'extreme coastal states'

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absence of any binding guidelines have led to the increased popularity of 'open registries'(defined by the United Nations Conference on Trade and Development as a registry where less than 10 per cent of ships are owned by nationals of that flag state). The number of open registry states increased from 11 in 1980 to 32 in 2003. Few of these states were part of any regional conservation organization. Panama is the lone open registry state to have enacted legislation covering standards set forth by the International Labour Organisation for work in the fisheries sector (Warner-Kramer 2004, pp. 500–501)

group, led by Chile, Ecuador, Peru, and Colombia, advocated the 'presencial sea' doctrine, which would have validated their exclusive rights over resources beyond the internationally recognized EEZ (Barston 1995, p. 161). This group argued that such an extension of territorial rights was necessary for the maintenance of the eco-system of the territorial waters of these states (Picard 1996, p. 340).

A second group of activist states that included Canada, Argentina, and Norway took a more restrained approach, advocating a right to control straddling stocks in areas adjacent to their EEZs. However, this group also developed a common position with the extreme coastal states to advocate an expanded zone subject to inspection and a right of a state to enact its own measures in its EEZ absent any consensus in a regional organization over minimum standards (Barston 1995, p. 160–61).

A third group, of moderate reformers, consisted of Australia and New Zealand. These states focused on improving the current measures instead of reformulating the boundaries of the EEZ. They advocated the establishment of a scientific data collection system and an increase in the responsibilities of flag states to monitor their vessels (Vigneron 1998, p. 596).

A fourth position was taken by the United States government, which faced domestic pressures from both a strong fishing industry and a strong pro-conservation lobby, forcing it to seek a compromise. The fishing lobby's aforementioned political influence provided a strong voice in favor of ensuring that the freedom of the high seas remained, especially in the plentiful 'Peanut Hole' in the Sea of Okhtosk. On the pro-conservation side, environmental groups had organized a consumers' boycott against tuna caught in driftnets because these methods also resulted in the suffocation of dolphins. In 1990, major American tuna processing companies responded to consumer demand by severing their business relationships with fishermen whose methods were unsafe for dolphins and attaching a 'dolphin-safe' label to canned tuna. That same year, Congress prohibited the sale of any tuna that failed to meet the dolphin-safe standard. The United States had also introduced a United Nations resolution that banned driftnet fishing on the high seas,[29] and amended the Magnuson-Stevens Fishery Conservation Management Act to ban the importation of products from states whose ships use large-scale driftnet fishing methods.[30] In the same period, beginning in the mid-1980s, US shrimp trawler fishermen were required to carry turtle excluder devices

[29] Following introduction of this resolution, Japan, Korea, and Taiwan all abandoned their driftnet fishing practices (Carr and Sheiber 2002, p. 65).

[30] In 1990, the United States imposed an embargo on imports of Mexican tuna. This action was subject to a series of GATT dispute settlement challenges, which the US government lost. See discussion below, at pp. 514, 521–3.

(TEDs) to prevent turtles from drowning in their nets. Because US fishermen believed that these methods placed them at a competitive disadvantage, they collaborated with environmental groups to compel Congress to embargo shrimp imports by states whose vessels did not use TEDs.[31] Thus, the US sought to promote conservation but not at the expense of its own opportunities on the high seas (Vigneron 1998, p. 596; Carr and Scheiber 2002, pp. 63–6; Ardia 1998, p. 563).

The coastal states quickly established and maintained a unified front. Immediately after the establishment of the Conference on Straddling Fish Stocks and High Migratory Fish Stocks, Canada hosted a meeting in which the coastal states coordinated their positions (Vigneron 1998, p. 595). This unity, combined with leverage derived from their control over EEZ fishing, allowed the coastal states to pressure the distant-water fishing states to adopt measures that would restrict their high-seas fishing activity despite UNCLOS' pronouncement of the freedom of the high seas.

The result was the 1995 United Nations Agreement on the Implementation of the Provisions of the UN Law of the Sea of 10 December 1982 Relating to Conservation and Management of Straddling Fish Stocks and High Migratory Fish Stocks (the Fish Stocks Agreement). The Fish Stocks Agreement managed to extend jurisdiction over high seas to areas that are 'compatible and coherent' with the protection of certain straddling and migratory stocks (Wolfrum et al. 2000, p. 240). The final agreement is asymmetric in the sense that it strikes a balance favored by coastal states and places greater restrictions on fishing than was preferred by distant-water fishing states. There is no evidence that coastal states made side-payments to induce commitment by distant-water fishing states. Under Article 7-2(a), distant-water fishing states are bound to not take actions on the high seas that would undermine conservation measures enacted by coastal states. By contrast, Article 7-2(b) merely requires coastal states to take previous high seas measures into consideration when they formulate their own conservation and management measures (Vigneron 1998, pp. 598–9).

The agreement stipulates that regional organizations will coordinate management policies for the high seas. Article 8(3) provides that states must either join a regional organization or agree to abide by the conservation measures established by that organization. Article 8(4) excludes states that are not members of the relevant regional fishing organization from fishing for the relevant fishing resources. Where there is no existing regional organization,

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[31] In 1998, the WTO invalidated US administration of the law but later ruled that subsequent administration efforts were WTO-consistent. See discussion below at pp. 521–2.

Article 8(5) states that 'relevant coastal states and states fishing on the high seas for such stock . . . shall cooperate to establish such an organization'. The coastal states also managed to obtain detailed clauses regarding mandating transparency for non-governmental organizations. The distant-water fishing states succeeded in leaving the regional organizations with some autonomy to set their own standards, even though the coastal states favored using their leverage at the talks to secure as many minimum international standards as possible. However, the lack of a firm mandate for the standards in regional organizations was not important to the US government, because the access to its market provides enough leverage to dominate regional organizations (Vigernon 1998, pp. 599–600; Wolfrum et al. 2000, pp. 240–41).

To facilitate compliance, the agreement provides for increased information collection and increased inspection powers for regional organizations to mitigate the effects of lax flag-state enforcement. It also increases the duties of flag states. Article 14 obligates states to provide comprehensive data relevant to straddling stocks and migratory fisheries. Article 21 allows any member of a regional organization to inspect any vessel belonging to another party-state (whether or not the flag state is a member of the particular regional organization) that is located within the regional organization's territory for the purpose of ensuring compliance. Article 18 contains numerous requirements for the licensing and regulation of vessels flying that country's flag. Article 33 limits the contravening behavior of non-parties by stating that all parties have the obligation to 'deter the activities of vessels flying the flag of the non-parties which undermine the effective implementation of this Agreement'. As of 13 August 2004, there were 52 parties to the Fish Stocks Agreement, including the European Union and the United States, but many distant-water fishing states – including Japan and China – had not ratified the Agreement.

To date, the results of the Agreement have been mixed. The Agreement failed to address an important source of the overfishing problem: fish subsidies regimes among developed states. Fish subsidies have favored the continued growth of the fishing industry to over 4 million boats despite stagnant yields (Eichenberg and Shapson 2004, p. 590). Experts estimate that subsidies account for as much as 20–25 per cent of the commercial fishing industry's annual revenues (Schorr 1999, p. 144). Although Pacific Rim nations have made this a priority trade issue, the United States and EU have historically opposed addressing fisheries subsidies within the WTO regime.

In addition, the increased number of open registries threatens to diminish the effectiveness of the agreement. Because none of the 32 open registry states have signed any of the major international agreements on high seas activity, the increase in vessels flying the flags of these states is seen by some as an ominous sign (Warner-Kramer 2004, p. 501).

Nonetheless, the Fish Stocks Agreement has produced some positive

results for an area once believed to be impossible to regulate. In recent years, there has been a 'perceptible slowing' of the trend towards fisheries depletion (Carr and Scheiber 2002, p. 77). In 2000, pursuant to the Agreement, 25 Pacific states, including the United States, concluded a regulatory regime for the Pacific: the Convention on the Conservation and Management of Highly Migratory Fish Stocks in the Western and Central Pacific Ocean. Article 9 of this Convention entrusts a commission with the power to determine the acceptable level of fishing and establish mechanisms to ensure cooperation. In 2002, pursuant to the Fish Stocks Agreement, the EU passed two relevant regulations: Regulation EC No. 2371/2002 calls for multi-annual management and recovery plans for fisheries, and Regulation EC No. 2347/2002 establishes access requirements for deep sea waters designed to limit fishing efforts. By the end of 2004, there were almost 30 international fishery organizations (Kiss and Shelton 2004, pp. 404–7).

In short, the power of coastal states has established an international basis for protection of global fisheries.

3. International agreements on air pollution and climate change

Initiatives to address global air pollution and climate change have resulted in two significant agreements, the Montreal Protocol and the Kyoto Protocol. The former agreement, which resulted from US-European coordination to use side-payments (in the form of financial assistance) and coercion (in the form of market leverage) to garner the support of developing countries, enjoys nearly global adherence and has been effective at substantially reducing the production and use of ozone-depleting substances. In contrast, the Kyoto Protocol embodies an approach to stemming global climate change that has split the world's two most powerful economic actors, the United States and the EU, so while the EU is a party to the agreement, the United States is not and the regime is ineffective.

3.1. The Montreal Protocol

The ozone layer, a sheet of O3 molecules, furnishes protection against the sun's ultraviolet radiation and against increases in the temperature of the stratosphere (Sands 2003, p. 343). Man-made emissions of inert gases, most notably chlorofluorocarbons (CFCs) and halons, rise to the ozone layer where ultraviolet rays break them down.[32] The decomposition of these CFCs and halons yield free chlorine and bromine, respectively, both of which erode the

[32] CFCs are used commonly as refrigerants, air conditioner coolants, aerosol-spray cans, styrofoam production (Sands 2003, p. 343), and solvents for cleaning electronic parts (Wettestad 2002, p. 156).

ozone layer. Scientists have shown that this erosion can cause harm to both human health and marine organisms.

In the mid-1970s, two groups of American scientists connected the emissions of CFCs with the erosion of the ozone layer. By the end of the 1970s, this issue attracted enough attention to be placed on the agenda of the UNEP and the World Meteorological Organization (Wettestad 2002, pp. 155–6). In 1985, the Vienna Convention for the Protection of the Ozone Layer was concluded, establishing a duty to cooperate on legal, technical, and scientific assessments,[33] and providing for exchange of information[34] (Kiss and Shelton 2004, p. 575). Article VIII provided the Conference of the Parties with the right to adopt Protocols.

After the Vienna Convention, the UNEP and the World Health Organization (WHO) published reports indicating serious dangers of continued trends in the production of CFCs (Kiss and Shelton 2004, p. 575). In 1987, the parties gathered in Montreal to sign a protocol that would be repeatedly amended to become increasingly stringent. The 1987 version stipulated that industrial countries would reduce their CFC emissions by 50 per cent by 1998 and halt halon production by 1992 (Kiss and Shelton 2004, p. 576). The Protocol entered into force on 1 January 1989. Article 7 of the Protocol constituted a compliance regime built on transparency alone: parties must report on production, imports, and exports of all controlled substances (Sands 2003, p. 356).

At the time of the first meeting of the parties in May 1989, new information indicated that ozone depletion was two to three times worse than previously thought. By the 1990 London Conference, the United States had succeeded in persuading the EC to declare it would eliminate CFCs by 2000 and would join the United States in agreeing to provide financial assistance to developed countries in order to support their compliance. India received a side-payment, commonly valued in India at $40 million, to agree to phase out the use of certain CFCs (Herring 1998). In 1992, the parties advanced the dates for industrial countries to eliminate halons (by 1994), CFCs (by 1996), methyl chloroform, and carbon tetrachloride. By 1996, the parties had agreed to eliminate methyl bromide production in industrialized countries by 2010, an expedited elimination of HCFCs in industrial countries, and their elimination in developing countries by 2040 (Kiss and Shelton 2004, pp. 576–7; Wettestad 2002, p. 159).

[33] See Annex I and Article II of Vienna Convention for the Protection of the Ozone Layer, 26 ILM 1529 (1985).

[34] See Annex II and Article IV of Vienna Convention for the Protection of the Ozone Layer, 26 ILM 1529 (1985).

In 1999, the Protocol's member-states strengthened the compliance regime by banning the importation and exportation of restricted products listed in Annex C from both member and non-member states. In 2001, the member-states passed a measure that requires them to request that private industry cover costs of the potential harm caused to ozone by new substances (Kiss and Shelton 2004, p. 578).

As a result of US–EU coordinated use of carrots and sticks to bring the world on board, the Montreal Protocol has been one of international environmental law's greatest global successes. From 1988–95, the annual production of the most menacing ozone-depleting substance, CFCs, had decreased by 76 per cent (Kiss and Shelton 2004, p. 579).

3.2. Division among the powerful: climate change and the Kyoto Protocol

Global warming is a climate trend that describes the trapping of the sun's radiation in the atmosphere by the emission of greenhouse gases (GHGs),[35] which has resulted in an increase of the global temperature over the decade of the 1990s of 0.5–0.9 degrees Celsius (Breidenrich et al. 1998, p. 315, fn. 3; Oberthur and Ott 1999, pp. 6–7; Victor 2001, p. 10).[36] Since the industrial revolution, the atmospheric concentration of carbon dioxide has increased by almost 30 per cent (Oberthur and Ott 1999, p. 7). This increase can be attributed largely to human activities, particularly the use of fossil fuels[37] to provide electricity and to power engines. The resulting warming trend has strengthened to the point that the decade of the 1990s was the fastest warming period in the last two millennia.[38] The continued acceleration of this warming trend[39] would likely precipitate negative changes in weather patterns, leading to increased desertification, disease, and floods. The Intergovernmental Panel on

[35] Greenhouse gases include carbon dioxide, nitrous oxide, methane, sulfur hexafluoride, hydrofluorocarbons and perfluorocarbons. Carbon dioxide emissions alone account for 70–72 per cent of the greenhouse effect and comprised 82 per cent of the GHG emissions by industrialized countries in the early 1990s (Breidenrich et al. 1998, p. 315, fn. 3; Oberthur and Ott 1999, pp. 6–7).

[36] For a brief summary of skeptical views on the certainty of global warming, see Murkowski 2000, pp. 347–8.

[37] The main fossil fuels are oil, coal, and gas, all of which emit carbon dioxide.

[38] The increase in temperature is all the more impressive because there was a period of global cooling from 1945–70 that may be attributed to the dimming of the sun or an increase in aerosol production resulting from volcanic and industrial activity (Victor 2004, p. 10).

[39] A recent study, sponsored group of scientific experts on the United Nations-sponsored Intergovernmental Panel on Climate Change (IPCC), projected that current emission trends mean a likely increase in the global mean temperature in between 1.4 and 5.8 degrees Celsius by 2100 (Browne 2004, p. 22).

Climate Change (IPCC) concluded that it is necessary to reduce human emissions by 60 per cent from their 1990 levels to avoid worsening the atmospheric concentrations of GHGs (Houghton *et al*. 1990, p. xxxvi).

Early multilateral efforts to address global warming Multilateral efforts to control climate change began in 1988, when the UNEP created the IPCC to assess trends in climate change. In 1992, the IPCC's above-mentioned findings regarding the need for sharp emissions reductions led to the United Nations Framework Convention on Climate Change (UNFCCC).[40] The 155 participants called for stabilizing the level of GHG concentrations in the atmosphere. The Convention urged all the countries listed in Annex I (mostly developed countries)[41] to take actions to limit human-induced GHG emissions. In April 1995, the UNFCCC signatories signed the Berlin Mandate, which stipulated that the Annex I countries would 'elaborate policies and measures, as well as set quantified limitation and other reduction objectives within specified timeframes' such that they would bring GHG emissions back to their 1990 levels.[42] In December 1995, the IPCC's Second Assessment Report emphasized the need for action by declaring 'the balance of evidence suggests that there is a discernible human influence on global climate' and that states could adopt measures to combat this trend.

The Kyoto negotiations In December 1997, representatives of over 160 states gathered in Kyoto, Japan to commit to halting human-induced climate change. Almost from the outset, the United States and a handful of other countries were isolated by the EU, former Eastern Bloc countries, and developing countries, which demanded a formula whereby most of the costs of GHG emissions reduction would be borne by the United States and a handful of other smaller developed countries. Under that formula, which was putatively consistent with the Berlin Mandate, 1990 was to be used as the base year for establishing maintenance and reduction commitments.

In 1990, the European Union accounted for 24.2 per cent of the carbon dioxide emissions from industrialized countries (Oberthur and Ott 1999, pp. 15–16).[43] At that time, these emissions had been expected to increase another 5–6 per cent by 2010. However, by the time of the Kyoto negotiations in 1996,

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[40] United Nations Framework Convention on Climate Change, 31 ILM 849 (1992) (entered into force 21 March 1994) (hereafter UNFCCC).

[41] The Annex I group is commonly referred to as the 'developed countries' and includes members of the OECD and some states located in the former Eastern Bloc.

[42] FCCC Conference of the Parties, 1st Sess., UN Doc. FCCC/CP/1995/7/Add.1, Decision 1/CP.1 (6 June 1995).

[43] This amounted to 15–16 per cent of the global emissions of carbon dioxide.

the reunification of Germany and the privatization of the British energy industry had led to respective emissions reductions of 10 per cent and 5 per cent from their base year levels.[44] The EU's dependence on imported fossil fuels also created a strong incentive to adopt conservation measures. Furthermore, EU industry was not an impediment: the protocol figured to benefit a large portion of European industries that had already undertaken commitments to reduce emissions.[45] The business community generally supported further reduction commitments as long as they were also applied to other industrialized countries. The fact that Green Parties had achieved parliamentary representation in over two-thirds of the EU member-states indicated public support for environmental measures (Oberthur and Ott 1999, p. 16). These environmentally favorable circumstances enabled the European Union to adopt an ambitious negotiating position that called for a mandatory 15 per cent reduction of 1990 emissions levels by 2010. Although the EU requested permission for 'internal differentiation', a scheme whereby different EU Member States could commit themselves to different levels of reductions as long as the EU as a whole met its assigned target, it did not support this policy outside the EU.[46] The EU proposed that developing countries should not undertake any new commitments (Schroder 2001, pp. 32–3).

The developing countries supported the European position, asserting that they should not be required to make any reduction commitments as the Berlin Mandate did not require them to agree to any reductions. Developing countries comprise three-fourths of the world's population and account for less than one-third of all carbon dioxide emissions (Grubb et al. 1999, p. 113). However, the lack of stringent air pollution standards in these countries and their likely continued economic growth means that their total emissions will surpass those of the developed countries by 2020 (Heller and Shukla 2003, p. 44).[47] By the time of the Kyoto negotiations, the coalition of developing countries known as the Group of 77 consisted of 130 countries, and China, although not a formal member, collaborated closely with it. A large subgroup of these countries maintained a common negotiating position, arguing that they should

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[44] German reunification had led to the closure of many emission-intensive industries in the eastern portion of the country. The British energy privatization led to a shift from coal to gas which is not as emissions-intensive (Grubb et al. 1999, p. 81).

[45] For instance, German industry had already committed itself to a 20 per cent reduction in 1987 levels by 2005 (Schroder 2001, p. 50).

[46] The plan permitted the EU's poorest countries to significantly increase emissions. For instance, Portugal was allocated a 40 per cent increase, Greece 30 per cent, and Spain 17 per cent (Schroder 2001, pp. 33, fn.77, and 50).

[47] China is expected to surpass the United States as the world's top emitter of greenhouse gases in 2020 (Oberthur and Ott 1999, p. 27).

be able to develop without need to address a problem they did not cause, and that no developing country commitment should interfere with their sovereignty over their natural resources (Oberthur and Ott 1999, pp. 24–7). The G-77 supported the EU's proposal that called for 15 per cent reductions from 1990 levels among Annex I states and opposed all flexibility mechanisms that would soften the economic costs of complying (Grubb 1999, pp. 58–9).

The states within the Former Eastern Bloc accounted for 17.4 per cent of global emissions in 1990. The closure of many vastly inefficient and energy-intensive enterprises had led to significant reductions in emission totals by 1997. Russia's carbon dioxide emissions had fallen by 30 per cent since 1990. Because these states were unlikely to approach their 1990 emission levels any time in the near future, any agreement that used 1990 as the baseline year and permitted emissions trading would allow these states to reap a financial windfall. Russia could earn as much as $3 billion annually from selling emissions credits. Hence, these countries also generally supported the EU position (Oberthur and Ott 1999, p. 21; Yandle and Buck 2002, p. 223).

The United States, which accounted for 35 per cent of the total carbon dioxide emissions of industrialized countries in 1990 (Oberthur and Ott 1999, p. 18), found it impossible to agree to the formula supported by the EU and most other countries. First, by the time of the 1995 negotiations, US emissions had already increased significantly since 1990.[48] Moreover, half of the emissions in the United States were from products that had a life-expectancy of at least 25 years, meaning that reversing the upward trend in emissions by 2008 would be impossible without seriously disrupting the economy. More broadly, the low cost of cheap fossil fuels within the United States has led to an energy-intensive lifestyle that has reduced the incentive for conservation. The existence of a large domestic fossil fuel industry created another loser from energy conservation (Victor 2004, pp. 3–4; 30–37; Grubb et al. 1999, p. 31).

In 1997, as the Kyoto negotiations were approaching their conclusion, a US domestic lobbying effort against the Kyoto formula began in earnest. A business lobby consisting of fossil fuel and other industrial companies launched a $13 million advertising campaign against the Kyoto Protocol, arguing that it would leave the US companies at a competitive disadvantage against developing countries. The industrial lobby also began to shadow the US delegation at climate conferences (Schroder 2001, p. 48). Shortly before conclusion of the Kyoto Protocol, the US Senate passed the Byrd-Hagel Resolution by a 95–0 margin,[49] making approval of any binding commit-

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[48] At close of 1990s, US emissions were already 15 per cent above 1990 levels and rising at 1.3 per cent annually (Victor 2004, pp. 3–4).

[49] The Byrd-Resolution can be located at: S. Res. 98, 105th Cong. (1997).

ment on the United States dependent upon a reciprocally binding commitment on developing countries.

These economic and political realities meant that the United States required a more flexible approach to meeting any potential obligations. The United States proposed a binding target to reduce emissions to 1990 levels by 2008–12, subject to flexibility mechanisms that would have provided alternative channels to gain emissions credits (Schroder 2001, p. 39; Grubb et al. (1999), pp. 89–96, 133–6). The proposed flexibility mechanisms included a joint implementation rule, a clean development mechanism that included an emissions trading scheme, and credit for carbon sinks (natural resources that recapture carbon from the atmosphere).[50] Furthermore, the Byrd-Hagel Resolution meant that the United States needed to secure some commitments from developing countries.

The United States had formed an informal coalition with a group of other developed countries consisting of Japan, Switzerland, Canada, Australia, Norway, and New Zealand. The goals among members of this coalition, known as JUSSCANZ, were not completely compatible, but these states were all committed to avoiding unduly harsh reduction commitments. Together the JUSSCANZ states accounted for 14.7 per cent of the carbon dioxide emissions among developed countries in 1990 (Oberthur and Ott 1999, pp. 15–18, 21).

States were not the only participants in the negotiations. An estimated 250 NGOs were observers in Kyoto. Business NGOs lacked a monolithic position. Although ‘gray’ groups that favored substantial flexibility were represented, other business NGOs such as the World Business Council for Sustainable Development and much of the insurance industry sided with environmental interests. Although differences existed among the ‘green’ NGOs, these NGOs remained committed to presenting a coordinated position. Representatives from these groups formally intervened in negotiating sessions, attended informal contact group meetings, and gained access to diplomats. Environmental NGOs also made strong efforts to involve the media by organizing press conferences and providing background materials. In turn, these media reports increased public support for an agreement (Oberthur and Ott 1999, pp. 31–2, 76; Carpenter 2001, p. 319).

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[50] Joint implementation would permit industrial countries to obtain credit for implementing climate protection measures abroad in other Annex I countries. The clean development mechanism would permit reductions for activities similar to joint implementation in non-Annex I countries. Carbon sinks are processes such as reforestation, afforestation, and land-use changes that result in the recapture of carbon from the atmosphere. Emissions trading is the process where a country that has not used its emission allotment can sell its unused portion to a country that has exceeded its allotment (Grubb et al. 1999, pp. 89–96, 131–2; Sands 2003, p. 374.)

Thus, the negotiating states involved found themselves under increased public pressure to reach an agreement. The alliance between the European Union, the countries in transition, and the developing countries capitalized on the increased external pressure to present the United States with an agreement that failed to meet the standards of the Byrd-Hagel Resolution. US representatives admitted that their fear of being held responsible for a failure in the Kyoto negotiations compelled them to sign the agreement (Schroder 2001, p. 92). The agreement contained some flexibility mechanisms, most notably the clean development mechanism, an emissions trading scheme that could take pressure off the North's pace of emissions reduction, and that could be seen as a side-payment to the South by virtue of technology transfer provisions and the likelihood of paying developing countries for emissions credits. Yet the United States suffered fatal defeats on other issues in the Protocol. In order to assure a 5 per cent global reduction in emissions by 2012, the agreement provided that the United States would reduce its carbon dioxide emissions by 7 per cent of its 1990 levels, which would have required a 25 to 30 per cent reduction in projected emissions levels (Schelling 2002, p. 3). While the EU agreed to an 8 per cent reduction for itself, it was already within range of those levels due to the above-mentioned changes in emissions among these economies since 1990 (Yandle and Buck 2002, p. 221). Furthermore, the EU was allowed to continue to pursue 'internal differentiation', but other states were not permitted to do so. Developing countries have no reduction commitments. The treaty was to enter into force upon the ratification of at least 55 countries including Annex I parties which collectively account for at least 55 per cent of the emissions among developing countries.[51]

Post-Kyoto negotiations and entry into force At the Hague Summit in November 2000, the signatories gathered to discuss outstanding issues, especially those relating to flexibility mechanisms. Carbon sinks became the focus of disagreement between the EU and United States. The United States requested credits for 20 per cent of the 288 million tons of carbon dioxide that its forests absorb annually. NGOs and the majority of developing countries supported the EU's stance of opposing significant crediting for carbon sinks. (Yandle and Buck 2002, p. 221; Grubb and Yamin 2001, pp. 264, 271–2).

The failure to obtain more favorable terms for the use of flexibility mechanisms left the United States with a costly agreement. The US Department of Energy reported that the implementation of the Kyoto Protocol would cause US gas and electricity prices to increase by 53 per cent and 86 per cent, respectively, by 2010 (Energy Information Administration 1998). Labor unions

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[51] Kyoto Protocol, Art. 25.

opposed the agreement on the expectation that it would lead to job losses in seven figures (Yandle and Buck 2002, pp. 202–3). In March 2001, President George W. Bush cited the high costs of participation to justify US withdrawal from the treaty process.

The remaining countries subsequently finalized outstanding details. Given the requirement that the treaty's signatories must account for at least 55 per cent of the industrialized countries' emissions for the treaty to enter into force, the absence of the United States forced the EU to make concessions to both Japan and Russia. In May 2004, the EU received a promise from Russia to ratify the treaty in exchange for the EU's endorsement of Russia's attempt to join the World Trade Organization. In late 2004, Russia ratified the treaty and submitted its ratification documents to the United Nations, triggering the Protocol's entry into force in February 2005.

The resulting agreement will be of limited effectiveness, at best. Without US participation, the deepest GHG reductions that can be expected by 2010 (compared to their 1990 levels) is a 2 per cent decline in the GHGs of parties to the agreement – yet without commitments for developing countries, the anticipated emissions growth in China and India alone will increase global greenhouse emissions by 75 per cent by 2020. (Macher 2004, p. 17). Moreover, as of the end of 2004, Canada, Japan, and most EU countries were not on target to meet their obligations, and they were likely to acquire credits from Russia through the Protocol's emissions trading scheme rather than incur the political costs of reducing emissions. Moreover, the Protocol lacks enforcement mechanisms and clear sanctions for countries that fail to meet their obligations (Victor 2001, p. 55). While the Kyoto Protocol has been used by many NGOs and countries to critique US international environmental policy, it is based on a politically divisive and unviable formula and it will not be effective at achieving its purported objectives.

4. Trade and the environment[52]

Trade-environment issues have been part of the international law landscape since at least as early at 1947, when US trade negotiators included in the draft GATT a set of provisions intended to permit trade restrictions that would be necessary to protect the environment. They moved toward the center of environmentalist NGOs' concerns in the late 1970s, when trade measures intended to protect the environment were embedded in agreements such as CITES. However, it was not until the late 1980s that trade-environment issues became particularly potent in the United States and Europe (Esty 1994). At that time,

[52] For elaboration of the points made in this Section, see Steinberg (1997 and 2002).

the EU adopted its Beef Hormones Directive,[53] discussed below, based partly on purported environmental and consumer concerns, leading to mobilization of the US beef industry, which claimed protectionism. At the same time, a series of GATT/WTO dispute settlement decisions relating to the environment mobilized environmental NGOs, which were further energized by concerns over the substance of agreements being negotiated in the GATT's Uruguay Round of trade negotiations.

After describing the core trade-environment issues, this section will analyze the politics behind and outcome of two significant trade-environment agreements, the Basel Convention and CITES, and then consider trade-environment politics in the world's three most important trade-related organizations – GATT/WTO, NAFTA, and the EU.

4.1. Core issues

Since the late 1980s, trade negotiators and environmentalists have considered a host of trade-environment issues, including fisheries subsidies (discussed above), tariffs on 'green' environmentally sound products (e.g., solar energy products), and the impact of trade liberalization on the global scale of consumption (Charnovitz 1994). However, the core of the debate has centered on two sets of issues: the legality of using import restrictions to protect the domestic environment, and the legality of using trade measures to influence activity affecting the environment located outside the jurisdiction of the country employing the measures.

Domestic health, safety, and environmental protection International trade organizations grapple with the tension between free trade and the desire of national governments to maintain domestic health, safety, and environmental standards. Environmentalists, consumer advocates, and labor unions often argue that liberalization increases the threat posed by imports to domestic health and safety standards, as imports with unsafe or dirty characteristics will face fewer trade barriers. To what extent may a country restrict imports for reasons related to protection of the environment within its territory?

Many who champion free trade are concerned that environmental regulations on international trade may be protectionist measures dressed up as 'environmental' measures. Such measures may garner domestic political support from what have been called 'Baptist-Bootlegger' coalitions of environmentalists and protectionists (Yandle 1983; DeSombre 1995). Serious US govern-

[53] Council Directive 96/22/EC of 29 April 1996, concerning the Prohibition on the Use in Stockfarming of Certain Substances Having a Hormonal or Thyrostatic Action, 1996 OJL 125, 3.

ment attention has been focused on European trade measures that have been supported by such coalitions. The EU's Beef Hormones Directive, which bans the European importation of beef from hormone-treated cattle, and the EU's *de facto* moratorium on the approval for sale of products containing genetically modified organisms (GMOs), are examples of such measures.

While protectionists often have a hand in measures like these, most governments want to be permitted to ban the importation of goods embodying standards that do not meet their chosen level of domestic environmental protection, as well as products embodying untested chemicals or genetically modified structures until they have completed scientific assessments of any potential risks posed by those products. In addition, most governments want to permit the eco-labeling of products so as to provide accurate and meaningful information to consumers about the potential environmental impacts of the products.

Trade measures aimed at extrajurisdictional activity: endangered species, foreign pollution, and the 'race to the bottom' At the same time, many governments have expressed concern about activities affecting the environment that take place outside their jurisdiction. For example, several US statutes[54] and multilateral environmental agreements (MEAs) to which the United States is a signatory[55] are aimed at restoring populations of endangered or threatened species, or managing populations of other species, that inhabit territories outside the United States by means that affect the activities of persons who are not US nationals. And some of those statutes and MEAs require parties to impose import restrictions or prohibitions to achieve their ends. Some commentators and activists are concerned about lax environmental standards in jurisdictions outside the United States, for moral reasons or because of associated negative externalities. In addition, some fear that goods will be increasingly produced in and imported from countries imposing less stringent production and processing methods (PPMs)[56] because *ceteris*

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[54] See, for example, African Elephant Conservation Act, Title II of the Endangered Species Act Amendments of 1988, PL 100–478; Marine Mammal Protection Act, 16 USC Sec. 1361 ff; Pelly Amendment to the Fisherman's Protective Act, PL 92-219 (1971); and Sec. 609 of PL 101-62 (1989) (generally prohibits imports of shrimp or shrimp products 'which have been harvested with commercial fishing technology that may affect adversely such species of sea turtles' protected under the US Endangered Species Act).

[55] For example, CITES, described beginning at p. 516.

[56] The OECD Secretariat defines PPM standards as standards that 'specify criteria for how a product is manufactured, harvested, or taken. They encompass emission and effluent standards, certain performance or operations standards, and practices prescribed for natural resource sectors. Terms such as "made with", "produced by" and

paribus goods are less expensive to produce under such conditions; many fear that this could cause industrial flight to such countries and place downward pressure on the stringency of environmental rules worldwide – a 'race to the bottom' (Stewart 1977; Esty and Geradin 2001). Empirically, it has proven difficult to confirm the hypothesis that firm locational decisions are affected by the stringency of environmental measures or that there is, in fact, a race to the bottom (Anderson and Kagan 1997). Nonetheless, many find the argument theoretically compelling and some anecdotal evidence is consistent with the hypothesis.

At the same time, sovereignty suggests that states have an exclusive legal right to control activities within their own jurisdiction (Steinberg 2004). This principle has been used to argue that a country may not restrict the importation of a product on the basis that it was made in a jurisdiction that requires less stringent PPMs.[57] Most developing country governments fear that affluent countries may use such extrajurisdictional measures to effectively coerce them into raising their environmental standards to levels that will slow their economic development.

4.2. The Basel Convention

A *sui generis* regime, the Basel Convention, exemplifies some of the tensions inherent in trade regulation intended to help governments protect their domestic environment. The transportation of toxic waste from one country to another has been a common method of transferring the costs of pollution (Kiss and Shelton 2004, pp. 606–7). Insofar as hazardous waste has been exported, it has tended to move from developed to developing countries (Wolfrum et al. 2000, p. 410). By 1990, 10 per cent of the waste generated in OECD countries was transported across the border (Kiss and Shelton 2004, p. 607). The 1990s bore witness to several accidents involving the illicit dumping of waste in developing countries (Sands 2003, p. 690).

In the mid-1980s, environmental NGOs from Europe and the United States

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"harvested by" signify a PPM standard . . . All PPM standards apply to the production stage, i.e., before a product is placed on the market for sale. These standards specify criteria for how a product is produced or processed. However, the PPM standard may address the environmental effects of a product all during its life-cycle, i.e., effects which may emerge when the product is produced, transported, consumed or used, and disposed of'. *Typology of Trade Measures Based on Environmental Product Standards and PPM Standards: Note by the Secretariat*, Joint Session of Trade and Environment Experts, OECD Environment Directorate and Trade Directorate, COM/ENV/TD(93)89 (28–30 September 1993).

[57] For example, this argument was advanced in 'United States–Restrictions on Imports of Tuna', Report of the Panel, DS21/R (unadopted), dated 9 September 1991, 39S/155 (hereafter Tuna I).

joined some developing countries, largely from Africa, to advocate the passage of a categorical ban on the international transport of hazardous waste (Wolfrum et al. 2000, p. 413). However, some other developing countries opposed such a ban, arguing that each sovereign state should be permitted to decide whether to import hazardous waste – whether to take payment for the import and bear the associated costs.

In 1989, broad international agreement was reached on the topic, when 116 states adopted the Basel Convention. The Convention defines hazardous waste as any substance or material generated in any one of 18 'waste streams' and lists 26 substances that are hazardous regardless of whether they flow in a waste stream (Wolfrum et al. 2000, p. 412). The Convention contains general obligations to minimize both the generation of the relevant waste and its transboundary movement, and permits exports of the covered materials only if the exporting state lacks the capacity for environmentally sound disposal, the waste is required as a raw material for recycling or recovery in the importing state, or according to other criteria decided by the parties. The heart of the agreement is a system of prior informed consent which stipulates that the exporter must provide advance notification to the government of the importing state and any transit state, transportation though a party-state requires its permission, and the exporting country must accept the return of the waste if requirements for transboundary movement of waste are not met. Article 11 allows for more stringent bilateral agreements as long as they are at least as environmentally friendly as those terms in the Convention, and Articles 12 and 13 list detailed reporting requirements intended to foster compliance (Sands 2003, pp. 692–4).[58] By 2000, 39 states had prohibited the importation into or

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[58] In December 1995, the parties to the Convention adopted Decision III/1. This decision, which is also known as the Ban Amendment, would prohibit the exports of hazardous waste from Annex VII countries (the EU and OECD states plus Liechtenstein) to non-Annex VII countries for the purposes of final disposal and recycling (Kiss and Shelton 2004, p. 609). This amendment will become effective after ratification by three-quarters of the members present at the time that the amendment was adopted. As of the end of 2004, about one-third (49) of the necessary ratifications had been secured and the United States had not yet ratified the Amendment.

In 2002, the parties developed guidelines for a liability protocol, which would establish strict liability for any person in control of the hazardous waste 'from the point where the wastes are loaded on the means of transport in an area under national jurisdiction of the state of export'. Art. 5 of the Protocol allows the establishment of fault liability in the event that intentional, reckless, or negligent acts or omissions lead to violation of the Convention. This Protocol will enter into force after 20 countries have ratified it. Currently, there are 13 signatories and three ratifications (Kiss and Shelton 2004, p. 610; Sands 2003, p. 925). The Secretariat's list of signatories and ratifications is available at http://www.basel.int/ratif/frsetmain.php#protocol. The United States has neither signed nor ratified the Protocol.

transshipment through their territories of transboundary waste (Kiss and Shelton 2004, p. 607).

4.3. Convention on International Trade in Endangered Species

CITES exemplifies many of the tensions inherent in a *sui generis* regime that uses trade measures to combat extrajurisdictional activity that is environmentally degrading. Some reputable scientists predict that up to 50 per cent of species alive in 2000 will become extinct by the end of the 21st century. The principal cause of this threat involves human activity that is destroying natural habitats. However, some species are also threatened by human hunting for their by-products such as hides, furs, and ivory. Experts appraise the likely retail value of the commercial wildlife trade at close to $50 billion, much of it in luxury goods such as fur coats (Reeve 2002, pp. 7–8; Kiss and Shelton 2004, p. 389).

International action to address the problem of species extinction began in the 1950s, when it became apparent that international wildlife trade was threatening wildlife populations (Curlier and Andresen 2002, p. 358). Initial attempts to address this problem were made through regional treaties.[59] In 1963, the General Assembly of the International Union for the Conservation of Nature pressured states to adopt measures to restrict the trade in designated species (Reeve 2002, p. 27). By the 1970s, states such as the United States and United Kingdom had adopted national measures to restrict imports of animals facing extinction,[60] but the lack of an effective international regime rendered their actions largely ineffective (Curlier and Andresen 2002, p. 359).

Establishment of the CITES regime At the 1972 Stockholm Conference on the Human Environment, the state participants passed Resolution 99.3, which called for a conference to create a convention concerning the 'import, export, and transit of certain species of wild animals and plants'. This led to a 1973 conference in Washington, DC, where approximately 80 states, including the United States, met to negotiate an agreement to address the problem. By December 1974, 56 states had signed CITES, which entered into force on 1 July 1975 (Curlier and Andresen 2002, p. 359; Kiss and Shelton 2004, p. 390).

The Western European countries, the United States, Canada, and Australia dominated the negotiations. Almost all wildlife trade is imported by developed

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[59] For example, Article 9 of the 1953 Western Hemisphere Convention, to which the United States is a party, demands permits for the importation or exportation of any protected species (Curlier and Andresen 2002, p. 358).

[60] In 1964, the United Kingdom adopted the Animals Restriction of Importation Act (Curlier and Andresen 2002, p. 358); in 1969, the United States adopted the Endangered Species Conservation Act (Reeve 2002, p. 27).

countries from developing countries, imbuing the developed countries with dominant market power in negotiations to regulate the trade. The United States was influential enough that its draft text served as the working document for the Conference (Kiss and Shelton 2004, p. 389; Curlier and Andresen 2002, p. 359; Reeve 2002, p. 28).

Terms of the Convention The Convention provides protection to species based on the Appendix list on which they appear. Appendix I consists of 'all species threatened with extinction which are or may be affected by trade'. Trade[61] in 'any recognizable part or derivative of a specimen of the listed plant or animal' is authorized only in exceptional circumstances.[62]

Appendix II includes 'all species which although not necessarily threatened with extinction may become so unless trade in specimens is subject to strict regulation in order to avoid utilisation incompatible with their survival'. Commercial trade of such species is permitted if it is not detrimental to the survival of the species and the specimen was not obtained in violation of the exporting state's law. The importation of an Appendix II specimen only requires the presentation of an export permit or re-export certificate (Kiss and Shelton 2004, p. 391; Sands 2003, pp. 508–9).

Appendix III includes 'all species which any party identifies as being subject to regulation within its jurisdiction for the purpose of preventing or restricting exploitation, and as needing the co-operation of other parties in the control of trade'. Trade in such species requires an export permit from the management authority in the exporting state, but the standard for issuance of a permit is set solely by the exporting state (Sands 2003, p. 509).

The Convention also establishes a tracking system to monitor shipments and facilitate compliance with the agreement. Article IV establishes quality control standards for the issuance of permits and nomenclature to be used (Reeves 2002, p. 33; Sands 2003, p. 514).

The Convention resolves the free-rider problem by requiring in Article X

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[61] Art. I(c) defines trade as 'export, re-export, import, and introduction from the sea'.

[62] Article III permits the conferral of an export permit only if: (1) a scientific authority of the exporting state has found that the export will not be detrimental to the survival of the given species; (2) a Management Authority believes that the given specimen was not procured in a manner that violates the given state's protection for fauna and flora; (3) the Management Authority must ensure that any living specimen must be shipped in a manner that minimizes the harm as much as possible; and (4) the Management Authority must be sure that the party in the importing country has obtained the requisite permit. In addition, the importing state's designated scientific authority must assert that the importation is not detrimental to the survival of the species.

that a party-state may import Appendix I or II species from a non-party state only if the goods are accompanied by 'comparable documentation' issued by 'competent authorities' in the exporting state, certifying that the non-party state has (1) made a non-detriment finding, and (2) the specimens in question were not obtained illegally. In order to be deemed 'competent', scientific authorities and institutions must be included in the Secretariat's most recent list of sanctioned non-state party authorities (Reeve 2002, pp. 34–5).[63]

The development and effectiveness of the CITES regime The CITES regime now covers over 33,000 species of fauna and flora. The high-priority Appendix I list has doubled since the Convention entered into force (Kiss and Shelton 2004, p. 390).[64] The CITES Secretariat has proven much stronger and more independent than in most environmental regimes (Curlier and Andresen 2002, p. 367). CITES's transparency and open access structure[65] have allowed conservation-oriented NGOs such as Trade Records Analysis of Flora and Fauna in Commerce (TRAFFIC), the World Conservation Monitoring Center, and the World Wildlife Federation to monitor compliance and enforcement (Sands and Bedecarre 1990, p. 800). TRAFFIC is particularly influential as it collects information on the illicit aspects of the wildlife trade and shares the information with the Secretariat (Reeve 2002, p. 68).

CITES has been effective at establishing the basis for global management of endangered species. Perhaps its most well-publicized success has been reversing the rapid decline of African elephant populations, which in the 1980s were being hunted in unsustainable numbers in order to support a lucrative ivory trade. By the late 1990s, following implementation of CITES rules, African elephant populations were thriving in many countries. Indeed, some African countries were experiencing elephant overpopulation problems, yet

[63] The CITES Convention contains three potentially important exceptions. First, Article VII (2) allows a member-state's management authority to issue a certificate that exempts specimen 'acquired before the provisions of the present Convention applied to that specimen'. Second, parties have the right to register reservations either at the time of ratification or by attaching an amendment to the appendix. Third, a party can register its objections to the listing of an Appendix I or II species up to 90 days after the specimen is added to the list; an objection to an Appendix III species can be listed at any time. If a party registers an objection, it is treated as a non-party in matters concerning the specimen in question.

[64] Some of the more notable species on this list include the tiger, leopard, whale, and various kinds of parrots (Kiss and Shelton 2004, pp. 389–90).

[65] Art. XII empowers the Secretariat to obtain assistance from 'suitable intergovernmental or non-governmental, international, or national agencies or bodies technically qualified in protection, conservation, and management of wild fauna and flora'. Art. XI (7) states that NGOs have the right to participate as observers at meetings.

most developed country governments and even environmental NGOs seemed so captured by popular public support for the plight of elephants that they ignored scientific assessments calling for diminished protection (Kaempfer and Lowenberg 1999; Kiss and Shelton 2004, pp. 395–6; Sands and Bedecarre 1990, pp. 806–16; Curlier and Andresen 2002, p. 370; Reeve 2002, pp. 81–8). By contrast, issues that do not capture as much public attention have been easier to address in a scientifically sound manner. For example, the crocodile was the first instance of downgrading a species from Appendix I to Appendix II. The sustainable use approach to management of the crocodile has led to a constant population; in turn, illegal trade has dwindled (Curlier and Andresen 2002, p. 370).

4.4. International trade organizations

State power and interests on trade-environment issues explain the relative environment-friendliness of trade rules in the world's three most important trade regimes – the WTO, European Union, and NAFTA. Process-tracing shows that in all three organizations, richer countries have been the demandeurs of greener rules; richer countries have used access to their large markets – threats to open or promises to close them – as a source of leverage in trade-environment negotiations; and green trade rules have become more salient in richer countries as integration has deepened. Thus, among the three regimes, trade rules are most environment-friendly in the European Union (because it has the deepest integration and market power has been concentrated in the large countries of northern Europe, most notably Germany), moderately environment-friendly in the NAFTA context (where market power is concentrated in the United States but where there is comparatively moderate integration), and least environment-friendly in the GATT/WTO (which has the least integration and the most diffuse market power structure) (Steinberg 2002). There is nothing inherent in the concept of integration to suggest that deepening integration will lead to more environment-friendly rules; the correlation exists only because of the political dynamic – that environment-friendly rules in a trade regime become more salient to powerful states as integration deepens.

In each of the three regimes, rules on the environment are best seen as a result of both side-payments and coercion. As indicated above, process-tracing shows that within each trade regime powerful states used access to their large markets as a source of leverage in demanding that poorer, weaker states agree to rules that are more environment-friendly that they preferred. Moreover, it is not clear that all states were made better off by accepting the relevant package of rules: in particular, as argued below, some WTO countries may have been made worse off than before by accepting the package of Uruguay Round agreements.

Trade-environment issues in the GATT/WTO Trade-environment rules are less well developed and less environment friendly in the GATT/WTO than in some other trade organizations, such as the NAFTA and the EU.

Three sets of GATT/WTO rules are most relevant to defining the conditions under which a green country can ban imports that threaten the maintenance of its chosen levels of domestic health, safety and environmental protection. First, Article XX – the GATT's 'general exceptions' – allows import bans, discrimination against imports, and other deviations from the GATT's rules in specified circumstances, including some relating to the conservation of exhaustible natural resources and some relating to human, animal or plant life, health or safety. Second, the Uruguay Round Agreement on the Application of Sanitary and Phytosanitary Measures (SPS)[66] covers measures relating to human, animal and plant health and safety in agriculture, including, *inter alia*, pesticide and fungicide tolerances, and inspection rules for meat. Third, the Agreement on Technical Barriers to Trade (TBT)[67] was designed mainly to ensure that technical standards and regulations not addressed by the SPS Agreement are not used for protectionist purposes.

The general rule under the GATT, the SPS Agreement, and the TBT Agreement is that each country may maintain regulations necessary to protect domestic life and health, and conserve exhaustible natural resources, and may determine for itself the level of risk it deems appropriate to embody in its product standards.[68] In general, the importation of products not meeting those standards may be prohibited. Each country may provisionally prohibit imports of goods while national control, inspection and approval procedures (e.g., FDA approval) are under way.[69] These environment-friendly rules are qualified to ensure that they are not used as disguised means of protectionism. Hence, product standards that limit imports must be applied on a most-favored-nation

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[66] The SPS Agreement was concluded as part of the Uruguay Round agricultural negotiations and catalyzed primarily by EU-US rows over health and safety measures relating to beef, wine, and other agricultural products. Agreement on the Application of Sanitary and Phytosanitary Measures, 15 April 1994 (hereafter SPS Agreement).

[67] The TBT Agreement is applied multilaterally through the Uruguay Round Final Act. Agreement on Technical Barriers to Trade, 15 April 1994.

[68] SPS Agreement, 15 April 1994, Arts. 2, 5, Agreement Establishing the World Trade Organization, Annex 1A, in Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Marrakesh, 15 April 1994, p. 69 (hereafter Final Act); Agreement on Technical Barriers to Trade, 15 April 1994, preamble, id. at 17; GATT (hereafter TBT Agreement). See also GATT Dispute Panel, Thailand – Restrictions on Importation and Internal Taxes on Cigarettes, 7 November 1990, GATT, BISD (37th Supp.) (1990), p. 200 (hereafter Thailand Cigarettes).

[69] SPS Agreement, Art. 5.7 and Annex C; TBT Agreement, Arts. 2–4.

(MFN) basis,[70] must be subject to national treatment disciplines,[71] must not 'arbitrarily or unjustifiably discriminate' against imports,[72] and must not be 'more trade restrictive than necessary'[73] to achieve the chosen level of environmental protection.[74] SPS measures either must conform with international standards, guidelines or recommendations – in which case they are deemed WTO-consistent – or must not be maintained 'without sufficient scientific evidence' of a relationship to the harm to be avoided.[75]

This balance may be considered friendly to the environment within the jurisdiction of a WTO member with relatively stringent environmental standards, inasmuch as members can generally ban imports that would undermine their domestic environmental protection. However, qualifications of that right may be used to attack the WTO legality of national environmental laws, as the decision in the WTO Beef Hormones case[76] has shown. Moreover, the GATT/WTO approach will not likely increase environmental protection in countries with relatively weak standards to the same extent that harmonization at a high level of protection would.[77] The net result of these GATT/WTO rules will be maintenance of, but little improvement in, the level of global environmental protection.

The GATT/WTO dispute settlement system has never fully condoned a challenged trade restriction aimed at extrajurisdictional environmental activity.

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[70] SPS Agreement, Art. 2.3; TBT Agreement, Art. 2.1.

[71] SPS Agreement, Art. 2.3; TBT Agreement, Art. 2.1.

[72] SPS Agreement, Art. 2.3; TBT Agreement, preamble.

[73] SPS Agreement, Art. 2.2; TBT Agreement, Art. 2.2. The SPS Agreement uses the word 'necessary', while the TBT Agreement uses the word 'required'. See also GATT, Art. XX; Thailand Cigarettes.

[74] A footnote in the SPS Agreement clarifies the meaning of this language: to challenge an import restriction successfully under this language, the challenging party must show that another measure that would achieve the same level of protection is 'reasonably available' and would be 'significantly less restrictive to trade'. SPS Agreement at n. 3.

[75] SPS Agreement, Art. 2.2.

[76] 'European Communities – Measures Concerning Meat and Meat Products (Hormones), Report of the Appellate Body', adopted on 13 February 1998, WTO Doc. WT/DS26/AB/R, WT/DS48/AB/R.

[77] The GATT/WTO approach may nonetheless result in some upward harmonization via two means. First, the SPS Agreement regards conformity to international standards as GATT-consistent, creating an incentive for poor countries that cannot afford testing simply to default and choose the international standard, which is generally more stringent than current developing country standards. Second, the right of wealthy green countries to ban imports that do not conform to their relatively stringent standards is likely to create market pressures on developing countries to produce products for export that meet those higher standards. On this latter point, see David Vogel (1995).

Developing countries have consistently opposed a right of importing countries under the GATT to impose any trade restriction or duty surcharge on goods produced in countries with less stringent PPMs. In addition, there has been no agreement to harmonize PPMs at a high level of environmental protection. GATT Article XX provides exceptions to the GATT's liberal trade rules, including actions necessary for the protection of human, animal or plant life or health,[78] or the conservation of exhaustible natural resources.[79] Those provisions were interpreted, in the Tuna II decision,[80] to permit import restrictions for the protection of health or exhaustible natural resources only within the national jurisdiction of the importing party.[81] That decision suggested that it would be GATT-illegal to apply CITES to goods exported from a GATT contracting party that was not a party to CITES. However, by 2005, less than a dozen WTO members were not members of CITES, implying that any risk of the WTO scuttling CITES is minimal (Reeves 2002, p. 314).

Moreover, the more recent and authoritative 'Shrimp-Turtle' Appellate Body Report[82] backed away from the Tuna II report's stance on the jurisdictional limitation of the relevant Article XX exception, representing a potentially environment-friendly shift in GATT/WTO jurisprudence. The Appellate Body expressly avoided a decision on the jurisdictional scope of Article XX(g), instead analyzing several factors that must be considered in determining whether such import measures might be deemed WTO-illegal on grounds that they were 'arbitrary' or unjustifiably 'discriminatory'. The Appellate Body ruled that the US shrimp-turtle law was WTO-inconsistent, and identified factors that limit the circumstances under which unilateral import measures aimed at extrajurisdictional activity would be found WTO-legal. Developing countries have cheered the resulting rules, fearing 'eco-imperialism' by the United States and other relatively green countries. Nevertheless, the United States was able to comply with the decision without lifting its shrimp-turtle import ban and many view the Appellate Body's standards for successfully invoking Article XX as relatively easy to meet.

While not as environment-friendly as rules in the two other regimes examined below, it is hard to see how GATT/WTO rules would be as environment-

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[78] GATT, Art. XX(b).

[79] Id., Art. XX(g).

[80] GATT Dispute Panel Report, United States – Restrictions on Imports of Tuna, 33 ILM 839 (1994) (hereafter Tuna II); see also WTO CTE Report.

[81] See Schoenbaum (1997, pp. 279–8). See also WTO CTE Report (especially para. 7).

[82] 'United States – Import Prohibition of Certain Shrimp and Shrimp Products, Report of the Appellate Body', WTO Doc. WT/DS58/AB/R, 12 October 1998 (hereafter, "Shrimp-Turtle" Appellate Body Report').

friendly as they are without European and US influence. Most developing countries oppose or want to highly constrain environmental bases for restricting imports – whether to protect the domestic environment or advance global environmental protection – whereas the EU and the United States have favored more environment-friendly rules. The US wrote the early rules, which became the GATT 1947, and presented them as a fait accompli to any country that wanted to join the regime. And in the Uruguay Round, the EC and the United States fashioned the package of agreements to which all countries were to adhere, then withdrew from the GATT 1947, presenting the developing countries with a new fait accompli: sign onto the WTO rules or lose the formal guarantee of access to the European and US markets. While the WTO agreements are generally a package of Pareto-improving market-opening rules, some of the agreements are not purely liberal, and some economists and developing country diplomats argue that the Uruguay Round package may have made some developing countries worse off (Finger et al. 1999; Harrison et al. 1996; Goldin et al. 1993).

Trade-environment issues in the NAFTA and NAAEC The system of trade-environment rules and institutions established by the NAFTA and the North American Agreement on Environmental Cooperation (NAAEC)[83] (herafter, the 'NAFTA/NAAEC system') are more developed and environment friendly than in the GATT/WTO.

The NAFTA rules on the use of trade measures to protect domestic human, animal, plant, and environmental health and safety are similar to those in the GATT/WTO. The NAFTA provisions on sanitary and phytosanitary measures were adapted from nearly final versions of the Uruguay Round SPS Agreement, described above. On technical barriers to trade, the NAFTA parties expressly agreed to adhere to the GATT/WTO TBT Agreement[84] – again adopting the GATT/WTO approach. Both the NAFTA and the GATT/WTO rules establish the right of a party to ban imports that in its view do not meet the appropriate level of domestic health, safety and environmental protection, subject to some general tests intended to ensure that the restrictions are not a disguised means of trade protectionism.

Problems raised by extrajurisdictional activity are addressed more fully, and in a more environment-friendly way, in the NAFTA/NAAEC system than in the GATT/WTO. While the NAFTA/NAAEC system generally prohibits

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[83] North American Agreement on Environmental Cooperation, 17 December 1993, US-Can.-Mex., pt. V, 32 ILM 1480 (1993) (hereafter NAAEC).

[84] North American Free Trade Agreement, 8, 11, 14, 17 December 1992, Art. 712.1, US-Can.-Mex., 32 ILM 289 (1993) (hereafter NAFTA), Art. 903.

import restrictions unless they are used to protect health or to conserve exhaustible natural resources within the jurisdiction of the importing country, in two circumstances the system permits import restrictions aimed at activities taking place outside its jurisdiction. First, unlike the GATT/WTO, the NAFTA expressly provides that import restrictions may be applied to enforce specified multilateral environmental agreements (MEAs), such as CITES, the Montreal Protocol, and the Basel Convention.

Second, and more significantly, the NAFTA/NAAEC system effectively increased the stringency of applied PPMs in Mexico. At the time the NAFTA was negotiated, reviews of Mexican PPMs suggested that, on the books, they were generally equivalent to those in the United States; the bigger problem was that Mexican PPMs were not enforced.[85] The NAAEC resolves the problem by providing that a party government may have recourse to dispute settlement to challenge another party's 'persistent pattern of failure to enforce' domestic environmental measures; demonstration of such a pattern and the failure to cure it gives rise to a monetary fine against the nonenforcing party and, eventually, a right to trade retaliation if the pattern of failure to enforce is not cured.[86] The NAFTA also permits environmental NGOs to submit a formal report 'that a Party is failing to effectively enforce' to specified trinational authorities, which may then prepare a factual record on the issue; that record may serve as a basis for further action by the parties on enforcement matters.[87] This set of solutions to problems associated with Mexican environmental law enforcement appears to have been successful, facilitating a substantial increase in the number of Mexican environmental enforcement officers, the number of annual inspections, and the number of annual plant closures due to noncompliance with Mexican environmental law.[88] Mexico strongly resisted this effective enforcement standard, but the Clinton administration forced Mexico to accept it as a condition of concluding the NAFTA and gaining preferential access to the US market.

Trade-environment issues in the EU The wealthier, greener, northern European countries (Germany and Denmark, in particular) have insisted on relatively high environmental standards at each step of deepening integration. Among trade organizations, the European Union maintains the most

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[85] See Garvey (1995, p. 442); Patton (1994, p. 90); confidential interviews with US government officials (from Office of the United States Trade Representative and the Environmental Protection Agency) who negotiated NAFTA trade-environment issues, Washington, DC (September 1994).

[86] NAAEC, Arts. 14, 15.

[87] Id.

[88] Steinberg (1997, pp. 249–53).

well-developed and environment-friendly trade-environment rules and institutions.

The European Union permits member-states to prohibit the import of goods insofar as 'necessary' to meet the importing country's chosen level of environmental or health risk.[89] This right is balanced against the principle of free trade. For example, such an import restriction must be maintained in a manner that provides for national treatment and MFN treatment, and evidence that harm would result from nonapplication of the restriction must be based on sound science.[90] But the European Union also provides for 'harmonization' or 'approximation' of member states' environmental,

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[89] Consolidated Version of the Treaty on European Union, as amended by the Treaty of Amsterdam, Done at Maastricht, Rome, and Amsterdam, 7 February 1992, 25 March 1957, and 2 October 1997, 37 ILM 56 (1998) (hereafter TEU), Art. 30. See also Case 302/86, *Commission v. Denmark*, 1988 ECR 4607, 1 C.M.L.R. 619 (1989) (Danish rules that certain beverages be sold only in recyclable bottles not inconsistent with Treaty of Rome, despite effects on intra-Community trade) (hereafter Danish Bottles case). An EU member state may also impose an import ban provisionally where it has not yet established the level of risk it is willing to accept for a particular additive or emission. Case 53/80, *Officier van Justitie v. Koninklijke Kaasfabriek Eyssen BV*, 1981 ECR 409, 2 CMLR 20 (1982) (European Court of Justice [ECJ] upheld Dutch ban on the use of nisin in processed cheese until clear health risks were established for maximum permissible intake) (hereafter Dutch Nisin case).

[90] The European Union also has a rule suggesting that the import restriction must be the least trade restrictive means necessary to effectuate the measure's legitimate purpose. See Case 120/78, *Rewe-Zentral AG v. Bundesmonopolverwaltung für Branntwein*, 1979 ECR 649 (German ban on French Cassis, on theory that French Cassis was low in alcoholic content and so could confuse German consumers into consuming too much alcohol, held inconsistent with Treaty of Rome) (hereafter Cassis de Dijon case); Case 130/80, *Criminal Proceedings Against Fabriek voor Hoogwaardige Voedingsprodukten Kelderman BV*, 1981 ECR 527 (Dutch ban on French brioches held inconsistent with common market principles in the Treaty of Rome). And the European Court of Justice has interpreted the rule as requiring 'proportionality' – a balancing test between the trade restrictiveness of the measure and the purpose of the measure. Cassis de Dijon case; Case 178/84, *Commission v. Germany*, 1987 ECR 1227, 1 CMLR 780 (1988) (German beer purity law, Reinheitsgebot, held to interfere impermissibly with intra-Community trade) (hereafter German Beer case). It may be argued that this invites a determination by the ECJ as to the importance of the measure's purpose, effectively substituting the Court's judgment about risk aversion for that of national authorities. However, the ECJ has been careful about intruding on national judgments in adjudicating disputes over import restrictions adopted for the purposes of domestic health or environmental protection. For example, in some well-known cases, the Court has upheld national laws apparently intended for these purposes. Danish Bottles case; Dutch Nisin case. But it has struck down other national laws that do not appear to have been legitimately so intended. German Beer case; Cassis de Dijon case.

health and safety standards.[91] As EU environmental measures[92] must be based on 'a high level of protection',[93] the EU harmonization/approximation process may be described as 'upward harmonization' (i.e., harmonization of standards at a high level of environmental, health and safety protection). Taken together, these approaches have led to more extensive cross-national environment-friendly convergence on the domestic environmental protection issue than in any other international organization.

The European Union goes further than any other international trade organization in addressing extrajurisdictional activities of concern to the greener members. EU rules specifically permit some import bans directed at poor environmental protection that is taking place outside a member-state's jurisdiction. For example, EU member-states are required to ban imports from other member-states and from outside the Community of goods embodying animal parts covered by CITES (plus all species of dolphin and cetacean products), the EC fur seal ban (1983), and the EC whale ban (1981). In addition, under

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[91] The European Union has engaged in a massive exercise in harmonization of product additive and emission standards. These efforts began in the late 1960s, but were not successful on a large scale until the exercise culminating in the Single European Act (1987–92). By the end of 1992, the European Community had harmonized or approximated 75 SPS measures and 18 other food law measures. (Baker & McKenzie 1994). In addition, the Community had established harmonization of EC-wide automobile emissions standards. See Dietrich (1996, p. 199).

[92] That is, action taken under the TEU, Art. 147.

[93] At Germany's insistence, the Single European Act, the Maastricht Treaty, and the Treaty of Amsterdam provide that harmonized or approximated standards (i.e., action taken under the TEU, Art. 95) and EU environmental measures (i.e., action taken under the TEU, Art. 147(2)) are to be based on 'a high level of protection'. TEU Arts. 95(3), 147(2). Moreover, at Germany's and Denmark's insistence, where Community standards for purposes of completing the internal market are adopted only by 'qualified majority voting' (i.e., where legislation is adopted by population-weighted voting by member states in the Council, so that the legislation may become EU law despite the objection of any particular member state), member states may maintain their own more stringent standards (Kramer, 1987, p. 680). See also Vandermeersch (1987, pp. 417–19). TEU, Art. 95(4). See also Danish Bottles case.

And for all other Community environmental measures, member-states may maintain or adopt their own more stringent standards. TEU, Art. 176. Each member-state must permit imports of products from other member states that comply with unanimously established Community standards. While harmonization or approximation measures are sometimes phased in or provide for derogations by the poorest member-states, most harmonization and approximation directives have required that the member-states eventually meet standards that are as high as those then in place in Germany. Hence, the EU exercise in upward harmonization or approximation of standards has generally maintained domestic health and environmental protection within the greenest northern European importing countries and simultaneously increased the stringency of pesticide, fungicide, product additive and emissions standards in the dirtier European countries.

some directives the member-states are required to ban imports of goods from outside the Community not produced in accordance with specified EU PPMs. And at least one European Court of Justice (ECJ) decision suggests that a member-state may maintain a national environmental rule that is more stringent than EU or international standards and that bans the importation of goods from other member-states, with the intention of protecting animal life outside its border.[94] Perhaps more significantly, the European Union has engaged in an upward harmonization or approximation exercise of dozens of PPM standards and has adopted over 200 directives[95] dealing with air, water, waste and chemicals.[96] Those exercises have been subject to the requirements that the directives use a 'high level of protection' and member-states are generally allowed to maintain more stringent standards.

5. Conclusions

It is easy to mistake international environmental challenges as simple cooperation problems among the world's states with similar interests in protecting the global environment. It may be tempting to think of most global environmental problems, such as overfishing or global warming, as a tragedy of the commons, a prisoners' dilemma, or as negative externalities that evade a Coasian solution because of collective action problems faced by states. Such cooperation problems would usually be solved through international agreements that establish focal points, credible commitments, information systems for monitoring and verification of the commitments, and a system of decentralized sanctions for enforcement. Some international agreements appear to possess those attributes – such as regional agreements governing land-based marine pollution – and so appear to confirm the analysis. And many may view symmetrical Pareto-improvement among the parties as the happy result.

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94 Dicta in Dutch Red Grouse case, described in Environment Directorate and Trade Directorate, Typology of Trade Measures Based on Environmental Product Standards and PPM Standards, OECD Doc. COM/ENV/TD(93)89 (28–30 September 1993). For the Dutch Red Grouse case, see Case 169/89, *Commission v. Netherlands*, 1990 ECR 2143.

95 This is according to former European Environmental Commissioner Ritt Bjerregaard's interview in the journal, *Europe*. Fallesen and Guttman, 1996, pp. 26–7.

96 For example, each member-state must now limit emissions of nitrogen oxides and sulfur dioxide in accordance with the Large Scale Combustion Directive; reduce lead content in gasoline and offer unleaded gasoline in accordance with the EC emissions directives; reduce water pollution in accordance with the water effluent directive; control or restrict the use of chemical substances in accordance with EC chemicals directives; and recycle a specified proportion of solid wastes in accordance with the Solid Wastes Directive.

In fact, however, there is a wide range of state interests on most international environmental problems – with some states favoring environmental protection and some opposed – suggesting that what is at issue is more than a cooperation problem. For example, as a general rule, richer is greener. This is particularly clear in international trade negotiations: wealthier countries prefer more environmental protection than poor ones. There are, of course, additional divisions among countries, such as a split in fisheries management negotiations between rich coastal states and rich distant-fishing states. Indeed, in all of the negotiations analyzed in this chapter, there has been political tension between states favoring stringent environmental protection and those that don't.

In this context, in some instances, side-payments have been used to facilitate agreement. For example, the United States and Europe provided some developing countries with aid so that they could sign and comply with the Montreal Protocol. Similarly, the Kyoto Protocol's clean development mechanism, a form of emissions trading with developing countries, and provisions on technology transfer, may be seen as side-payments by Europe to obtain support for the agreement from many developing countries. Nonetheless, side-payments may be eschewed by wealthier countries because they are expensive and it is often politically unpopular to be seen to be paying countries to diminish their polluting activities. Moreover, coercion may be an option.

Hence, effective solutions to global environmental problems have often required coercion of weaker, less environment-friendly states by powerful greener states. For example, to the extent that international fisheries agreements are now regulating global fishing, they have been largely imposed on distant-fishing states by more environmentally conscious coastal states, which have leveraged their local power over coastal fisheries to regulate both those fisheries and straddling and migratory stocks. Similarly, the effectiveness of CITES and the Montreal Protocol has resulted from the capacity of environment-friendly states with rich markets to threaten to close them to specific products from less environment-friendly markets. And in trade organizations, environment-friendly rules have resulted only when richer, greener countries have used their market power to bring them about. In only one issue area examined here, LBMP, was agreement reached due exclusively to an apparent alignment of similar environmental interests. Hence, most effective environmental agreements are asymmetrical contracts between states resulting at least partly from coercion.

Less effective regimes result when the power of environment-friendly states is dispersed or the environmental interests of powerful states is divided. Hence, for example, the Kyoto Protocol's formula for addressing global warming has divided the United States from the European Union, China, and Russia, resulting in an agreement that will have little meaning. Similarly, fish-

eries are most fully regulated in regions where there are powerful, environment-friendly states and least well-regulated in regions where there are not. And of the world's three main trade regimes, rules are least environment-friendly in the GATT/WTO, where the power of environment-friendly states is relatively dispersed.

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13. International telecommunications

Rohan Kariyawasam[1]

Only connect!
E.M. Forster (1879–1970) *Howards End*

1. Introduction

The noted international trade lawyer and legal jurist John H. Jackson once defined international economic law as embracing 'trade, investment, services when they are involved in transactions that cross national borders, and those subjects that involve the establishment on national territory of economic activity of persons or firms originating from outside that territory'.[2] He left out competition, although it could be argued that competition by its nature would be encompassed indirectly by the reference to 'economic activity'. Furthermore in looking at the definition, one could easily see that telecommunications as an 'economic activity' would also fall within Jackson's definition. As an *economic* sector, telecommunications is generally a vertically integrated sector generating economies of scale with very low marginal costs. Telecommunications as a *technical* sector is covered by a number of international treaties including the Outer Space Treaty 1967, the Intelsat Agreement 1971, the Convention of International Telecommunication Union (ITU Convention), the World Administrative Telegraph and Telephone Conference

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[2] J. Jackson (1989) *The World Trading System*, Cambridge, MA: MIT Press 21–2.

(WATTC), and the Conventions on Satellites. However, the aim of this chapter is not to discuss telecommunications as a technical *subject*, but to discuss telecommunications as a *sector* of international trade. In light of this, the chapter will discuss the most relevant treaties that cover telecommunications as an economic sector, specifically the WTO covered agreements.[3] The Author contends that of all the multilateral institutions that will shape the focus of international telecommunications in the decades ahead, the WTO, and to a lesser extent the International Telecommunications Union (ITU), will take this role in terms of regulatory measures affecting trade in telecommunications. The ITU will retain its position of significance as regards the gatekeeper of telecommunication technical standards given its long policy-making history in this area, but its role as a *de facto* regulator, for example in areas of competition and market access, is easily eclipsed by the emerging role of the WTO. A glimpse of the rising role of the WTO is reflected in the recent Dispute Settlement Body (DSB) case between the United States and Mexico on interconnection fees between incumbent telecommunication carriers.[4] The *Mexico-Telmex* Case is a landmark case, marking the first panel ruling by the WTO's Dispute Settlement Body in the telecommunications sector. Another case, the recent *United States – Measures affecting the cross-border supply of gambling & betting services* (discussed below in section 13.3.3) creates a crucial precedent for the content of electronic services of a cross-border nature, services that flow over telecommunication networks. The WTO's DSB is perhaps the only international regulator which has an enforcement procedure with 'real teeth', in that failure to implement its rulings could (eventually) result in trade sanctions.

This chapter, in discussing the role of the WTO in increasing international trade in telecommunications, will discuss the need for the WTO Secretariat to reform existing measures and deal with five significant challenges: (a) clarifying its role with that of the ITU;[5] (b) resolving classification issues of new internet services that will be important for all network-based transactions;[6] (c) developing existing provisions on competition built into the GATS, Annex on Telecommunications and regulatory Reference Paper;[7] (d) clarifying the system by which international telecommunication operators settle inter-carrier payments (Accounting Rates),[8] particularly as more traffic is now switched

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[3] GATS, GATT, TRIPS, and Information Technology Agreement (under the GATT).

[4] *Mexico – Measures Affecting Telecommunications Services*, 1 June 2004, DS204 (referred to in this chapter as the '*Mexico-Telmex*' Case).

[5] Section 2 on the *ITU* in this chapter.

[6] Section 3.1 on *Classification of telecommunications issues* in this chapter.

[7] Section 4.2 on the *Reference Paper in light of Mexico-Telmex* in this chapter.

[8] Section 2.1 on *Accounting rates* in this chapter.

through packet-switched networks;[9] and (e) increasing the participation of developing countries.[10]

This chapter looks briefly at the international framework for telecommunications, reviewing the main WTO measures including the Annex on Telecommunications (AT), regulatory Reference Paper (RP), the *Mexico-Telmex case*, and ITU Recommendation D.50 and the 'APEC principles', the latter two issues being potentially significant for developing countries. The AT, one of the first multilateral WTO instruments on telecommunications and negotiated as part of the Uruguay Round culminating in the formation of the WTO, provides a level of regulatory certainty for foreign investors requiring access to the target state's incumbent telecommunications carrier's network in order to provide services (for example financial) that have been scheduled as commitments in the target state's schedule of specific commitments. The AT applies to valued-added or enhanced telecommunications services mainly (as opposed to basic or voice telecommunications services, usually the subject of a monopoly by the target state incumbent telecommunications operator). The RP, negotiated much later than the AT, and coming into force in 1998, applies specifically to basic (for example, voice services) telecommunications services. Its significance lies in a set of regulatory principles, the most important perhaps being the 'interconnection' principles that provide the basis for further liberalization of a WTO member's telecommunications sector. The RP is classed as an additional commitment and therefore not compulsory for WTO members to adopt (as opposed to the AT, which being an annexe to the GATS is mandatory), but nevertheless they are often required to do so as a condition of further foreign investment into the sector (see discussion below). The *Mexico-Telmex* case is the first dispute case (reaching a panel) in telecommunications at the WTO and demonstrates the significance of telecommunications as a strategic economic sector within international trade, but also demonstrates the absolute need for governments to have effective and transparent measures in place that will stimulate both competition and innovation. The case hinges on the interpretation of the regulatory principles enshrined in

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[9] A data communications network that uses packet-switching technology [a switching procedure whereby two parties have a logical connection across a network, but no dedicated facilities (unlike a circuit-switched network which sets up a dedicated connection), and where units of transmission have a maximum size (usually 128 or 256 octets): this is a store and forward technique where nodes in the network may store a packet for some time before forwarding it to the next node (or router) in line. See G. Kessler (1990), *ISDN*, McGraw-Hill, p. 281.

[10] Note also that the impact of reform of domestic regulation measures under the GATS, Article VI, particularly on mutual recognition agreements and standards setting, is also an area that needs to be addressed by the WTO, but is outside the scope of this chapter.

the RP. There has been considerable disagreement over the DSB panel decision in *Mexico-Telmex* (discussed below) and the interpretation of the term 'anti-competitive practices' as found in the RP. This case looks to set an important precedent for future potential disputes in this sector, for example in setting guidelines on the interpretation of RP rules on interconnection and on unfair competition. As mentioned above, following the adoption of the AT, RP, and the settlement in *Mexico-Telmex*, the WTO appears to be in the 'driving seat' as regards international regulation of telecommunications with the ITU a technical standard setter and important provider of technical support to developing countries. This chapter will start with an assessment of the role of the ITU in the three significant areas mentioned above (accounting rates, interconnection, and Voice over Internet Protocol (VoIP)) and the ITU's somewhat conflicting position (particularly in recent years) with that of the WTO; the role of the WTO in issues of classification of telecommunication services (current service classifications are in urgent need of revising); the contentious view of whether or not current schedules of specific commitments need to be revised to include new internet services and network-based transactions; and finally with the increasing take-up of digital networks as data signals surpass voice, the international regulation of internet infrastructure services.[11]

2. The ITU

The ITU was established on the principle of cooperation between governments and the private sector.[12] Founded over 135 years ago, it is the oldest international organization in the world,[13] and its current membership includes regulators, network operators, equipment manufacturers, hardware and software developers, regional standards-making organizations and financing institutions. As Codding argues, the ITU has 'survived two world wars, a cold war, and at least one major depression'.[14] In the last decade, the ITU membership has faced rapid evolution given the changes in the way telecommunication services are delivered and the convergence of telecommunication, information technology, and broadcasting networks, resulting in a wide range of new content rich network-based transactions. Furthermore, the liberalization and deregulation of the telecommunication sector in many countries has pushed its

[11] The international regulation of content that flows over internet networks is beyond the scope of this chapter.

[12] See the ITU's website at: www.itu.org, date accessed September 2005.

[13] G. A. Codding (1995), 'The International Telecommunications Union: 130 Years of Telecommunications Regulation', *Denver Journal of International & Policy*, 23, 01, p. 1.

[14] Ibid, p. 9.

membership, particularly many of the developing countries, to encourage the ITU to take a greater role in international policy making.

The ITU is divided into three broad Sectors – Radiocommunication (ITU-R), Telecommunication Standardization (ITU-T), and Telecommunication Development (ITU-D). These Sectors cover all aspects of telecommunication, from standards setting on interworking of equipment and systems worldwide to operational procedures for wireless services and designing programmes to improve telecommunication infrastructure in the developing world. Each of the three ITU Sectors works through conferences and meetings, where members negotiate the agreements which form the basis of telecommunication standards and services. Study groups made up of experts drawn from separate national Public Telecommunication Operators carry out technical work, preparing the detailed studies that lead to ITU Recommendations. ITU-R draws up the technical characteristics of terrestrial and space-based wireless services and systems, and develops operational procedures. It also carries out technical studies which serve as a basis for the regulatory decisions made at radio communication conferences. ITU-T experts prepare the technical specifications for telecommunication systems, networks and services, including their operation, performance and maintenance. Their work also covers the tariff principles and accounting methods used to provide international services. Finally, ITU-D prepares recommendations, opinions, guidelines, handbooks, manuals and reports, which provide decision-makers in developing countries with 'best business practices' guidelines on standards and systems. Currently there are 24 study groups spanning the Union's three Sectors (seven in ITU-R, 14 in ITU-T, two in ITU-D), which together produce around 550 new or revised Recommendations every year.[15] All ITU Recommendations are voluntary agreements. The ITU is also responsible for the International Telecommunications Regulations (ITRs), which had their origins in the 19th century and remain one of the oldest of the ITU treaties.[16] ITRs cover the international telecommunications business setting out rules for *administrations* (government departments responsible for telecommunications and not private undertakings) to put in place procedures for running international telecommunications networks and services,[17] mutually agreed routing,[18] charging and accounting,[19] and special arrangements which allow not

[15] ITU's website at: www.itu.org, date accessed September 2005.

[16] T. Kelly (2003), 'International Telecommunications Regulation: A Trophy or Atrophy', in Gary Madden (ed.), *World Telecommunications Markets*, Cheltenham, UK and Northampton, MA: Edward Elgar, p. 200.

[17] Article 1.

[18] Article 3.

[19] Article 6.

only administrations but also private organizations or persons to conclude special arrangements for the establishment, operation and use of special telecommunications networks (for example money transfer through SWIFT or navigation, such as INMARSAT).[20] The current ITRs were adopted in Melbourne in 1998 and appear in the Final Acts of the World Administrative Telegraph and Telephone Conference (WATTC-88). The ITRs are a binding treaty instrument and form part of the Administrative Regulations of the ITU: they are to be amended through subsequent WATTCs.[21] The ITRs are in need of amendment to keep pace with the rapid change of technology and the introduction of the Transmission Control Protocol/Internet Protocol (TCP/IP) as the basic production standard of telecommunications networks, but there has been resistance within the ITU membership. Many of the developed countries see the ITRs as having been superseded by the WTO's Fourth Protocol and Reference Paper, although the terms of these measures remain vague. Many developing countries (DCs) and least developed countries (LDCs), however, that still retain monopoly markets would like to see the ITRs amended and revived.[22] At the time of writing, the position has yet to be confirmed.

In 1996, the ITU initiated the World Telecommunication Policy Forum (WTPF) to harmonize telecommunication policies on issues that have a transnational nature. The forum is organized on an ad-hoc basis determined by the ITU's executive policy-making body, the *Plenipotentiary Conference*, in conjunction with its annual governing body, the ITU Council. In November 2000, WTO Director-General, Mike Moore and ITU Secretary-General, Yoshio Utsumi, agreed to strengthen relations between the two organizations, by signing a Cooperation Agreement which was approved by the 2000 Session of the ITU Council, and later ratified by the full ITU membership in a Plenipotentiary Conference. The Agreement was to foster cooperation activities between the WTO and ITU on matters at the intersection of trade and telecommunication policy, to provide assistance to ITU members interested in WTO accession and to allow for each organization to participate as an observer at specified meetings of the other. The agreement also provided for the ITU to receive information on dispute resolution matters. It is difficult to assess the effect of the cooperation agreement in the day-to-day business of the two institutions. WTO advisers do sit on ITU expert groups. Further the work of the ITU in technical areas, such as interconnection, accounting rates, and standard setting for emerging technologies, such as VoIP, will most certainly have an important bearing on the future direction of the work of the

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[20] Article 9.
[21] Supra note 169.
[22] Ibid, p. 221.

Council for Trade in Services and the WTO Secretariat in reforming existing WTO measures on telecommunications, such as the regulatory Reference Paper to the Fourth Protocol (the Basic Agreement on Telecommunications). It is in perhaps these three areas: accounting rates, interconnection and VoIP that we will expect to see the greatest overlap between the work of the WTO and ITU. Each is discussed in the next three sub-sections.

2.1. Accounting rates

Accounting rates are generally straightforward to apply: In the telecommunications sector, when an international telephone call is transmitted from one country to another, the Public Telecommunication Operator (PTO) in the country that originates the call has usually made a compensatory payment to the operator in the country that receives the call. Payments arise when the traffic in one direction exceeds the level of traffic flowing in the other direction. The level of payment is based on bilaterally negotiated 'accounting rates'.[23] Developing countries have long argued that international settlements are required to continue to invest and upgrade existing legacy infrastructures, which in the developed world have been the preserve of monopolies for many decades. They argue that such settlements are not only used for telecommunications, but also used by national treasury departments in upgrading general infrastructure, such as power and water facilities. By contrast developed countries argue that net payments based on artificially high settlements do not reflect actual cost structures, which are falling due to improved transmission efficiencies, resulting therefore in net overpayments. The International Telecommunication Regulations (ITRs), discussed above, an international treaty administered by the ITU, sets out the accounting rate regime. ITRs in turn are complemented by the 'D-Series' of Recommendations, which are the work of the ITU Study Group 3, charged with the thorny task of reforming the accounting rate system. Reform has been aggressively pushed for by net paying countries, such as the United States, which in its unilateral attempt to accelerate the process by introducing Federal Communication Commission

[23] http://www.itu.int/ITU-T/studygroups/com03/accounting-rate/, date accessed November 2005. The accounting rate revenue division procedure envisages an international call as a single 'joint-service' for which the two operators negotiate an agreed 'accounting rate'. The accounting rate is then divided in half (the 'settlement rate') and applied to traffic flows in both directions. As both traffic flows are priced at the same rate, the scheme results in an overall net payment from the operator originating more traffic to the operator originating less traffic, based on the volume of traffic in each direction. See Accounting Rate Reform Undertaken by ITU-T Study Group 3, Communication from the ITU, Informal Note, Council for Trade in Services Job. 2947, 11 May 2000, para 2.

(FCC) benchmark levels on accounting rates, has run into stiff opposition from developed and developing countries alike in arguments on extending territoriality of FCC jurisdiction and US courts to foreign-based PTOs. It is however generally accepted now by the ITU membership that reform is required. At the time of writing, three main multilateral institutions have worked (and are still working) on the problem: (i) the OECD is seeking to develop a consensus among governments in developed countries; (ii) ITU Study Group 3 is studying the sector (discussed later); and (iii) the informal expert group, appointed by the previous ITU Secretary-General (Dr Pekka Tarjanne), put forward a set of 'guiding principles' which favoured increased competition and the 'move to transparent, non-discriminatory, cost-orientated settlement arrangements'.[24]

In recent years, reform of the international accounting rate system in telecommunications has been one of the most fiercely contested issues between developed and developing countries. The traditional accounting rate regime clearly contravenes the MFN principles as set out in Article II GATS. Article II requires non-discriminatory treatment between WTO members, and as a general clause, cannot be contravened, unless an exception is scheduled at the time of accession. However, when the Fourth Protocol was being negotiated by the Negotiating Group on Basic Telecommunications following the Uruguay Round,[25] it was agreed that a 'gentleman's agreement' should be reached whereby international accounting rates would fall outside the purview of the GATS, but be subject to review at the next trade round.[26] This position

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[24] See Tarjanne's speech on the ITU website at www.itu.org, date accessed September 2005.

[25] The Fourth Protocol (sometimes referred to as Protocol 4 or as the Basic Telecommunications Agreement) was signed in March 1997.

[26] This is widely known as the *Understanding on Accounting Rates*, which is contained in a Report by the Group on Basic Telecommunications made on 15 February 1997 at the close of negotiations on the Fourth Protocol (BTA). The Report which appended the draft Schedules of Specific Commitments states:

'7. The Group noted that five countries had taken Article II exemptions in respect of the application of differential accounting rates to services and service suppliers of other Members. In the light of the fact that the accounting rate system established under the International Telecommunications Regulations is the usual method of terminating international traffic and by its nature involves differential rates, and in order to avoid the submission of further such exemptions, it is the understanding of the Group that:

– the application of such accounting rates would not give rise to action by Members under dispute settlement under the WTO; and

– that this understanding will be reviewed not later than the commencement of the further Round of negotiations on Services Commitments due to begin not later than 1 January 2000.'

has now been 'qualified' somewhat by the WTO DSB's panel ruling in *Mexico-Telmex*, discussed later in this chapter.[27]

The Fourth Protocol to the GATS has already introduced market access opportunities[28] (through commitments scheduled under the 'market access' entry of the member's schedule of specific commitments) and cost-based interconnection rates (the actual cost for interconnection measured without a specific form of mark-up and by measuring in accordance with an industry standard, such as the *Long Run Incremental Cost* for example[29]) by way of the regulatory Reference Paper.[30] The GATS regime has effectively signalled the end of traditional correspondent-type relationships (dedicated agreements between incumbent operators setting fixed international accounting rate settlements) on accounting rates, replacing the old regime with a new regime of cost-based interconnection. This new regime has resulted in 'new modes of operation' by developed countries in bypassing traditional incumbent carriers in developing countries, and therefore operating outside the conventional accounting rate regime. By operating outside the conventional accounting rate system, foreign carriers are able to avoid paying settlement rates that exceed the actual cost for transmission (interconnection), a saving in some cases of many millions of US dollars.

The new modes of operation include:[31] *International simple resale,* the resale of leased-line (private line) capacity to provide a public switched international telephone service; *Foreign points of presence (PoPs)*, where an operator in one country is permitted to build-out its network into the destination country, interconnecting with the destination domestic carrier by way of a point of interconnection; *Refile*, sometimes referred to as hubbing, re-origination or anonymous refile, where an operator directs its international traffic to a country where low charges apply for forwarding traffic to its ultimate destination or third country; *International alliances*, alliances whether by joint

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[27] See Section 4.2 on *The Reference Paper in light of Mexico-Telmex.*

[28] Article XVI GATS, which must be read in conjunction with the Member's Schedule of Specific Commitments, which sets out any exceptions the Member may have taken in the four different modes of supply under the GATS (Mode 1: cross-border, Mode 2: consumption abroad, Mode 3: commercial presence, Mode 4: movement of natural persons).

[29] A discussion of the differing cost measurement standards is beyond the scope of this chapter. For a more detailed treatment see L. Correa (2001), 'The Economics of Telecommunications Regulation', in *Telecommunications Law*, London: Blackstone Press, 16–52.

[30] Article 2.2(b) Reference Paper to the Fourth Protocol of the GATS.

[31] For a more extensive analysis see the ITU paper: *Transforming Economic Relationships in International Telecommunications,* Chairman's Report of the Seventh Regulatory Colloquium, Geneva, December 1997.

venture or merger between operators who aggregate traffic over combined networks, serving mainly the needs of the multinational corporation; and *Internet telephony*, which due to its use of packet-switched networks internet telephony falls outside the conventional accounting rate system.

Several jurisdictions including the US and Europe have looked at the possible regulation of internet telephony as a voice service, but have to date not sanctioned regulation or imposed universal service obligations or mandatory interconnection obligations on the providers of such services on grounds that internet calls are not directly substitutable for conventional voice calls primarily due to quality. With improvements in technology however, this situation is fast changing.[32]

International settlements based on correspondent relations between operators are negotiated by the operators themselves and not by governments. As such, the WTO as a diplomatic agreement between nation states is not directly concerned with negotiations between private entities, but would have relevance for example where differential accounting rates are inconsistent with obligations under the GATS, and where specific commitments in telecommunications have been scheduled. This is exactly what happened in the *Mexico-Telmex* case.[33] As mentioned earlier, this inconsistency has been allowed to continue as a result of a gentleman's agreement during the talks on the Fourth Protocol (Basic Agreement on Telecommunications). The GATS provides for the replacement of the accounting rate regime with a cost-oriented interconnection regime.[34] As such, accounting rate reform has been the subject of intense discussion by the Council for Trade in Services.[35]

Presently, ITU-D Study Group 3, charged with accounting rate reform, is developing a set of general principles for accounting rates that will include the cost components to be included in such rates, costing methodologies for determining rates, and providing for transition periods for developing countries. The ITU's work in accounting rate reform will not change the New Modes of Operation described above, but would help developing countries ascertain their cost base when negotiating cost-based interconnection with carriers in other countries. This is a major step forward which will save developed countries millions of dollars in accounting rate payments for terminating voice call traffic in developing countries. For this reason, a number of developing countries are understandably reluctant to adopt the Reference Paper, as clearly the intention is to move towards a cost-orientated system of interconnection

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[32] See Section 2.3 below (VoIP).

[33] Discussed in more detail in Section 4.2 on *The Reference Paper in light of Mexico-Telmex* below.

[34] Article 2.2 WTO Reference Paper.

[35] Job No. 2974, June 2000, WTO.

payments for both call origination and call termination as called for by Article 2 RP. The ITU's study group is working with the Council for Trade in Services to achieve a workable compromise, given that accounting rate reform will have a significant effect on trade in telecommunications.[36] In the interim, the ITU's Understanding on Telecommunications Accounting, part of the ITU's Telecommunications Regulations, will continue to apply,[37] although it should be emphasized that the terms of the Understanding on Telecommunications have now been 'qualified' to some extent by the decision of the WTO's DSB panel in the *Mexico-Telmex* case.[38]

2.2. Interconnection

Interconnection is the foundation for competition in telecommunications. Interconnection in telecommunications is based on the fundamental principle of 'any to any connectivity'. Control of interconnection by any undertaking whether private or state-owned is essential to the control of the network and therefore the market for interconnection services, and the wider markets for domestic and international telecommunications. The upshot of this is that the regulation of wholesale interconnection is now seen as an important lever for telecommunications regulation. Furthermore, in an IP-based network environment,[39] interconnection (and the corresponding right of 'access') is increasingly needed over different layers and platforms.[40]

The voice telecommunications network is founded on the principle of *universal connectivity*: the integration of networks to enable a customer connected to one carrier's network to call a customer connected to another carrier's network. A handset, a subscription, and a number is understood to mean that the customer can reach all other numbers and can itself be reached. No one network can stand in isolation: To give customers value for money, a network operator is compelled to interconnect with others so as to increase the overall reach of its services. The right to interconnection is necessary in a deregulated telecommunications market. Indeed, interconnection can be described as the key fundamental to the viability of competition

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[36] Ibid.

[37] Section 1 above.

[38] See Section 4.2 on *The Reference Paper in light of Mexico-Telmex* below for a more detailed discussion of this case and its effect on international accounting rate settlements.

[39] Discussed in more detail in Section 4.3 on *Internet Interconnection*.

[40] See (October 2005), R. Kariyawasam, 'Defining Dominance for Bits & Bytes: A new Layering Theory for Interpreting Significant Market Power?' *European Competition Law Review*, (10), 581–94, for a more complete discussion of a new Layering Theory for the regulation of complex digital networks involving different protocols and platforms.

in telecommunications.[41] However, the principle of 'any to any connectivity' is not the only concept as regards the regulation of interconnect. Two other important concepts also play an important role. They are:

- *Equal access* – this denotes the ability of the customer directly connected to the incumbent network to access retail services of the new entrant on a seamless and equivalent basis to that which the customer accesses the same retail services of the incumbent;
- *Non-discrimination* – this denotes the ability of the new entrant to be provided with interconnection services on no less favourable terms than the incumbent provides to itself.

Other forms of 'soft law' also assist in the governance of interconnect, such as guidelines on pricing and on the way negotiations should be structured. In Europe, for example, the European Commission has issued the Access Directive[42] to help National Regulatory Authorities (NRAs) in the various EC member states deal with regulating interconnect.

Most countries that have opened their telecommunications markets to competition have also established general principles which must be followed by the incumbent in order to provide interconnection. Furthermore, at least 87 member states have taken Specific Commitments under the WTO's Fourth Protocol (Basic Agreement on Telecommunications) that came into force on 5 February 1998.[43] In addition, some of these same members took an *Additional Commitment* in the form of the regulatory Reference Paper which details, as part of a legal framework for liberalization, specific rules on interconnection. Section 2.2 of the Reference Paper sets out interconnection obligations on major suppliers.[44] Under Section 2.2 (RP), interconnection must be provided:

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[41] See for example Colin Long's (2000) discussion of interconnection in *Telecommunications Law & Practice*, 2nd edn, London: Sweet & Maxwell.

[42] Directive 2002/19/EC of the European Parliament and of the Council of 7 March 2002 *on access to, and interconnection of, electronic communications networks and associated facilities* (Access Directive).

[43] The Council of the European Communities ratified the Fourth Protocol by Decision 97/838 [1997] OJ L336.1.

[44] A Major Supplier is defined in the Reference Paper as one who has market power because of (a) its control over an essential facility or (b) its position in the market. The important doctrine of 'Essential Facilities' is discussed further in Section 4.1 on the *Annex on Telecommunications and the Reference Paper* below.

- at any technically feasible point in the network;
- on non-discriminatory terms, rates and of a quality no less favourable than for the incumbent's own supply;
- in a timely fashion and on terms that are transparent and reasonable;
- at cost-orientated rates;
- on an unbundled basis so that a buyer does not pay for unnecessary services.

As mentioned earlier, the Reference Paper sets out a cost-oriented basis for interconnection, effectively making redundant the accounting rate settlement system so favoured by many developing countries. Cost-based interconnect reduces the net payments made by developed countries to developing countries for terminating the cost of calls in developing countries. The WTO *Mexico-Telmex* case further confirms this point (discussed below). Not all WTO members took out the additional commitment of the Reference Paper, applying the above principles of cost-based interconnection.[45] In effect, each country will have its own framework and principles of interconnect.[46] The structure of an interconnect agreement itself will be closely linked to and dependent on the regulatory framework within which that agreement sits. However, the GATS now provides a gateway to a legal framework for cost-based international interconnect, and the provisions of the GATS are binding.

Since the coming into force of the Fourth Protocol in February 1998, new commitments have been made either by new members, upon accession, or in a unilateral fashion by an existing member. New negotiations on services, including telecommunications, were started at the Doha Round in 2000. Within the time-frame of the overall negotiating deadline of 1 January 2005, paragraph 15 of the Doha Development Agenda establishes that 'participants shall submit initial requests for specific commitments by 30 June 2002 and initial offers by 31 March 2003'. Pursuant to the Doha mandate, participants in the services negotiations have been exchanging bilateral initial requests

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[45] For a full list of current member commitments, see the WTO website at: http://www.wto.org/english/tratop_e/serv_e/telecom_e/telecom_commit_exempt_list_e.htm, date accessed September 2005.

[46] Although WTO law does not usually have direct effect, under European law (Cases 267–269/81 *Amministrazione delle Finanze dello Stat v SPI* and *SAMI* [1983] ECR 801), measures converting WTO obligations into European law have to be interpreted in accordance with WTO law (Case 69/89, *Nakajima All Precision Co Ltd v Council of the European Communities* [1991] ECR 2069). It can be implied therefore that EU Member States should directly or indirectly apply WTO and therefore General Agreement on Trade in Services (GATS) law.

since 30 June 2002. Between 31 March 2003 and 30 October, 39 Members had submitted initial offers.[47] Unfortunately, negotiations at the Doha Round came to a standstill in 2006.

Clearly the ITU has an important part to play in continuing to develop standards for interconnection both at the circuit-switched and packet-switched level. These standards in turn will need to be reflected in progressive amendments to the regulatory Reference Paper in successive trade rounds. In this way the apparent roles of the ITU and WTO become clearer to see. In the next sub-section, the last on the ITU, we see the role that the ITU has taken in the development of standards relating to VoIP.

2.3. VoIP

Voice over Internet Protocol (VoIP) is another crucial area where the work of the WTO and ITU could overlap and where a commonality of approach will be required. One main reason for this is that calls via the internet will soon move from its prototype status to becoming a major mode of operation for carrying commercial traffic. This could happen entirely outside the conventional regulatory framework, and certainly outside the traditional settlement system. This is because VoIP unlike most other technologies, for example wireless technology, allows operators to bypass the conventional accounting rate regime by sending voice calls in digital packets over an internet network (packet-switched network) as opposed to over a conventional circuit-switched voice network. The costs for transmission are far cheaper and consequently the marginal costs for the service are lower. The downside with VoIP has always been a quality issue in that calls over the internet have traditionally not been equivalent in terms of quality to calls over conventional voice telephony networks. This position however is fast changing. It is also important to distinguish between VoIP and Voice over the Internet. VoIP is a technical standard for internet calls over private networks whereas Voice over the Internet is a technical standard for internet calls over the public internet. VoIP over a closed private network is able to generate a much higher quality call than Voice over Internet. The question that regulators are asking, particularly at the national level, is as internet calls come closer in quality to matching conventional voice calls, should the providers of such calls also be regulated in the same way as conventional telecommunication operators (common carriers)? In Europe, the European Commission has been active in this area. In June 2004, the EC issued a Communication on the treatment of VoIP under the EC Regulatory Framework.[48] The Commission was building on the work of two

[47] See WTO website at: http://www.wto.org/english/tratop_e/serv_e/s_negs_e.htm, date accessed September 2005.

[48] European Commission. *The Treatment of Voice over Internet Protocol* (VoIP)

earlier notices that it had issued on VoIP in coming to its more recent Communication.[49] Under these two earlier notices, VoIP was effectively exempted from regulation in the European Union in that the regulatory framework that applied to conventional voice telephony calls did not apply to VoIP. However, under the Commission's new regulatory framework for electronic networks and services,[50] and following the principle of technological neutrality, all digital networks and services including VoIP services are covered by the EC's new framework, including obligations for interconnection. In the United States, VoIP has been classified as an unregulated *information service* under the US Telecommunications Act 1996,[51] effectively exempting it from common carrier regulations under the US Telecommunications Act.

At the multilateral level, ITU-T is responsible for studies, naming, addressing and numbering resource assignment for IP telephony and technical standards for IP telephony (H.323 Series). The work of the ITU-T will feed into the work of the Council for Trade in Services in discussing telecommunications. This will be particularly important for classification issues. In 2004, the World Bank commissioned field research to determine how nation-states worldwide are classifying their telecommunication and internet services.[52]

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under the EU Regulatory Framework. European Commission. DG Information Society. Brussels, 14 June 2004. See: http://europa.eu.int/information_society/topics/ecomm/doc/useful_information/library/commiss_serv_doc/406_14_voip_consult_paper_v2_1.pdf. The Communication explains the conditions that apply to each different kind of VoIP and the level of obligations that each provider will face according to the type of services offered. The 2004 Communication classifies VoIP services into three main categories: (i) Self-provided with no specific service provider charging a fee for providing a VoIP service: this category of service will fall outside the scope of the EC's Framework Directive because there is no service provided by a provider with the intention of making a profit taking it outside the scope of an 'electronic communications service' (Article 1 Framework Directive); (ii) Corporate Private Networks/Internal Use: private electronic communication services will fall within the scope of both the EC Framework and Authorization Directives; and (iii) Publicly Available IP Telephony: this provision is more complex and the type of regulation that will apply will generally depend on whether the VoIP service 'looks' more like an electronic communications service or whether it looks more like a conventional voice service and therefore is regulated as a Public Available Telephone Service (PATS) under the EC's Universal Service Directive 2002/22/EC (Article 2(c)). See the EC 2004 VoIP Communication for more details.

49 Commission notice on the legal status of Voice on the Internet under Directive 90/388/EEC OJ C6, 10.1.1998 and Commission Communication on VoIP OJ C369, 22.12.2000.

50 Discussed in detail Section 3.1 on *Classification of Telecommunications Issues* below.

51 See FCC website at: http://ftp.fcc.gov/cgb/consumerfacts/voip.html, date accessed September 2005.

52 Discussed in Section 3.1 below (*Classification of Telecommunications Issues*).

This is in part to determine a better system of more accurately classifying telecommunication services. Clearly there is a problem at present with the classification of telecommunication services, as the current Services Sectoral Classification List in Telecommunications service sectors (MTN.GNS/W/120), is woefully out of date as regards new internet-based services, such as VoIP. Classification of telecommunications services is discussed below (Section 3.1 Classification of Telecommunications Issues).

3. The WTO

This section covers some of the main areas in telecommunications that the WTO could seriously impact in the *future*. These areas include: classification of telecommunication services for the purposes of negotiating new trade schedules (mentioned above) and network-based transactions (how telecommunication services can be coupled with complimentary services in other sectors such as computing, financial, and distribution services to generate increased trade in electronic products (e-commerce)). The accurate classification of telecommunication services is important as when technology progresses, existing classifications become quickly redundant, one of the problems faced by GATS negotiators in the last round. The section begins with an overview discussion of the potential work of the WTO in telecommunications in the final stages of the Doha Round and post Doha. The sub-section aims to capture the need for the WTO to consider the key dynamics influencing the telecoms sector and also the new commercial structures arising as the result of convergence of telecommunication, information technology, and broadcasting networks.

Potential work for the WTO post Doha The WTO Basic Telecommunications Agreement ('BTA') is a plurilateral agreement. Although only a subgroup[53] of the WTO's 144 members have made specific commitments for basic telecommunications, the full WTO membership can take advantage of the trade benefits conferred by those commitments. Most countries making specific commitments under the BTA did so as part of negotiations of the BTA, but countries may continue to make new (or improved) commitments through three principal routes: (1) when joining the WTO; (2) as part of a formal 'round' of negotiations; or (3) unilaterally.

In telecommunications, the last decade saw unrivalled privatization and corporatization programmes in many countries all over the world generating the free flow of capital into the sector. The BTA played an important role in

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[53] As at 2003, there were at least 84 countries who had made offers under the BTA.

putting in place a basic regulatory framework that would assist in protecting such investment. But where did this new capital come from? Large increases in international and domestic calls and reduced costs through more efficient transmission allowed firms to generate increased margins in conjunction with increased earnings, which in turn were retained in the sector fuelling new investment. Telephone companies became increasingly profitable and with the glimpse of the new economy, such operators were able to attract investment from other sectors. The present decade however is completely different. Now, telecommunication operators are faced with managing increasing levels of debt rather than investing in new capital. Furthermore, the industry is yet to prove that technological changes and new service development will have a net impact other than in reducing the cost base and adding intense pressure on current market prices. Coupled with debt arising from huge sunk costs, the advent of IP as the basic protocol and foundation stone for the production of new telecommunication services, the industry is fast transforming its whole production function. In this way, the Doha Round was completely different to the earlier Uruguay Round. The Uruguay Round culminated in the BTA, the Doha Round, which ended in standstill made only small steps forward, notably as regards developing countries.[54]

In telecommunications, the World Bank has already commissioned research that will seek to answer a range of fundamental questions that will impact on whether or not members make new commitments post Doha. These questions include:[55]

- to provide an analytical framework for understanding, with specific reference to the telecommunications sector, the potential economic benefits and risks of accession and/or an enhanced offer under GATS/WTO;
- to explore the relationship between the WTO offer and the processes of domestic policy reforms within the telecommunications sector and other relevant policy developments, such as may be the case with competition policy;
- to demonstrate, through the use of case studies and other 'primary' data from selected developing countries, the economic benefits and risks that have resulted from the BTA offers made under the 1996/7 GATS/WTO framework;

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[54] See the Doha Round section of the WTO's website at: www.wto.org, date accessed September 2005. Developing countries and telecommunications are discussed in Section 3.3 below.

[55] World Bank (2003), *Terms of Reference, Telecommunications Trade Liberalisation and the WTO*.

- to consider the ways in which new trade agenda items may redefine the benefits and risks associated with the WTO Doha negotiations in telecommunications and to consider some of the new trade issues that are emerging as a result of broader deployment of ICTs across an economy.

In defining the work of the WTO post-Doha in telecommunications, greater emphasis will be placed on the new trade agenda items cited above. Defining these items is difficult as technology changes so rapidly, and so perhaps we need first to understand the *key dynamics* influencing the telecommunications industry, before beginning to define possible new trade agenda items. Key dynamics will include: new technologies and data services, particularly technologies that will continue to lower international transmission costs, such as optical fibre, quite often used for transmission within cities as well as national and international transmission; satellite channels; Digital Subscriber Loop (DSL) technology which can enhance the capacity of the local loop offering broadband-type functionality; the next generation Internet Protocol IPv6;[56] and fixed wireless access. For developing countries, wireless access has been particularly important in reaching rural or mountainous areas difficult to serve with conventional fixed-line networks. As such, the reduction in the price of mobile network infrastructure and the success of operators in countries often considered to be too poor to offer commercial potential have influenced the priorities for negotiations under Doha. It is anticipated that this will continue with the establishment of 3G technologies giving the potential to reduce the value of wire-based access in countries which do not already have viable wireline access infrastructure.

Besides these new technologies, there will also be new industry *commercial structures*, for example multinational corporation consolidation, and the emergence of multi-technology operators and service providers through joint ventures, mergers or other technology transfer arrangements. Market struc-

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[56] See for example http://www.ripe.net/ripe/meetings/archive/ripe-38/presentations/RIPE_Jan_01_%20IPv4_Address_Exhaust_draftB/sld001.html. Note that the Universal Mobile Telecommunications System (UMTS) industry is actively working for a move to IPv6. If successful, UMTS will need many addresses. It is a new service, potentially supported on new network infrastructures. Early adopters of IPv6 will face the additional cost in interfacing with IPv4 (where by far the most content is), in finding software that uses IPv6 without reducing performance, and in obtaining bandwidth to carry bigger v6 headers. In all probability, the two versions will coexist and interwork indefinitely, but developing countries in particular will need to consider carefully the costs involved in a move to IPv6, as the incumbent will be required to compete with new entrants (often heavily resourced by foreign shareholders) while simultaneously foregoing monopoly rents.

tures have fundamentally moved away from the use of legacy circuit-switched networks to packet-switched networks, giving rise to new categories of operator, such as internet backbone operators, transit operators, and application service providers. Together with the new operators have come changes in the way in which such operators interconnect to exchange traffic, often based on an exchange of leased-line capacity on a settlement-free basis (peering) and moving to sophisticated methods of negotiating transit on a payment basis. Regulators have mostly exercised forbearance in regulating such agreements between internet service providers, but have been slowly moving in this direction as greater volumes of internet traffic are originated and terminated. Other key dynamics will include the effect of huge sunk investments by operators and service providers, explaining their waning interest in entering new, developing and higher risk markets, and finally, the effect of new regulatory mechanisms, such as auctions (for example for UMTS), and the large investment in new licences.

Furthermore, the emergence of bilateral and multilateral trading blocs through free-trade area agreements and customs unions will have a significant impact on future trade policy in telecommunications. At the bilateral level, the number of bilateral investment treaties (BITs) covering FDI in services reached 2,265 by the end of 2003, and involving 175 countries.[57] In 2004, this number increased to 2392 (World Investment Report 2005). There is a risk of multiple standards emerging when agreements are signed outside of the global multilateral trade institutions, which may reduce WTO negotiations to a 'lowest-common denominator'. There is evidence that this has already happened to some extent: for example in several bilateral/FTA agreements negotiated by the United States,[58] we see provisions encouraging the take-up of digital trade, which depends both on having access to the necessary infrastructure and protection of the intellectual property in content that flows over such infrastructure (so called TRIPS-plus provisions, such as provisions on digital rights management and anti-circumvention of copyright controls). Many of these provisions relating to digital trade (e-commerce) have not yet been agreed at the multilateral level at the WTO.[59] However, regional initiatives can also assist WTO accession, through technical assistance programmes implemented at a regional level, or through the aggregation of regional

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[57] UNCTAD (2004), *World Investment Report*, 221.

[58] See for example the US-Jordan Free Trade Agreement and US-Singapore agreements.

[59] The WIPO 'Internet Treaties' have not for example been ratified by all members of the WTO but do include more extensive provisions on digital rights than included in the TRIPS, for example on anticircumvention and the reproduction right of electronic copies.

demand (particularly where investors may be wary of investment in smaller countries, for example island states), for instance through customs unions or other regional regimes. The recent UNCTAD World Investment Reports 2004 and 2005 highlights the shift to services, and the greater reliance placed on bilateral and regional trade agreements respectively.

As mentioned above, internet networks have transformed the production function of telecommunications. For this reason, it will be necessary to consider the potential impact of the ITU's Recommendation D.50 on international internet interconnection agreed at the WTSA in October 2000. This recommends that 'administrations [i.e. telecommunications operators] involved in the provision of international Internet connections negotiate and agree to bilateral commercial arrangements enabling direct international Internet connections that take into account the possible need for compensation between them for the value of elements such as traffic flow, number of routes, geographical coverage and cost of international transmission amongst others'. The implications of Recommendation D.50 are hard to gauge at this stage, but it could have far-reaching ramifications on the international trade of internet traffic between operators, and therefore indirectly affect consumer welfare.[60] New trade issues will also include, on the part of developed countries, the strengthening of competition principles, either at the WTO level or through some form of amendment to the Reference Paper,[61] through reforms required as a condition of World Bank funding of infrastructure or new legislative programmes, or perhaps through a separate plurilateral agreement. The recent Mexico-Telmex case for example has led to further clarification of the competition provisions of the Reference Paper. The extent to which existing commitments under the GATS, and the Services Sectoral Classification List, cover new service delivery sectors, such as services delivered over Transmission Control Protocol/Internet Protocol (TCP/IP) ('internet networks'), for example electronic commerce services, will also be included. In conjunction with this, the likelihood of 'bundled' sectoral commitments in complimentary service sectors, such as computer, audiovisual, distribution, advertising, and financial sectors that seek to facilitate 'network-based transactions' (e-commerce) in these sectors will also be a target, particularly for countries,

[60] Internet interconnection is discussed in more detail in Section 4 on *Developments in Multilateral Telecommunication Measures* below.

[61] The recent *Mexico-Telmex* case discussed in Section 4.2 on *The Reference Paper in light of Mexico-Telmex* below highlights how the competition provisions of the regulatory Reference Paper for example have now been interpreted and further strengthened by the panel's ruling. However, some commentators would argue that the panel has created examples of anti-competitive practice, such as a restriction on cartels that has never been agreed by the WTO membership.

such as the United States, which has actively pursued a 'Digital Trade Agenda' (mentioned above) as part of its negotiations for bilateral and Free Trade Agreements with a range of countries including Singapore, Jordan, and Australia. Finally, new trade issues in telecommunications post Doha could also include new commitments on technical cooperation and capacity building made by member governments in the Doha Declaration. Classification of telecommunication services and network-based transactions are discussed in more detail in the following two sections. They constitute two of the most significant challenges for the WTO in encouraging increased trade in telecommunications and the electronic services that flow over digital networks.

3.1. Classification of telecommunications issues

As mentioned earlier, the classification of telecommunication services is important given that telecommunication services serve as valuable inputs in the production and distribution of other services. Given also the rapid rate of convergence in this sector (broadcasting, information technology and telecommunications networks coming together) made possible through digital technology, the need to accurately classify relevant services into their distinct service schedules is necessary for the trade negotiators to enter into request and offer negotiations as part of the trade round (often bilateral as offers are targeted at particular WTO members or groups of members).

The current classification system used by trade negotiators in telecommunications broadly splits telecommunication services into eleven basic categories, the most important of which include: fixed, wireless, national, international, satellite, and data services. Many of these service offerings have now become blurred with the take-up of digital technology. For example, there is now a distinction to be made between geographic (identified by location) and non-geographic services (independent of location), conditional access systems (pay-per-view broadcasting systems) and video-on-demand. Currently, the WTO Agreements make use of two classification systems: the harmonized commodity description and coding system (HS), which applies to goods under the GATT, originally created under the auspices of the World Customs Organization (WCO), and the classification list (W/120),[62] which is based to a great extent on the United Nations' *central product classification* (UNCPC), and applying mainly to services under the GATS. Although both the HS and the UNCPC were originally developed for statistical purposes, most scheduled commitments of WTO members are based on these classification systems. The HS provides a system for the identification of products (product lines) that helps members identify the customs duties payable, and

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[62] MTN.GNS/W/120 of 10 July 1991.

the collection and comparison of trade statistics. The HS is made up of a number of chapters that separate products by their physical characteristics rather than their end-use criteria. The chapters are further divided by headings, subheadings, and finally, the six-digit HS code number. The HS nomenclature is used to classify anything that qualifies as a good and in accordance with its *physical characteristics.*

To add another layer of complexity, the United Nations also defines services as comprising all economic activities included under the 'tertiary sector' in the United Nations International Standard Industrial Classification (ISIC) (Rev. 3.1). Telecommunications and Posts is just one category that falls under the ISIC. Also included are financial services, business services, television broadcasting and entertainment. The United Nations Statistical Classifications Section is now starting its fourth revision of the ISIC for use from 2007, to take account of changes in technology as well as deregulation, liberalization and privatization of previously state-controlled operations.[63] At the time of writing, a new information and communication category is planned with second-tier groupings for telecommunications, broadcasting and internet providers (currently grouped under a sub-set of 'transport, storage and communications'). The UNCPC mentioned above provides a greater level of disaggregation than the ISIC in that it specifies individual product categories (more than 600) as opposed to the ISIC's general service descriptions.[64]

Leading up to the negotiations on the BTA, the WTO Secretariat prepared an informal note on the full list of telecommunication services sub-sectors from the W/120 Classification List to help participants in the Negotiating Group on Basic Telecommunications in drafting their Schedules of Specific Commitments under the GATS.[65] The informal note and Notes for Scheduling of Specific Commitments under the GATS[66] were later incorporated into a final version of the Guidelines for the Scheduling of Specific Commitments under the GATS in 2001.[67]

Most WTO members have made commitments using the W/120 classification list,[68] but some have used their own method of classification, and some a

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[63] UNCTAD (2004), *World Investment Report*, 145.

[64] Ibid, p. 146.

[65] Draft model Schedule of Commitments on Basic Telecommunications, Job 1311, WTO, April 1995.

[66] Note by the Chairman of Group on Basic Telecommunications, S/GBT/W/2/Rev.1, WTO, January 1997.

[67] S/L/92, WTO, March 2001.

[68] It is also important to note that Schedules of commitments in the telecoms sector have been made on the basis of two 'guidance notes': (i) *Note for Scheduling Basic Telecom Services Commitments* (S/GBT/W/2/Rev.1); and (ii) *Market Access Limitations on Spectrum Availability* (S/GBT/W/3). The first note states that any

combination of the two.[69] The W/120 classification list basically divides telecommunications services into two broad categories: (a) *Basic* telecommunications services which include all telecommunication services, both public and private, that involve end-to-end transmission of customer supplier information;[70] and (b) *Value-added* telecommunication services which include services for which suppliers 'add value' to the customer's information by enhancing its form or content or by providing for its storage and retrieval.

As of March 2004, 41 WTO members still used the W/120 classification list to submit their initial offers in the telecommunications services sector as part of the Doha Round. There are however on-going problems with the continued use of W/120 (including the fact that many sub-sectors set out in W/120 are not technologically neutral which will inevitably lead to redundant classifications as technology changes): that a number of service sub-sectors do not correspond with modern trade in telecommunications (telegraph and telex services[71]); that categories of services potentially overlap particularly in light of converged digital services; that the link with the UNCPC creates confusion in that the UNCPC is itself not up-to-date, and that a number of telecommunication services now overlap with the computer-related services sector. In

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services committed can be supplied for local, long-distance, and international transmission on a public or non-public basis, on a facilities-basis or on a resale-basis and with *any technology* (my emphasis) whether the user is mobile or not. This could mean that existing commitments would cover new and previously unexpected technologies, although some members would argue against this. The second note allows for members to impose restrictions on the number of wireless operators without such a restriction being classed as a 'market access' restriction. All commitments made under the BTA have to be read in conjunction with these guidance notes. The notes have also been included in Members WTO Scheduling Guidelines (S/L/91). The Scheduling Guidelines were further updated in March 2001, when the members of the Council of Trade in Services adopted Guidelines for the Scheduling of Specific Commitments under the General Agreement on Trade in Services (GATS)(S/L/92). It is important to remember however that if there were deficiencies in the original classification, then the notes would not cover those deficiencies, and will only apply to those sectors actually committed.

[69] Gambia has based its commitments on the CPC, Argentina used partly the CPC and an own list of services, whilst some members used their own lists for all scheduled telecom service commitments (Brunei, Colombia, Malaysia, Singapore, Sri Lanka, and Uganda).

[70] Paragraph 1 of the Decision on negotiations on basic telecommunications services, which forms part of the Annexes of the Uruguay Round agreements, states that: 'Negotiations shall be entered into on a voluntary basis with a view to the progressive liberalisation of trade in telecommunications transport networks services (hereinafter referred to as 'basic telecommunications') within the framework of the General Agreement on Trade in Services'.

[71] Although a small number of Least Developed Countries (LDCs) still use such services.

light of these difficulties, the European Commission in 2004 issued a non-paper setting out suggestions for revision of the W/120.[72] The EC's primary suggestion is to simplify the classifications based on the complex and out-of-date W/120 by defining telecommunication services as 'any service consisting of the transmission and reception of signals by any electromagnetic means'. Commitments for all telecommunication services can then be made with that definition in mind,[73] and where members do not wish to make a commitment for a specific service (for example for broadcasting transmission), they would simply inscribe under the market access and national treatment columns 'none except for broadcasting transmission'.

Certainly, the EC's definition would remove the artificial construct now existing between basic and value-added telecommunication services that is fast becoming increasingly redundant given the switch to transmission production based on the IP protocol. Furthermore, there is no doubt that the existing WTO member Schedules on market access and national treatment in telecommunications will not be able to deal with the evolution of technology in this sector. The question remains as to whether the EC's suggested revision goes far enough to cover the new range of internet services or so called 'complimentary services' based on transmission production switching to the IP protocol?

3.2. Network-based transactions and complimentary services

As mentioned above, the United States has for some time discussed the need for other WTO Members to schedule commitments in basic and value-added telecommunications services but also in 'complimentary services', such as distribution, express delivery, computer, advertising, and certain financial services that can be integrated into network-based transactions.[74] The US argues that increased market access, particularly in GATS modes 1 (cross-border supply) and 3 (commercial presence), is a necessary step for a WTO member to create an environment attractive to increased foreign investment. Increasing market access commitments for services enhanced through the use of networks, encourages both growth of the underlying network and the services that ride over them. Given the US position of dominance as regards electronic commerce services, arguing for increased market access in compli-

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[72] European Communities non-paper on classification in the telecommunication sector under the WTO-GATS Framework, 10 May 2004.

[73] By inserting the EC's suggested definition in the column identifying the sector.

[74] See US paper on *Market Access in Telecommunications and Complimentary Services: The WTO's role in accelerating the development of a globally networked economy* available from the WTO website database at: www.wto.org.

mentary services makes sense. But such an argument could also apply to other WTO members active in developing their technology service *exports*. This would also depend crucially on whether technology service exports (electronic intangibles) were classed as goods under the GATT and therefore potentially liable to tariffs *or* services under the GATS and liable to governmental measures (discussed briefly in the next section). Putting the problem of classification to one side, increased market access commitments in complimentary services could not only benefit the US but also a number of developing countries which have successfully grown their in-house software and hardware industries, such as Singapore, Chinese Taipei, Chinese Hong Kong, Korea, and India as selected examples. Under Article 5(b)(3) of the Annexe on Telecommunications service suppliers are guaranteed that they can employ the *protocol* of their choice in delivering any service over a telecommunications network that has been scheduled by the WTO member concerned as a specific commitment. This is an extremely important provision and could cover the cross-border delivery of internet services, although not all members would agree with such an interpretation. The Annexe on Telecommunications of course, unlike the Reference Paper, applies to value-added services (and specifically to gain access to a member's incumbent telecommunications network for the purpose of providing services that have been inscribed in that member's schedule of specific commitments).

The OECD has also undertaken research on considering various services as necessary 'inputs' for the facilitation of electronic commerce.[75] The OECD argues that the 'rationale for a cluster approach in services negotiations is to allow an appropriate recognition of the commercial linkages between selected service sectors, without disturbing the Services Sectoral Classification List, on which existing schedules of specific commitments are based'.[76] The OECD argues that a basic cluster of services necessary for internet-based commercial transactions would include: telecommunications services, banking services, computer and related services, and delivery services (postal and courier). A more extended cluster could also be envisaged as including: advertising, legal, market research, photographic, web-site design, and distribution.[77]

3.3. Electronic intangibles

The previous section discussed complimentary services, services that can be delivered as network-based transactions and the clusters of commitments required to be scheduled in order for such services to be provided through any

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[75] TD/TC/WP(2000)9/FINAL.
[76] TD/TC/WP(2000)33/FINAL, para. 24.
[77] Ibid, para. 27.

of the modes of supply under the GATS. No doubt, such commitments if scheduled would advantage any Member who is in a position to exploit the new market access opportunities, currently the developed countries, and in particular, the United States, but also countries with an active technology sector, such as Singapore, Korea, Japan, Taiwan, and increasingly India and China.

The whole approach to network-based transactions and seeking commitments from WTO Members that will allow for complimentary services that could run over a telecommunication network is simply a stepping-stone to generating increased trade in electronic commerce. As mentioned, at present, the United States will be an obvious winner of increased commitments, reflecting clusters of services and complimentary network-based transactions, given its strength in exporting electronic products, in this chapter referred to as electronic intangibles.[78] As trade in electronic intangibles increases, there will however be another problem that will need to be resolved in the course of time, again linked to the problem of classification. Just as the WTO is facing the issue of how to refine and redefine the W/120 classification system for telecommunication services under the GATS, so too is it facing difficulty in defining whether electronic intangibles should be classed as goods under the GATT or as services under the GATS or as some form of hybrid product.[79]

Recently, we have seen significant determinations by WTO Panels and the Appellate Body, and requests for panels on similarly diverse products from apples,[80] genetically modified crops[81] to steel.[82] But the issue of electronic intangibles, 'content rich' products that can be delivered directly to consumers by way of the internet, is likely to become one of the most eagerly contested issues in the WTO as trade in electronic commerce continues to escalate. The

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[78] A generic term, sometimes referred to as e-products or digital goods and services, ranging from MP3 files, pay-per-view/video-on-demand movies to customized software in sectors as diverse as audiovisual to health and education. Such products, often a digital combination of binary code, are referred to in this chapter as 'electronic intangibles'.

[79] The issue of electronic intangibles, 'content rich' products that can be delivered directly to consumers by way of the internet is likely to become one of the most eagerly contested issues in the WTO as trade in electronic commerce continues to escalate, estimated to reach at least US$2.4 trillion in the Asia-Pacific region alone by 2006 (Gartner Group, report in the *People's Daily Online* 2001).

[80] *Japan-Measures affecting the importation of apples* (Case WT/DS245/AB/R), WTO, November 2003.

[81] *European Communities-Measures affecting the approval and marketing of biotech products* (Case WT/DS291/23), WTO, August 2003.

[82] *United States-Definitive safeguard measures on imports of certain steel products* (WT/DS251/AB/R-WT/DS259/AB/R), WTO, November 2003.

recent WTO Dispute Settlement Appellate Body case, *United States – Measures affecting the cross-border supply of gambling & betting services* ('US gambling', WT/05285/AB/R, April 2005) creates a crucial precedent for trade in electronic services under Mode 1 (cross-border) GATS. The case has confirmed the rule of *technological neutrality* as regards the trade in cross-border services, although no decision has yet been reached on whether the TRIPS, GATS or GATT should specifically apply to the classification of electronic intangibles (sometimes referred to as e-products or digital goods and services, effectively a digital combination of binary code). The *US-gambling* case confirms that all GATTs Mode 1 committments include the electronic form of delivery of the 'like' physical service. This is an important precedent, as international rules on the movement of electronic intangibles will have a direct effect on the ability of countries to export overseas. The position is yet to be confirmed.

4. Developments in multilateral telecommunication measures

The aim of this section is to discuss the key legal WTO instruments impacting telecommunications in greater detail (the RP and AT), and also other 'soft law' that is is likely to have an impact in the future. The section also examines the current weakness of the Reference Paper in light of recent case law. The section begins with a discussion of the two most important WTO instruments affecting *trade* in international telecommunications, besides the schedules of specific commitments of the WTO members themselves (both the 1994 and 1997 commitments). Section 4.1 discusses the Annex and Reference Paper, Section 4.2 discusses the weaknesses of the Reference Paper in light of the recent *Mexico-Telmex* case heard by the WTO's DSB[83] in 2004. Section 4.3 looks at the increasing relevance of internet interconnection as operators switch their transmission production functions to ones based on the IP protocol. Section 4.3 also looks at whether or not the Annexe or the Reference Paper can cover a new breed of internet network and the ITU Recommendation D.50, and the APEC principles, both of which relate to the potential regulation of internet traffic, but which are examples of 'soft law'.

4.1. Annex on telecommunications and the reference paper

ANNEX ON TELECOMMUNICATIONS The Annex on Telecommunications is a separate Annex to the GATS and negotiated at the time of the Uruguay Round. The Annex is a very important legal instrument that being part of the GATS is

[83] *Mexico – Measures affecting telecommunications services*, WT/DS204/R, 2 April 2004.

mandatory and binds all WTO members. Its principal point of use is that it provides a form of legal certainty to foreign investors needing to have access to the telecommunications network of the target state incumbent operator for the purposes of providing services that have been scheduled as commitments in the schedule of specific commitments of the target state. The Annex therefore must be read in conjunction with the schedule of specific commitments in order to determine its significance as a form of security for foreign operators. In short, the Annex applies to measures of a member that affect access to and use of its public telecommunications transport networks and services.[84] The Annex does not apply to measures affecting cable or broadcast distribution of radio or television programming.[85] As mentioned, the obligations contained in the Annex are aimed at facilitating the exploitation of scheduled commitments only, and do not create a right to supply a service where no scheduled commitment for that service exists.[86] The Annex is basically an instrument that provides a certain level of security for those investors investing in ancillary service markets, such as banking and insurance, where market access commitments have been scheduled, and which require access to the local Public Switched Telephony Network (PSTN) to provide such services. Importantly, the Annex at paragraph 5(e) provides for service suppliers to be able to interconnect with the incumbent's network using any *interface protocol* to do so. The question arises then as to whether the Annex provides for access to internet networks and also for the interconnection of an internet network with the local Public Switched Telephony Network (PSTN). The issue is still under debate within the Council for Trade in Services, with many developing countries arguing that no such access was scheduled for in many members' commitments.

REFERENCE PAPER Whereas the Annex applies to value-added services, the Reference Paper (RP) applies to basic (for example voice) telecommunication services.[87] The Annex is mandatory, but the Reference Paper takes the form of an *additional commitment* in a member's schedule (not mandatory, but once accepted, binding). The RP can be seen as a measure for liberalization of a

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[84] Para 7.288 Report of the Panel on *Mexico – Measures affecting Telecommunications Services*, April 2004.

[85] Para 1, WTO Annex on Telecommunications.

[86] Para 7.293 Report of the Panel on *Mexico – Measures affecting Telecommunications Services*, April 2004.

[87] Defined as 'the real-time transmission of customer supplier information between two or more points without end-to-end change in the form or content of the customer's information'. Section 3(b) GATS Annex on Telecommunications. See also para 7.32 WT/DS204/R (*Mexico-Telmex* case).

member's telecommunications sector, including provisions on competition, interconnection, licensing, dispute resolution, regulatory structure, and access to spectrum amongst others. Its primary aim is to improve market access in basic telecommunication services (an area that many WTO members refused to enter into negotiation over during the Uruguay Round, as basic telecommunication services were seen as the 'cash cow' for many nations dependent on international accounting settlements to bolster their treasury departments). However, with the wave of privatization and increased foreign investment mentioned above, members perceived the need to liberalize in order to attract the necessary investment to develop the alternative infrastructure that would encourage further competition and service delivery in domestic markets. As of March 2004, 35 WTO members have taken out an additional commitment in the form of the Reference Paper in its entirety or with modifications and extensions. The RP is a deceptively simple instrument in *appearance*, and yet its effect, particularly on the domestic telecommunications policy of any one member, is potentially very far reaching, ushering in competition-type provisions to check abuse of monopoly power and interconnection safeguards to guarantee interconnection to the local incumbent's (publicly available) telecommunications network.[88] The RP sets out rules for governments on regulating 'major suppliers' of basic telecommunications services, major suppliers being defined as:

> a supplier which has the ability to materially affect the terms of participation (having regard to price and supply) in the relevant market for basic telecommunication services as a result of:
> (a) control over essential facilities; or
> (b) use of its position on the market.

Essential facilities in turn being defined by the RP as:

> facilities of a public telecommunications transport network or service that
> (a) are exclusively or predominantly provided by a single or limited number of suppliers; and
> (b) cannot feasibly be economically or technically substituted in order to provide a service.

These terms seek to import an essential facilities doctrine at the multilateral

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[88] In other words, networks and services that are made available to the general public through a national numbering plan. Corporate private networks are therefore excluded, although Closed User Groups may or may not be included depending on whether the member in question has excluded such a provision or not in its own Reference Paper.

level in terms of regulating telecommunications. The essential facilities doctrine concerns mandated access to an incumbent's network, where the incumbent has refused to grant access, and for no objective reason, or has withdrawn supply, or is applying some form of discriminatory policy in granting access (for example treating its own subsidiaries more favourably).[89]

The RP also requires governments to take measures ensuring that major suppliers do not engage in anti-competitive practices such as cross-subsidization,[90] using confidential information (for example on interconnection) in an inappropriate way, or unnecessarily withholding technical information (for example on standards) from competitors. Also covered are requirements for cost-orientated interconnection (which is not defined under the instrument), mandated interconnection with major suppliers networks for the provision of basic telecommunications services, and unbundled services so that users are not paying for network components or facilities that they do not actually require.[91] Provisions also exist for maintaining policy measures to achieve universal service (left to the discretion of the member), the creation of separate regulatory bodies from incumbent operators to allow for arm's-length regulation of the operator, and the use of transparent and non-discriminatory procedures for allocation and use of scare resources (such as spectrum and numbering).[92] Probably most importantly, the RP provides for dispute settlement on interconnection at Article 2.5. Although the RP refers to the dispute settlement body as being the independent regulator envisaged by Article 5 RP, in fact, the settlement body could be any independent domestic body, or if the dispute is between governments as opposed to private entities, perhaps the Dispute Settlement Body of the WTO itself. Within the WTO membership, it is widely recognized that most disputes do not end up before a panel, having being settled by the respective governments as part of the procedure envisioned by the Dispute Settlement Understanding.[93] The combination of polit-

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[89] In Europe, a string of cases including *Stena Sealink* (OJ 1994 L15/18), *Magill* (C-241/91P and C-242/91P), and *European Night Services* (OJ 1994 L259/20) sought to introduce the essential facilities doctrine into European law, but it was eventually made more difficult to apply pursuant to the test adopted in the case of *Oscar Bronner* (C-7/97). See chapter by R. Kariyawasam, (2000), 'Interconnection, Access and Peering: Law and Precedent', in *Telecommunications Law*, London: Blackstone Press, 136–223.

[90] Article 1.1 Reference Paper.

[91] Article 2 Reference Paper.

[92] Articles 3–6 Reference Paper.

[93] P. Cowhey and Kilmenko M. (2001), 'Implementing Telecommunications Liberalization in Developing Countries after the WTO Agreement on Basic Telecommunications Services', in R. Stern (ed.), *Services in the International Economy*, University of Michigan Press, p. 359.

ical pressure and threat of litigation before a WTO panel often strengthens the position of the regulatory authority that favours increased competition (Cowhey and Kilmenko 2001). This is exactly what happened in the *Mexico-Telmex* case discussed in the next section.

4.2. *The reference paper in light of* Mexico-Telmex[94]

Mexico-Telmex is a landmark WTO case, the first heard by the WTO's DSB in the telecommunications sector. The panel's report stretching to over 238 pages has already produced intense discussion on its possible future implications for WTO members, particularly those who still rely on high international accounting rate settlements to fund their domestic infrastructure. Effectively, the case leads the way for a cost-based interconnection framework for the termination of international calls and for the interpretation of the term 'anti-competitive practice' as found in the RP. A more detailed discussion follows. The author's intention in this section is to discuss some of the main issues arising from the panel's ruling rather than describe in detail the historical relationship between the United States and Mexico that led to the dispute.[95]

In *Mexico-Telmex*, the United States presented three main claims: (1) that Mexico had failed to ensure that its major telecommunications supplier provided interconnection on 'terms, conditions . . . and cost orientated rates that are . . . reasonable' in accordance with section 2 of its Reference Paper commitments; (2) that Mexico had not maintained appropriate measures to prevent Telmex, a major supplier, from engaging in 'anti-competitive practices' in accordance with section 1 of its Reference Paper commitments; and (3) that Mexico failed to ensure 'access to and use of' its public telecommunications transport networks and services, including private leased circuits, on 'reasonable and non-discriminatory terms and conditions', in accordance with its obligations under section 5 of the GATS Annexe on Telecommunications.[96] In brief, the panel accepted claims (1) and (2) of the US claim. However on claim (3), the panel argued that a specific provision in Mexico's GATS schedule allowed Mexico to prohibit the supply of cross-border services using leased-line capacity in Mexico.

An important element of the case focuses on *cross-border* interconnection rights. The US argued that the existence of an international accounting rate regime that may apply in certain cases to cross-border interconnection did not

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[94] *Mexico – Measures Affecting Telecommunication Services*, WT/DS204/R, April 2004.

[95] For a detailed discussion of the history of the case see the previous WTO working documents on *Mexico – Measures concerning Telecommunication Services* available on the WTO database.

[96] Ibid, para. 7.1 Section VII Findings.

mean that cross-border interconnection is excluded from the scope of the Reference Paper.[97] In contrast, Mexico argued that the provisions of the Reference Paper on interconnection do not apply to the cross-border supply of a service. It argued that the Reference Paper commitments were additional commitments undertaken under Article XVIII GATS, and could not therefore apply to cross-border interconnection, a market access issue covered under Article XVI. The panel however accepted the US position that the term interconnection 'does not distinguish between domestic and international interconnection, including through accounting rate regimes' and that the 'term interconnection within Mexico's Reference Paper does not justify a restricted interpretation of interconnection . . . which would exclude international interconnection, including accounting rate regimes, from the scope of Section 2 Reference Paper'.[98]

Another important ruling that the panel made which will affect international telecommunications is its decision on qualifying the Understanding on Accounting Rates on whether or not members' accounting rate settlement regimes will be shielded from dispute settlement, which the Understanding provides for. The panel argued that the accounting rates described in the Understanding should be 'understood to be limited to: (a) traditional accounting rate that is not cost-oriented; (b) that can be interpreted as a measure of a Member, or that triggers a Member's obligations under Article VIII on monopolies; and (c) that applies discriminatory rates on the basis of the national origin of the cross-border traffic, and thus may be inconsistent with the MFN principle in Article II'.[99] The crucial upshot of this is first, that not all international interconnection pricing is *excluded* from dispute settlement by the Understanding, only traditional accounting rate regimes with 'differential rates', and second, that the exclusion applies solely to dispute settlement not arising from the substantive obligations of the GATS, including the schedules of specific commitments. In effect the panel argued that the Understanding does *not* allow for all forms of cross-border interconnection to be *shielded* from dispute settlement.[100] This ruling in discussing the provisions of the Understanding, which although not a legally binding instrument was long held to be a form of gentleman's agreement, now effectively dilutes it.

The panel then went on to determine whether Telmex was a major supplier under the terms of the Reference Paper and also accepted that it had to define the 'relevant market' and whether Telmex had 'the ability to materially affect

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[97] Ibid, para. 7.97.
[98] Ibid, para. 7.117.
[99] Ibid, para. 7.136.
[100] Ibid, para. 7.138.

the terms of participation . . . in that market', and decide whether that ability resulted either from 'control over essential facilities' or 'from use of its position in the market'. Accordingly, the panel found the 'relevant market' to be the termination in Mexico of international calls from the US.[101] The panel also determined that Telmex was a major supplier with respect to call termination in that it had the ability to materially affect the price of termination of calls from the United States into Mexico, as a result of its special position in the market which allows it to set a uniform price applying to all its competitors on terminating calls from the United States.[102] Furthermore, the panel determined that the price Mexico was charging for terminating incoming international calls,[103] was not in accordance with the principles of cost-orientation as set out in Section 2.2 Mexico's Reference Paper.[104] The panel's extensive discussion on the meaning of the term *cost-orientation*, running to several pages of its decision (and based mainly on US-supplied methodologies which were for some reason not refuted by Mexico), will almost certainly be used in further DSB proceedings on interconnection in future years. This is an important precedent in international telecommunications, in that the term 'cost-orientation' was never defined in the Reference Paper.

The final significant element of the panel's ruling concerned the interpretation of 'anti-competitive practice' and is probably the one section of the ruling that has been the subject of criticism in terms of legal reasoning and methodology.[105] The panel found that Mexico had a special obligation to control Telmex as a 'major supplier' to ensure that it did not engage in 'anti-competitive practices'. Anti-competitive practices are not defined as a term in Section 1 of Mexico's Reference Paper. The panel instead turned to the *Shorter Oxford Dictionary* and the *Merriam Webster* dictionary references to define terms such as *competition* ('rivalry in the market, striving for custom between those who have the same commodities to dispose of') and *anti-competitive* ('tending to reduce or discourage competition').[106] The panel also found that the meaning of 'anti-competitive practices' was informed by related provisions of some international instruments that address competition policy; for example, Article 46 of the 1948 *Havana Charter* for an International Trade Organization already recognized that restrictive business practices, such as

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[101] Ibid, paras 7.149–7.152.

[102] Ibid para. 7.159.

[103] Ibid para. 7.230.

[104] Ibid, para. 7.216.

[105] For a good critical discussion of the panel's ruling on the competition issues raised by the *Mexico-Telmex* case, see P. Marsden (2004), 'WTO decides its First Competition Case, with Disappointing Results', *Competition Law Insight*, May.

[106] *Mexico-Telmex*, para. 7.230.

price-fixing and allocation of markets and customers, could adversely affect international trade by restraining competition and limiting market access.[107] The panel also argued that 'the importance of ensuring that firms refrain from engaging in horizontal price-fixing agreements, market or customer allocation arrangements and other forms of collusion is likewise emphasised in the United Nations *Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices*'.[108] The panel felt that it was also worth pointing out that both Mexico and the US are members of the OECD, and that the OECD has adopted a Recommendation calling for a strict prohibition of cartels.[109] It is interesting to note however, that in negotiations for the Reference Paper, none of these treaties was discussed or referred to in a similar way. In short, the panel's interpretation of the competition provisions as set out in the Reference Paper was not envisaged by the WTO membership at the time of its negotiation.[110]

In conclusion at paragraph 7.238 of its ruling, the panel found that 'the term 'anticompetitive practices' in Section 1 of Mexico's Reference Paper includes practices in addition to those listed in Section 1.2, in particular *horizontal* practices related to price-fixing and market sharing arrangements'. This is perhaps one of the most contentious issues in the panel's ruling as it effectively sets aside Mexican law (state action doctrine) on the application of uniform rates for call termination. Mexico had argued that practices required by regulation could not be 'anti-competitive' as they were mandated by 'ILD rules that are part of the regulatory framework of laws intended to increase competition' by preventing predatory pricing by foreign entrants.[111] The European Communities, as a third party to the proceedings, agreed with Mexico on this point, arguing that: 'the fixing of a uniform price cannot be an anti-competitive practice since uniform prices are required by law'.[112] The panel agreed that pursuant to doctrines applicable under the competition laws of some members, a firm complying with a 'specific legislative requirement of such a member (eg a trade law authorising private market sharing agreements) may be immunized from being found in violation of the general domestic competition law'. However, the panel also argued that international commitments made under the GATS 'for the purpose of preventing suppliers . . . from engaging in or continuing anti-competitive practices' are designed to limit the

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107 Ibid, para. 7.236.
108 Ibid.
109 Ibid.
110 See Marsden's analysis, supra note 105.
111 Ibid, para. 7.241.
112 Ibid.

regulatory powers of WTO members.[113] This is a remarkable finding in that the panel is using principles of international economic law (WTO law) to subvert national state doctrines. It must be said however that the European Commission has also found ways to circumvent the application of the state doctrine in DGIV Competition cases, for example in the *Deutsche Telekom* (DT) decision.[114] In the DT case, which concerns margin squeezing by the dominant incumbent Deutsche Telekom for wholesale prices offered for unbundled access to Deutsche Telekom's local loop network, although it was accepted that an undertaking could not be held responsible for breach of the antitrust rules if such a breach occurs because of the state having imposed on the undertaking a specific course of action (in this case the imposition of a price cap for local loop prices by the German regulator, *RegTP*), the Commission was still able to show that within the state-mandated action, the undertaking could have avoided the margin squeeze and subsequent infringement of Article 82 Treaty of Rome (abuse of a dominant position).[115] Clearly the European Commission's circumvention of the state action doctrine in *Deutsche Telekom* is not as direct as the panel's ruling in *Mexico-Telmex*; however, the author submits that the panel in *Mexico-Telmex* perhaps went a little too far in its interpretation of the term 'anti-competitive practice'. For instance, in finding as an example the use of price-fixing cartels as an anti-competitive practice, the panel read into the interpretation of the Reference Paper an example of an anti-competitive practice (price-fixing cartel) that has never been agreed by WTO members in their schedules of additional commitments or in any WTO covered agreement covering telecoms. This aspect of the panel's ruling is perhaps a worrying precedent for future WTO cases in the telecommunications sector.

Further to an agreement between the governments of Mexico and the United States, Mexico has decided not to appeal the case and will comply with the panel's recommendations. However it did add that: 'the flaws in some of the panel's reasonings and findings were particularly important in the light of the ongoing service negotiations'.[116]

4.3. Internet interconnection

Given the WTO's DSB panel's potentially wide and far-reaching ruling in

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[113] Ibid, para. 7.244.

[114] See Commission Press Release IP/03/717, 21 May 2003.

[115] See Keynote Address by Eric Van Ginderachter, European Commission Competition Directorate General, Communications and EC Competition Law, Brussels, October 2004.

[116] WTO News: Dispute Settlement Body 1 June 2004, *DSB adopts panel report on Mexican measures affecting telecommunications services from the United States.*

Mexico-Telmex, the panel nevertheless did not have to rule on issues in relation to *internet* traffic. The relevant market considered in the case was the termination of international voice calls in Mexico, calls that had originated in the US. These calls were conventional voice calls transmitted over circuit-switched networks. The position might have been very different if the nature of the calls had been internet calls or calls transmitted across packet-switched networks. Given the move by telecommunication operators towards the transmission production of voice and data calls based on the IP protocol, future cases before the WTO's DSB may very well involve internet calls. In which case, we need to pose the question: what is the relevance to the international trade in telecommunications of the interconnection model under the BTA's Reference Paper as applied to internet networks? For example, what effect would a move to include VoIP as either a voice or a packet-switched data service have on the Specific Commitments to the WTO of two of the most powerful actors in international telecommunications, the US and EU?[117] As part of a legal framework for liberalization, the Reference Paper details additional commitments on regulatory principles, including specific rules on interconnection. As mentioned above, Section 2.2 Reference Paper sets out obligations on major suppliers for interconnection.[118]

The coverage of some internet-related services, for example internet access services, by the BTA requires clarification. Some members have explicitly scheduled these services, whereas others regard internet access as being covered by either basic or value-added telecommunications commitments. Furthermore when an internet network is defined as a public telecommunications transport service and/or network by a member, the Annexe on Telecommunications will apply to access and use of the network, guaranteeing access and use of the network for any service scheduled as a specific commitment. It is not entirely clear however to what extent this position is accepted by the majority of the WTO membership and whether the Annex ensures access to internet networks and services for service suppliers.[119]

The point of interest is that for the supply of voice or packet-switched data transmission services (i.e. TCP/IP services) for all modes of supply covered

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[117] In a statement, the then Director of the WTO's trade in services division, David Hartridge, stated the urgent need for WTO member states to clarify their existing WTO agreements, making it clear which sections apply to e-commerce (and the internet). See 'WTO Director slams dangerous e-commerce ideas', *Total Telecom* (14 July 2000).

[118] A major supplier is defined in the Reference Paper as one who has market power because of: (a) its control over an essential facility; or (b) its position in the market.

[119] S/L/74, July 1999.

under both the US and the EU's Specific Commitments made as part of the BTA negotiations, i.e.: (1) cross-border supply, (2) consumption abroad, (3) commercial presence and (4) presence of natural persons, both the US and EU member states (for existing commitments) have placed no restrictions on market access or national treatment.[120] This would mean that if VoIP was classed as either a voice or packet-switched data service, then the interconnection obligations that both the US and EU have decided to accept as an Additional Commitment under their Schedule of Specific Commitments (i.e. the Reference Paper) would apply to all major suppliers of such services in both the US and EU.[121] This in turn would place an obligation on the major suppliers to interconnect with ISPs (including ISPs in developing countries who are member states of the WTO) in accordance with WTO guidelines in the following way:

- at any technically feasible point in the network;
- on non-discriminatory terms, rates and of a quality no less favourable than for the incumbent's own supply;
- in a timely fashion and on terms that are transparent and reasonable;
- at cost-orientated rates; and
- on an unbundled basis so that a buyer does not pay for unnecessary services.

This obligation to interconnect by a major supplier would benefit any Internet Service Provider (ISP) providing public telecommunications transport networks or services. The transparency obligation in particular when applied to negotiations between large global Internet Backbone Providers (IBPs) and

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[120] With certain exceptions however reserved for Luxembourg, Greece, Spain, Ireland and Portugal. See the WTO's Trade in Services paper GATS/SC/31/Suppl.3 11 April 1997.

[121] But this would depend on whether VoIP (over private networks) or Voice over Internet (over the PSTN) could be classed as a Basic Telecommunications Service or an Enhanced Service. In its latest offer, the US would appear to class VoIP as an information service (see later commentary). The interconnection obligations of the Reference Paper apply only to major suppliers of Basic Telecommunication Services. At present, a debate is raging within the WTO as to whether internet TCP/IP applications can be rightfully covered by the Reference Paper to the Fourth Protocol (and in effect any of the WTO agreements). The US claims that internet services are covered by WTO agreements, particularly the Annex on Telecommunications, as they would like to see other services, such as distribution and financial services, that can be integrated into telecommunications network transactions included in the offers of other member states as part of the Doha negotiations. Certainly under the EU's Schedule of Specific Commitments to the WTO, the Reference Paper does cover packet-switched data services, which would include TCP/IP services.

smaller ISPs, where the larger IBP is found to be a major supplier, would undermine the current industry practice of the IBP requiring negotiations to be governed by a non-disclosure agreement.

In other words, IBPs who are classed as major suppliers could be required to 'come clean' with their terms on peering and transit (interconnection agreements used for packet-switched networks). In addition, an ISP with third-country stakeholders could threaten to complain to the WTO if the IBP refuses to structure its peering arrangements on non-discriminatory terms with all its downstream customers, regardless of whether or not those customers are the IBP's own affiliates. The upshot of this would be that an IBP would no longer be able to give preferential terms for peering to its own downstream affiliates. Such a position could have major implications for US IBPs' revenue streams.

Interestingly however, in its latest offer to the Doha negotiations,[122] the United States classified packet-switched services as *information services* (packet-switched information services) without any reference to the UNCPC coding system discussed earlier. Under the US Telecommunication Act 1996, information services are *not* classed as telecommunication services and can therefore not be regulated as basic telecommunication services. Furthermore, VoIP services under US law are also currently classed as information services.[123] The Reference Paper only applies to basic telecommunication services. It would appear therefore that the US in classifying packet-switched services as information services has moved the regulation of these services away from regulatory capture by the Reference Paper (with its strict interconnection obligations) and under the capture of the Annexe on Telecommunications (which catches only those services that have been scheduled as specific commitments).

The obligation to interconnect on non-discriminatory and transparent terms would only appear to cover all major suppliers under the Reference Paper. The term 'major supplier', discussed above, applies to one who has control of an essential facility and/or is able to use its position in the market to influence competition and price. It is quite clear that the WTO's major supplier term refers to the concept of ownership of an essential facility, which would seem to cover only those operators who are 'super-dominant,[124] whereas the term for 'dominance' used by the European Commission, for example in its Framework Directive, is based on an economic analysis test,[125] where domi-

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[122] TN/S/O/USA, April 2003.

[123] See Section 2.3 on *VoIP* above.

[124] This would be particularly relevant given the high threshold test for the interpretation of an 'essential facility' given by the European Court of Justice in the case of *Oscar Bronner v. Mediaprint* Case C-7/97 (1998).

[125] The definition for dominance under Community case law was originally seen in Case 27/76 *United Brands v. Commission* ECR (1978).

nance could include any operator who could consistently keep prices high independently of competitors regardless of whether or not that operator owned an essential facility.[126]

Also, the WTO's definition of major supplier refers to an operator's 'position on the market'. This is fairly vague wording and it is not entirely clear whether such a definition would in competition law terms fall squarely within the definition for SMP (dominance) as used by the European Commission. It may be that this distinction between 'major supplier' under the WTO Reference Paper, and 'dominance' under the new EU directives will become crucially important as regulators become more experienced in dealing with anti-competitive practices arising in new TCI/IP markets.

4.4. ITU Recommendation D.50 and the APEC principles

There has in recent years been fierce debate as to which operators should bear the cost of the international leased line to and from third countries to the United States, where the third country hosts a substantial amount of content in the US or hubs a substantial amount of data traffic through US servers. Following the APEC Cancun Ministerial Statement in spring 2000, there has been extensive international debate on the principle of 'appropriate mutual compensation' for the use of internet resources. Relevant work continues in various public industry fora, and in closed commercial circles. The most vocal proponents of mandated cost-sharing have been the relatively developed Asian economies, plus Australia. The major telecommunications carriers in these countries, such as Singapore Telecom and VNSL in India, are all vying to become major internet traffic hubs. They see sharing the costs of international connections as a necessary step towards putting their cost bases on a more even footing with those of the USA.[127] The less developed Asian economies

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[126] However, in the earlier version of the draft Framework Directive, the Working Paper on a new regulatory framework published by the Commission in April 2000, the term for dominance included a reference to an essential facility. Following criticisms that the Commission was trying to create a new level of 'super-dominance' that would catch only those operators who would have enjoyed special or exclusive rights before the European 1998 telecommunications liberalization watershed (Full market liberalization: Council Resolution 1994 OJ C379/4 set a target date of 1 January 1998 for the removal of special and exclusive rights by European telecommunications operators), the Commission dropped the reference. Now dominance (significant market power) is interpreted in accordance with EC competition jurisprudence following the case of *United Brands* (for example, a market share in excess of 40 per cent leads to a presumption of dominance).

[127] See the research report produced for the UK's Department for International Development and co-authored by the author on 'Reducing the Costs for Internet Access for Developing Countries', 2001, at: http://www.wesra.com/cost1.htm.

recognize that they would not have much to gain from traffic-based cost-sharing in the short term, because the direction of traffic is strongly asymmetric towards them.[128] VoIP could change this picture in that traffic flow will be bi-directional as opposed to traffic generated from requests to access websites, which is more unidirectional. This would mean much more traffic being carried by Asian operators out to US hubs reinforcing the argument for a more balanced division of infrastructure costs between Asian ISPs and US backbone operators (currently tilted in favour of the US market players).

The issue has shifted from debate towards realization with the increasing role of commercial negotiators advancing internet interconnection arrangements. The proposed role of central authorities has fallen back to competition law enforcement, should infringements be found.

Traffic-based interconnect has already been introduced between major operators for certain services for commercial reasons (for example, global mobile roaming and VoIP). This is not a trivial step, as it entails measuring traffic and assessing its type, source, and/or destination. Once implemented, these techniques may also be applicable to general internet traffic exchange.[129]

The ITU debated this issue at the World Telecommunication Standardization Assembly 2000 (WTSA 2000). At the assembly, the United States voiced strong objections over the purpose of mutual charging arrangements, warning that it could have an adverse effect on the successful development of the internet. In the WTO, Australia and Chinese Taipei have proposed that where there are dominant players or *de facto* monopolies, members must play a role in promoting fair competition.[130] Colombia has called for the elimination of barriers to access specifically the high interconnection tariffs that backbone ISPs charge for connection to international backbone networks (see WTO paper S/LSS/W/119, November 2001). Mexico has called for internet interconnection principles to encourage the use of the internet for economic development (see WTO paper S/CSS/W/101, July 2001). Internet charging arrangements between providers of network services should be commercially negotiated and, among other issues, reflect:

(a) the contribution of each network to the communication;
(b) the use by each party of the interconnected network resources; and
(c) the end-to-end costs of international transport link capacity.

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[128] As the biggest part of the traffic is web pages downloaded from the USA to the developing country.

[129] See R. Kariyawasam, 'Defining Dominance for Bits & Bytes: A New Layering Theory for Interpreting Significant Market Power', *European Competition Law Review*, S&M, 26(10), October (2005), pp. 581–94.

[130] S/CSS/W/17, December 2000.

APEC eventually adopted these provisions at Cancun. The ITU in Recommendation D.50 adopted a more diluted approach:

> That administrations involved in the provision of international internet connections negotiate and agree to bilateral commercial arrangements enabling direct international internet interconnections that take into account the possible need for compensation between them for the value of the elements such as traffic flow, number of routes, geographical coverage and cost of international transmission amongst others.[131]

It is still too early to determine the effect of the APEC provisions or the ITU's Recommendation D.50 on international internet communications. An ITU Study Group (Study Group 3) followed up the recommendation with research on internet interconnection eventually producing a set of guidelines to go with the Recommendation D.50, and which were adopted by the ITU in June 2004. The guidelines include supporting the need for traffic aggregation at local and regional exchanges to reduce the volume of internet traffic being hubbed abroad (usually in the US). The World Summit on the Information Society has also received the position of DCs and LDCs and internet interconnection costs and has called for funding to enhance connectivity and the creation of internet exchanges.[132] At this stage, implementation will be at the commercial rather than regulatory level, and if commercial, then will depend entirely on the bargaining positions of the parties concerned. The Recommendation D.50 is nevertheless an important stepping-stone to potential 'hard core' regulation, subject of course to potential intense industry lobbying in this area.

5. Conclusion

At the time of writing, the second Phase of the World Summit on the Information Society (WSIS) is currently taking place in Tunisia in 2005, and it is hoped that following the Summit, a number of goals set out in the Action Plan will have been achieved. One of the main objectives of the WSIS is to achieve by 2015 a number of targets as set out in Article 6 WSIS Action Plan,[133] including for example to adapt all primary and secondary school curricula to meet the challenges of the Information Society, taking into account national circumstances; to ensure that all of the world's population

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[131] ITU Recommendation D.50 available on the ITU website at www.itu.org.

[132] See R. Kariyawasam, *International Economic Law and the Digital Divide: A New Silk Road*, Cheltenham, UK and Northampton, MA, USA: Edward Elgar (forthcoming).

[133] *World Summit on Information Society*, Document WSIS-03/GENEVA/DOC/5-E, December 2003.

have access to television and radio services; to encourage the development of content and to put in place technical conditions in order to facilitate the presence and use of all world languages on the internet; to ensure that more than half the world's inhabitants have access to ICTs. Clearly, we are some way from these targets, but with increased commitment to telecommunications reform at the level of the WTO addressing some of the weaknesses in current measures, for example on the issue of classification of telecommunication services (such as whether internet services can be interpreted as being within member commitments); increased domestic competition, but within the means of a member's planned liberalization agenda; and increased *transparency* in regulation through independent and well-resourced regulators, we will come some steps closer to meeting the targets set out in the WSIS Action Plan.[134]

[134] A more detailed discussion of developing countries and telecommunications is outside the scope of this chapter. For more information on the use of telecommunications, competition, intellectual property, technology transfer and development law see the forthcoming monograph by R. Kariyawasam, *International Economic Law and the Digital Divide: A New Silk Road?*, Cheltenham, UK and Northampton, MA: Edward Elgar, (forthcoming).

14. Private dispute resolution in international economic law

Diane P. Wood

Introduction

Global commerce, all agree, has reached unprecedented proportions in the twenty-first century. According to the World Trade Organization, the aggregate value of merchandise trade imports in the year 2003 was $7,569 billion; the value of merchandise trade exports was $7,294 billion.[1] The numbers for global trade in commercial services are just as impressive: 2003 imports were valued at $1,780 billion, and exports were valued at $1,795 billion.[2] Even one with a Panglossian view of the world will recognize that this enormous volume of commerce cannot take place without occasional friction between the parties. That friction, in turn, sometimes requires the use of a dispute resolution mechanism. In the most successful cases, the parties manage to resolve their problems informally, through discussions, the good offices of a trade association, or a trained mediator. Quite often they turn to arbitration, which has the twin virtues of being adaptable to the particular situation and producing an award that is enforceable in court. And, of course, the court systems in nations around the world are regularly presented with disputes that involve parties from beyond their borders, the need to apply foreign law, the need to gather evidence scattered around the world, and the question of enforceability of the judgments and orders of foreign courts.

Considering the complexity of the task and the potential volume of cases, private dispute resolution in international economic transactions today is essentially a success story. National courts routinely handle cases with some kind of foreign or international element, and their judgments normally put the dispute to rest. And for those who have reservations about national court systems, for whatever reason, there is a wide and growing array of arbitral institutions around the world, as well as an eager *corps* of potential arbitrators, who stand ready to provide their services to parties who would like to purchase dispute resolution on the private market.

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1 See WTO, 'World Trade in 2003 – Overview', Table 1.3, available at http://www.wto.org/english/res_e/statis_e/its2004_e/its04_overview_3.pdf.

2 *Id.*, Table 1.4.

Nevertheless, the fact that the system appears to be working reasonably well does not mean that there is nothing left to be done. To the contrary, a closer look reveals where the cracks and strains exist. For example, it has proven to be devilishly hard for the respected Hague Conference on Private International Law to draft a comprehensive convention that would provide for recognition and enforcement of money judgments in civil and commercial cases, much less to have any such convention enter into force at the global level.[3] Just as troubling is the failure to reach any international consensus on the way national courts ought to approach matters such as *lis pendens,* interim measures, and permanent injunctive relief. The mechanisms for coordinating parallel litigation in several countries are rudimentary at best, despite the fact that such litigation occurs with some frequency, and despite the fact that there are areas such as bankruptcy or decedent's estates where coordination is fast becoming a necessity. Effective adjudication is also impeded by continuing problems of obtaining evidence located outside the nation-state in which the court sits, even though this topic is regulated to a certain degree by an international convention.[4] As arbitration becomes more popular, new questions have arisen about the standards that should apply to the arbitral process itself and the nature of the judicial examination that precedes recognition and enforcement. Finally, new technologies have created a new generation of problems. Which court or courts should be empowered to adjudicate cases involving internet commerce, which touches every country at the same nanosecond? Whose law should apply when one country wishes to prohibit material on a website that is affirmatively protected elsewhere?

These and similar questions must be answered if international private dispute resolution is to remain as effective for the future as it has been up until now. This chapter begins with a look at the basic contours of the system, including a brief description of its scope for present purposes; it then turns to the problems that have resisted solution for so long and explores why that might be the case; and finally, it looks to the new generation of issues that have challenged every legal system to confront them. This examination

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[3] After working for more than a decade on a proposed convention on recognition and enforcement of foreign judgments in civil and commercial matters, the Hague Conference scaled back its ambitions and ultimately concluded a more modest Convention on Choice of Court Agreements on 30 June 2005. The text of the convention is available on the Hague Conference's website, at http://www.hcch.net/index_en.php?act=conventions.text&cid=98. The Choice of Court convention avoids the knottier issues of agreed rules on personal jurisdiction and exclusions that were impeding progress on the possible broader convention.

[4] Hague Convention on the Taking of Evidence in Civil and Commercial Matters, opened for signature 18 March 1970, 23 UST 2555, 846 UNTS 231; reprinted in 28 USC § 1781 note (hereinafter the Hague Evidence Convention).

suggests that more work needs to be done, within both the private systems of dispute resolution and the public systems of national courts. This is difficult work, as the history of prior efforts demonstrates, but it is essential nonetheless. Courts are institutionally ill-equipped to forge direct links to their counterparts around the world, but unless those links are created, it will become increasingly difficult to resolve international disputes efficiently, consistently, and logically.

The dispute resolution system: an overview

There are three aspects of any system of dispute resolution that are important: first, what are the institutions to which the parties will turn; second, what procedures will those institutions follow; and third, what law will those institutions apply? When one thinks of international dispute resolution, there is a fourth problem as well, which is what coordination mechanisms exist, either to allocate disputes to one country's institutions or another, or to enable cooperation while disputes are pending, or to decide what effect a prior judgment or award rendered by a stranger institution ought to have. A look at all four issues reveals an increasing level of complexity, going from the first to the last.

Institutions

Private economic disputes are resolved in two fundamentally different kinds of institutions: governmental institutions, also known as national court systems, and private institutions, known generically in the United States as 'alternative dispute resolution' or ADR bodies. Both are actively used, and each has certain prerequisites to access, certain advantages, and certain limitations. In the overview that follows, the chapter focuses on the courts of the United States as the primary example of a court system, with comparisons to those in other countries as needed. Because of its prominence, arbitration is the primary ADR mechanism discussed.

NATIONAL COURT SYSTEMS In the United States, parties faced with an economic dispute may choose generally between two kinds of court: the state courts of general jurisdiction, and the federal district courts, which are the courts of first instance in the federal system. Economic disputes often, though not always, involve questions of private law, such as the law of contract, tort, or property rights; those issues in the United States are generally governed by state law, whether the adjudication takes place in state court or federal court. Some economic disputes, however, are not so easily put in the 'private law' box: antitrust claims, securities claims, and other claims where US courts recognize a private right of action under a general regulatory scheme have an important public element. The latter claims, which often fall within the exclu-

sive jurisdiction of the federal courts, have been among the most difficult to handle at the international level: disputes about the reach of the prescriptive jurisdiction of the United States and the failure of the ordinary choice-of-law mechanisms have led to numerous confrontations over the years between the United States and other interested countries.

Because national court systems stand ready to resolve disputes, the decision to choose arbitration raises the question of why and when one forum is better than the other. In particular, it is helpful to consider what factors might drive the parties to use national court systems in preference to their own, tailor-made dispute resolution mechanism. The answer to this question is intertwined with questions of power. National courts have the power to command parties to appear before them; the power to compel not only parties but third-party entities to turn over information relevant to the resolution of the dispute; and the power in the end to enforce a judgment, whether by seizing assets under their control to satisfy a money judgment, or by imposing sanctions against individuals that will induce their compliance with declaratory or injunctive relief. (There is also an international convention, discussed below, that often conscripts domestic courts to enforce arbitral rulings as well.) In addition, parties may prefer courts because litigants typically have a right to a full explanation of the court's ruling, the opportunity to argue for a change in law, and a chance for meaningful appellate review. These features will encourage the use of courts rather than arbitral tribunals if, in the aggregate, they yield net benefits to the parties. Because the decision to arbitrate is often taken at the time a contract is signed, parties will decide between courts and arbitration based on which option *ex ante* appears more likely to yield a higher total value.

Power may not always be the reason for preferring a judicial forum, however: some parties may simply be inattentive, or unfamiliar with arbitration, or unfamiliar more generally with the workings of international economic transactions. The courts in the latter cases resolve the disputes because they are the default institution.

ALTERNATIVE DISPUTE RESOLUTION INSTITUTIONS In a back-handed compliment to the courts, virtually every other kind of dispute resolution mechanism or institution is normally dubbed an 'alternative' method. In addition to arbitration, this term includes a wide array of other options, such as conciliation, mediation, mini-trials, and the use of a third-party referee. ADR first began to receive sustained scholarly attention in the United States with Professor Frank Sander's 1976 path-breaking article on 'Varieties of Dispute Processing'.[5]

[5] Frank E.A. Sander (1979) 'Varieties of Dispute Processing', Addresses

Professor Sander identified a set of processes for dispute resolution including, at one end of the spectrum, adjudication (in court, through arbitration, or in an administrative process), and avoidance at the other end of the spectrum; in between, he placed an ombudsman or other fact-finding inquiry, mediation, conciliation, and negotiation.[6]

Important though the less formal ADR mechanisms are for international economic transactions, lack of hard data makes it difficult to say much about them. The major international arbitration institutions all offer mediation or conciliation services, along with their more formal arbitration procedures.[7] Anecdotal reports indicate a high rate of success in such mediations, despite the fact that they do not produce a result that can be recognized or enforced either in the territory of the country in which the proceeding took place or in that of another country. Without in any way minimizing the importance of this method of dispute resolution, therefore, the focus here is on the more intractable disputes that wind up either in formal arbitration or in court.

Although there are tens, if not hundreds, of institutions sponsoring international arbitration services around the world, Professor Thomas Carbonneau suggests that a mere handful of institutions has 'a virtual lock upon the trans-border arbitration service industry'.[8] He identifies the American Arbitration Association (AAA),[9] the International Chamber of Commerce (ICC),[10] the London Court of Arbitration (LCIA),[11] and the Stockholm Chamber of Commerce (SCC)[12] as the most important private institutions. He also

Delivered at the National Conference on the Causes of Popular Dissatisfaction with the Administration of Justice (7–8 April 1976), in 70 *Federal Rules Decision* 111, April, at 111.

6 *Id.* at 130–31. See also Frank E.A.Sander (1985), 'Alternative Methods of Dispute Resolution: An Overview', *Univeristy of Florida Law Review*, 37, 1.

7 See Elena V. Helmer, 'International Commercial Arbitration: Americanized, 'Civilized', or 'Harmonized' 19 *Ohio St.J. on Disp. Res.* 35, 48 n. 94 (citing ICC ADR R), at http://www.iccwbo.org/drs/english/adr/pdf_documents/adr_rules.pdf (in force as from 1 July 2001); AAA Int'l Mediation R., at http://www.adr.org/index2.1.jsp?JSPssid=15747 (amended and effective 1 July 2003); LCIA Mediation P., at http://www.lcia-arbitration.com/med/index.htm (effective 24 June 2002); R. Mediation Stockholm Mediation Inst., at http://www.sccinstitute.com/_upload/shared_files/regler/mediation.pdf (in force as of 1 April 1999).

8 Thomas E. Carbonneau (2002), 'The Ballad of Transborder Arbitration', *University of Miami Law Review*, 56, 773, 796.

9 See American Arbitration Association's International Centre for Dispute Resolution website, at www.adr.org/International.

10 See ICC's International Court of Arbitration website, at www.iccwbo.org/court/english/arbitration/introduction/asp.

11 See LCIA website, at www.lcia-arbitration.com/lcia/.

12 See www.sccinstitute.com/uk/Home/ for an English-language version of the Stockholm Chamber's international arbitration services.

discusses a number of institutions that are available for private party/state arbitrations, such as the International Centre for the Settlement of Investment Disputes (ICSID), which is affiliated with the World Bank.[13] These institutions do not handle anything like the volume of cases that come before national courts or the general arbitral bodies. ICSID, for example, reports on its website that it has had 89 concluded cases since 1972,[14] and (coincidentally) that it presently has 89 pending cases.[15] The ICC's International Court of Arbitration, in contrast, reports that in 2004 alone, it handled 561 requests for arbitration; 580 requests in 2003; 593 requests in 2002; and so on.[16] While these numbers may not seem overwhelming against the backdrop of the volume of international economic activity, it is worth recalling that the overwhelming majority of transactions are not dysfunctional enough to require any form of dispute resolution at all.

In addition to the private institutions under whose auspices international arbitrations take place, there is the United Nations Commission on International Trade Law, known familiarly as UNCITRAL. UNCITRAL is the primary vehicle through which the United Nations addresses international trade law. It has made arbitration one of its central projects. Perhaps best known are the UNCITRAL Arbitration Rules, originally issued in 1976 and revised in 1982.[17] The Commission describes these rules as follows:

> [T]he UNCITRAL Arbitration Rules provide a comprehensive set of procedural rules upon which the parties may agree for the conduct of arbitral proceedings arising out of their commercial relationship. The Rules are widely used in ad hoc arbitrations as well as administered arbitrations.[18]

In addition, the Commission's website lists the UNCITRAL Conciliation Rules (1980), the UNCITRAL Model Law on International Commercial Arbitration (1985), the UNCITRAL Notes on Organizing Arbitral Proceedings (1996), and the UNCITRAL Model Law on International Commercial Conciliation (2002), as its contributions to this area.[19] The Commission also lists the Convention on

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[13] See http://www.worldbank.org/icsid/.

[14] See http://www.worldbank.org/icsid/cases/conclude.htm (last visited 25 April 2005).

[15] See http://www.worldbank.org/icsid/cases/pending/htm. (last visited 25 April 2005).

[16] See http://www.iccwbo.org/court/english/right_topics/stat_2004.asp; same, stat_2003.asp; same, stat_2002.asp.

[17] See UNCITRAL website, http://www.uncitral.org/english/texts/arbitration/adrindex.htm.

[18] *Id.*

[19] *Id.*

the Recognition and Enforcement of Foreign Arbitral Awards, usually known as the New York Convention, as among its instruments, although it acknowledges that the Convention was drafted before UNCITRAL came into existence.[20] Nevertheless, the Commission works hard to promote the Convention as 'an integral part of the Commission's programme of work'.[21] UNCITRAL's influence through both the Arbitration Rules and the Model Law has been extensive, both in developing countries and more generally.

The New York Convention deserves special attention, as it has served as a critical part of the international arbitration system. Signed by over 120 countries, including most countries with large economies, the Convention requires contracting parties to recognize agreements to arbitrate and to enforce arbitral awards in international commercial disputes. The courts of a contracting state must refuse to hear a case in which there is a relevant arbitration clause and compel the parties to honor their agreement to arbitrate. Contracting states must also recognize and enforce within their own jurisdictions arbitral awards subject to such clauses. A refusal to enforce an arbitral award is permitted only under a narrow set of exceptions that are primarily concerned with ensuring a fair and impartial process. Thus, Article V.1 of the Convention permits a court to refuse to honor an arbitral award on grounds of incapacity or invalidity of the agreement, lack of proper notice of the arbitration proceedings or the appointment of the arbitrator, failure of the arbitral award to restrict itself to the terms of the submission, composition of the arbitral tribunal not according to the arbitration agreement, and non-finality of the arbitral award. Article V.2 authorizes the courts of the enforcing country to refuse recognition and enforcement for two broader reasons: the subject matter of the dispute is not capable of resolution by arbitration under domestic law, or recognition and enforcement would be contrary to domestic public policy. Needless to say, the New York Convention provides tremendous comfort to private parties engaged in international business activity. It offers a reliable way to avoid the potential biases of domestic courts and ensures that arbitral awards can be collected in virtually any country – an assurance that does not presently exist for court awards.

Procedural rules

With these basic institutions in mind, we can now turn to the procedures that typify each one. Procedural differences are often touted as the reason to use either a court or an arbitral institution, on the hypothesis that the substantive

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[20] *Id.*

[21] *Id.*

law that will be applied should not vary. We can examine the latter hypothesis more closely when we turn to the choice-of-law topic. For the sake of simplicity, however, let us assume that both a national judge and an arbitrator will respect a choice of law made by the parties to the same degree; that both will follow predictable choice-of-law rules; and the odds of either one reaching a correct result are roughly equal. That leaves procedure on the table for further examination.

NATIONAL COURT SYSTEMS Obviously, it is neither possible nor desirable to undertake a comprehensive canvass of the procedures of every national court system in an essay of this scope. It is useful, however, to highlight the features that these systems normally share, because those are the features that users of court systems will expect to find. Recently, the American Law Institute (ALI) and UNIDROIT (more formally known in English as the International Institute for the Unification of Private Law) completed work on a set of Principles and Rules of Transnational Civil Procedure, which aimed 'to draft procedural principles and rules that a country could adopt for adjudication of disputes arising from international commercial transactions'.[22] The summary of fundamental similarities among procedural systems that the Reporters identified serves as a good list of the topics that every set of civil procedure rules must cover:

- standards governing assertion of personal jurisdiction and subject-matter jurisdiction,
- specifications for a neutral adjudicator,
- procedure for notice to defendant,
- rules for formulation of claims,
- explication of applicable substantive law,
- establishment of facts through proof,
- provision for expert testimony,
- rules for deliberation, decision, and appellate review,
- rules of finality of judgments.[23]

Each of these factors plays a distinctive role in a formal court system, as

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22 ALI/UNIDROIT Principles and Rules of Transnational Civil Procedure, Introduction at 3 (Cambridge University Press, 2006). The final set of Principles is available from UNIDROIT at http://www.unidroit.org/english/principles/civilprocedure/ali-unidroitprinciples-e.pdf; the February 2004 draft of the Rules is available from UNIDROIT at http://www.unidroit.org/english/ publications/proceedings/2004/study/76/s-76-12-e.pdf.

23 ALI/UNIDROIT Principles and Rules, Introduction at 5.

opposed to a consensual arbitral tribunal. I comment briefly on the more important ones, using the US federal court system as my point of reference.

Critical to any court's assertion of power is its fundamental competence to act – that is to say, its jurisdiction. Two aspects of jurisdiction are essential: jurisdiction over the subject-matter of the claim, and jurisdiction to adjudicate with respect to the particular person, entity, or thing before the court. In the United States, the federal courts are courts of limited subject-matter jurisdiction. Thus, they ordinarily do not hear cases involving many private law matters unless there is so-called complete diversity among the parties: none of the plaintiffs may have the same citizenship as any of the defendants. In international economic litigation, this requirement is often satisfied, however, because there is a branch of diversity jurisdiction referred to as 'alienage' jurisdiction, which permits the federal courts to entertain a case between a foreigner and a US party.[24] For present purposes, the details of federal subject-matter jurisdiction are not the central point. What matters is that there is a pre-existing set of rules that must be satisfied before the litigant has the right to use the federal court. In arbitration, in contrast, the parties are free to confer authority to act with respect to any 'arbitrable' subject at all.[25]

Courts are more similar to arbitral bodies when it comes to adjudicatory jurisdiction. The Supreme Court of the United States has characterized the right not to be dragged into court against one's will as part of the personal liberty guaranteed by the federal constitution's due process clauses.[26] Thus, it is always possible for a party to consent to the jurisdiction of a court, although the court may still refuse to adjudicate the case, if it regards itself as an inconvenient forum or if it concludes that it should defer to pending litigation elsewhere, as discussed below. Similarly, the parties must agree to submit themselves to the authority of the arbitral tribunal. The difference, therefore,

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[24] See 28 USC § 1332.

[25] The qualification about 'arbitrable' subject matter is important. National law may specify that some topics (normally public-law based) may not be assigned to private dispute resolution bodies. To take an extreme example, criminal law is one such topic. At one time, it was thought that private actions under the US antitrust and securities laws were also 'nonarbitrable', but the Supreme Court held otherwise. See *Scherk v. Alberto-Culver Co.*, 417 US 506 (1974) (international securities); *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 US 614 (1985) (international antitrust); *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 US 477 (1989) (domestic securities). See also *PacifiCare Health Systems, Inc. v. Book*, 538 US 401 (2003) (finding claims under Racketeer Influenced and Corrupt Organizations Act arbitrable, despite lack of assurance that arbitrator was empowered to award treble damages); *Vimar Seguros y Reasequros SA v. M/V Sky Reefer*, 515 US 528 (1995) (finding claims under Carriage of Goods by Sea Act arbitrable).

[26] See *Insurance Corp. of Ireland Ltd v. Compagnie des Bauxites de Guinee*, 456 US 694, 702–03 (1982).

between a court and an arbitral body arises when, for whatever reason, there is no enforceable pre-existing agreement between the parties to proceed before a particular tribunal, and the aggrieved party must find a court with the power to force an appearance (and ultimately to enforce a judgment whether or not the defendant shows up). For that, elaborate rules governing personal jurisdiction have evolved in every jurisdiction. In the United States, the touchstones are 'minimum contacts' and 'fair play and substantial justice'.[27] In the European Union, Council Regulation No. 44/2001 spells out the rules for personal jurisdiction in litigation involving nationals of Member States, taking place before Member State courts. Links such as domicile, principal place of business, and the conduct of significant business related to the lawsuit are typical grounds permitting an assertion of the court's adjudicatory jurisdiction over the unwilling party.

National law prescribes the rules for selecting a neutral adjudicator. Putting to one side the fact that the United States still guarantees the right to have a lay civil jury in almost all cases (although that right is often not invoked), these rules dictate who the judges will be. In some countries, they will be specialized career civil servants; in others like the United States, they will be mid-career or older generalists, who obtained their judgeship either by executive selection (as in the federal courts and some states) or by some type of election. Well-run court systems do not allow the parties to manipulate the identity of the judge before whom they appear; instead, they must accept the next judge in the rotation, or the randomly assigned appellate panel. Arbitration once again is completely different: most arbitration clauses in contracts give the parties a large say over who the arbitrator(s) will be.

The rules for the formulation of claims play an important role in access to any dispute resolution procedure. The Federal Rules of Civil Procedure in the United States use a system of simple notice pleading, under which it is not even necessary for the plaintiff to allege facts supporting each element of the claim, as long as the defendant can tell what the case is about.[28] It is thus relatively easy to get in the door; once in, the plaintiff has at her disposal the powerful tools of federal discovery, to compel the production of evidence that will support her case. The Supreme Court continues to support this balance, as the following excerpt from its 2002 decision in *Swierkiewicz v. Sorema N.A.* illustrates:

> . . . Federal Rule of Civil Procedure 8(a)(2) . . . provides that a complaint must

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[27] See generally *International Shoe Co. v. Washington*, 326 US 310 (1945). See also *Helicopteros Nacionales de Colombia, S.A. v. Hall*, 466 US 408 (1984); *Asahi Metal Indus. Co. Ltd. v. Superior Court*, 480 US 102 (1987).

[28] See *Swierkiewicz v. Sorema N.A.*, 534 US 506, 512–13 (2002).

> include only 'a short and plain statement of the claim showing that the pleader is entitled to relief.' Such a statement must simply 'give the defendant fair notice of what the plaintiff's claim is and the grounds upon which it rests'. . . . This simplified notice pleading standard relies on liberal discovery rules and summary judgment motions to define disputed facts and issues and to dispose of unmeritorious claims. . . . 'The provisions for discovery are so flexible and the provisions for pretrial procedure and summary judgment so effective, that attempted surprise in federal practice is aborted very easily, synthetic issues detected, and the gravamen of the dispute brought frankly into the open for the inspection of the court.'[29]

Most other procedural systems place a higher initial burden on the plaintiff than the federal courts of the United States require, and thus need correspondingly less scope for court-enforced discovery. This balance, in their view, helps to avoid the so-called fishing expedition, on which they fear many US plaintiffs embark.[30] Indeed, the chorus of criticism about the incentive structures and price tag of the federal system is sometimes deafening. The only problem with attributing all of the demonstrated preference for ADR among international economic actors to these facts about the US system is that it does not explain why the same actors are not simply selecting the courts of countries whose civil procedure systems operate more efficiently in their contracts.[31] The courts of the United States, like the courts of most countries, enforce such clauses without hesitation.[32]

One final point about courts bears mentioning: the fact that the courts are organs of the state that created them affects parties' willingness to use them. Inevitably, there is a certain political perception about the court system of any country: courts operating in a well-established liberal democracy that strongly supports free trade and that has a history of scrupulous national treatment of foreigners will be trusted; courts in a struggling developing country that is plagued by corruption and that has only recently abandoned laws that disadvantage foreigners will not be. Parties have less control over the court system of any particular country than they do over a private dispute resolution mechanism that they create for themselves. It is thus no accident that ADR was popular, before the fall of the Berlin Wall, for companies doing business in the former Communist countries, where confidence in courts was not high, and that it continues to be popular wherever economic actors fear – rationally or

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29 *Id.* (internal citations omitted).

30 One need only look at the unflattering portrayal of the US discovery system found in the UK House of Lords' decision in *Rio Tinto Zinc Corp. v. Westinghouse Electric Corp.*, [1978] AC 547 (HL), [1978] All ER 434, to see how it appears from the outside.

31 See *generally* John H. Langbein, 'The German Advantage in Civil Procedure', 52 U. Chi. L. Rev. 823 (1985).

32 See *The Bremen v. Zapata Off-Shore Co.*, 407 US 1 (1972).

not – that some kind of local bias will taint the courts that might address their disputes.

ARBITRAL BODIES As the Supreme Court of the United States repeatedly has emphasized, arbitration is a creature of agreement.[33] Arbitrators therefore have the power to resolve only those disputes that the parties have entrusted to them. Beyond this important limitation on their authority over the merits of a dispute, there are also both limitations and freedoms they enjoy with respect to the procedures that they use. The principal limitations with respect to procedures, apart from those inherent in the fact that arbitration is a consensual process, come from the parties themselves. Parties are free to adopt particularized procedures for a specific arbitration, or to select an off-the-shelf set of procedural rules from an established organization such as the institutions referred to earlier, including the AAA, the ICC, the LCIA, and the Stockholm Chamber of Commerce. Stand-alone procedural rules are also available, such as those adopted by UNCITRAL.[34]

The UNCITRAL rules begin by acknowledging that they must yield to 'provision[s] of the law applicable to the arbitration from which the parties cannot derogate'.[35] Other articles address such topics as the manner in which notice must be served,[36] the contents of the required notice of arbitration,[37] composition and selection of the arbitral tribunal,[38] the course of the proceedings (including topics like place of arbitration, language, pleadings, evidence, experts, and interim measures),[39] defaults,[40] and the award and associated costs.[41] Merely to list the topics is to illustrate how comprehensively imaginative parties can control the proceedings. If, fearing the scope of discovery of facts in US courts, they wish to curtail exchanges of evidentiary material, they

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33 See, for example, *Howsam v. Dean Witter Reynolds, Inc.*, 537 US 79, 83 (2002), citing *Steelworkers v. Warrior & Gulf Nav. Co.*, 363 US 574, 582 (1960); *First Options of Chicago, Inc. v. Kaplan*, 514 US 938, 943 (1995) ('these two answers [to the questions the Court posed] flow inexorably from the fact that arbitration is simply a matter of contract between the parties; it is a way to resolve those disputes – but only those disputes – that the parties have agreed to submit to arbitration'); *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 US 614, 626 (1985).

34 See note 17, *supra*.

35 Arbitration Rules of the United Nations Commission on International Trade Law, 15 ILM 701 (1976) ('UNCITRAL Arbitration Rules'), Art. 1.2.

36 *Id.* at Art. 2.1.

37 *Id.* at Art. 3.

38 *Id.* at Arts 5–14.

39 *Id.* at Arts 15–27.

40 *Id.* at Art. 28.

41 *Id.* at Arts 31–41.

may do so. If they want to insist on very detailed statements of fact in the demand for arbitration, analogous to a complaint in court, that is their option. If they want a non-lawyer to serve as a sole arbitrator, or as part of a panel of three (or more) arbitrators, that too is possible.

While all this flexibility has its advantages, it may not be an unqualified good. Courts are very reluctant to interfere in ongoing arbitral proceedings, and they are equally reluctant to refuse to recognize and enforce final arbitral awards. One party may feel that the arbitrator has clamped down so hard on the discovery of evidence that its ability to present its case has been severely compromised; another party may believe that the arbitrators have failed to render a prompt decision. Procedural improprieties that might matter in a formal court proceeding may be overlooked. As Judge Richard Posner observed in one such case,

> Both allegations of impropriety [i.e. *ex parte* communications and alleged bias of the arbitrator] bespeak a lack of understanding of how arbitration differs from adjudication. Arbitrators are not professional judges; often they are not lawyers at all, though this one was. Parties that opt for arbitration trade the formalities of the judicial process for the expertise and expedition associated with arbitration, a less formal process of dispute resolution by an umpire who is neither a generalist judge nor a juror but instead brings to the assignment knowledge of the commercial setting in which the dispute arose. . . . Stricter rules cabin the generalist because he is more apt to be led astray by the lawyers and witnesses in a matter in which his only knowledge comes from them. When disputants repose their trust in a specific individual rather than having to take the luck of the draw, it is right that they should have to take the bad with the good unless the individual runs completely off the rails.[42]

Put in an unflattering way, this suggests that parties who opt for arbitration are gambling, hoping that a procedure cut loose from any particular national court system and the opportunities for transparency and review that such a system provides will give a faster, and adequately reliable answer. Anecdotally, it seems that much of the time the gamble pays off. But it does not always, and one is increasingly seeing admissions like the one found in a leading casebook on international litigation and arbitration, that arbitration is not *always* preferable to litigation.[43] Both can be expensive; both can be slow; and both can in some circumstances confound the pre-existing expectations of the parties.

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42 *Lefkovitz v. Wagner*, 395 F.3d 773, 780 (7th Cir. 2005).

43 Charles S. Baldwin, IV, Ronald A. Brand, David Epstein and Michael Wallace Gordon, *International Civil Dispute Resolution* (St. Paul, MN: West 2004), 626.

Choice of law, or private international law

Earlier, we put the question of choice of law to one side. It is, however, central to international dispute resolution. Differences large and subtle exist not only among the private law regimes in states around the world, but also among the public or regulatory regimes that businesses confront. As noted already, to a substantial degree it is possible for parties to choose the private law that will govern their dealings. Whether disputes are resolved in a court or in an arbitral body, such a choice is useful. Private choice of public law has never been possible. One does not see contracts between large multinational companies that purport to choose the competition law of the European Community over the antitrust laws of the United States, and if such a contract were written, it is safe to predict that the Commission of the European Communities, the US Department of Justice, no less than the competition authorities of Canada, South Africa, or any other country, would disregard it. The Securities and Exchange Commission similarly would pay no attention to a clause that attempted to oust its regulatory authority in favor of a foreign agency, if its own jurisdictional analysis persuaded it that the transaction affected US markets or issuers. Realistically, therefore, party choice of law operates only in the field of private law.

The situation is somewhat more complex for the courts. Faced with a possible question of choice of law (or private international law, as others might say), a court will apply the choice rules of the jurisdiction where it sits. For international transactions, there is thus a real advantage to arriving first at the courthouse door of choice. One party might prefer the outcome that would be dictated by the issue-by-issue 'most significant relationship' analysis used in many US states, following the Restatement (Second) of Conflict of Laws.[44] Another might find the European Community's Convention on the Law Applicable to Contractual Obligations (also known as the Rome Convention), which uses the concept of the 'characteristic performance' of a contract as the governing one for selecting a law for the entire contract, to be more satisfying.[45] Acting in the utmost good faith, a European court might apply its choice rules and come up with the substantive law of state A, and a court (federal or state) in Wisconsin might apply its choice rules and come up with the substantive law of state B, for the critical issue in the case. In the absence of global harmonization analogous to the intra-European Rome Convention, this uncertainty will be part of any international litigation where no effective choice has been, or may be, made by the parties.

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[44] See ALI, Restatement (Second) of Conflicts of Law §§ 6, 188 (1971).

[45] Convention on the Law Applicable to Contractual Obligations, 19 June 1980, EEC, 19 ILM 1492, effective 1 April 1991. See especially Art. 4.2.

Coordination mechanisms

Although ADR is fine for relationships and problems that can be foreseen, all too often international economic disputes arise that are messier than that. The net covering those affected by the problem may be broad, including business partners, consumers, suppliers, banks, insurance companies, and countless other actors. In the case of international bankruptcies, creditors all over the globe may be vying for an inadequate pool of assets, and litigation may be needed to ascertain exactly what is in the pool. Inevitably, courts of more than one country may become involved in a single matter. At this point, some kind of coordination mechanism becomes desirable, if not essential.

A number of such mechanisms exist, but they work imperfectly at best. At least five such devices operate in a spirit of cooperation:

- generally observed rules for allocating prescriptive jurisdiction, the observance of which might cause a particular court to exercise 'negative comity' and to decline to adjudicate a case;[46]
- *forum non conveniens*, the doctrine whereby a court that has technical authority to entertain a case dismisses because it is an inconvenient forum, and an alternative forum exists that would be preferable;[47]
- stay of proceedings or abstention based on factors such as the pendency of a related lawsuit in another jurisdiction (*lis pendens*)[48] or certain kinds of foreign government involvement (act of state);[49]
- rendering of, or requesting, assistance from a foreign court in the collection of evidence[50] or the recognition or enforcement of a court judgment;[51]

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[46] Examples from the US Supreme Court include *EEOC v. Arabian American Oil Co.*, 499 US 244 (1991) (construing US employment laws as inapplicable to an employee recruited in the United States but working in Saudi Arabia); *F. Hoffman-La Roche Ltd. v. Empagran S.A.*, 542 US 155 (2004) (rejecting an expansive interpretation of the antitrust jurisdictional statute).

[47] See *Gulf Oil Corp. v. Gilbert*, 330 US 501 (1947); *Piper Aircraft Co. v. Reyno*, 454 US 235 (1981).

[48] The *lis pendens* doctrine is discretionary in the United States; courts would enter this type of stay as part of their general equitable powers to manage litigation. In Europe, it has more formal status, in Article 27 of the EU Regulation on Jurisdiction and Judgments, EU Reg. 44/2001, 2001 OJ (L12).

[49] See *generally Banco Nacional de Cuba v. Sabbatino*, 376 US 398 (1964); *W.S. Kirkpatrick & Co. v. Environmental Tectonics Corp. Int'l*, 493 US 400 (1990).

[50] See the Hague Evidence Convention, *supra* note 4; see also *Intel Corp. v. Advanced Micro Devices, Inc.*, 542 US 241 (2004); 28 USC § 1782.

[51] Recognition and enforcement of foreign court judgments is still a matter of state law in the United States. For one approach to the subject, see Uniform Foreign Money – Judgments Recognition Act, 13 ULA 263 (1986 & Supp. 2004). The ALI has

- recognition and enforcement of foreign arbitral awards.[52]

Other more contentious devices also exist, primarily the anti-suit injunction. Courts may attempt to enjoin parties within their power from taking any steps to cooperate with litigation in a foreign jurisdiction. Such an order, however, may only be as effective as the foreign jurisdiction allows it to be. It can put the private party caught between two sovereigns in an exceedingly awkward position, as the 1980s experience of Sir Freddie Laker and the antitrust litigation surrounding the demise of his discount airline between the United Kingdom and the United States demonstrated.[53] In this important respect, international litigation is still stuck in the Westphalian world of separate sovereigns, awkwardly if at all working together, even while it tries to deal with global economic transactions that are practically seamless.

Familiar unsolved problems

This brings us to the list of problems in international economic dispute resolution that still need substantial attention. The first group of such problems, discussed in this section, have been around for a long time; the second group have emerged – either literally or as a matter of public attention – more recently. Neither set can be solved, however, until countries are willing to accept more flexible arrangements between courts. This is not to accuse any country of irrationality in thus far refusing to do so: any such country may have good reasons for preferring its domestic tribunals. It is only to say that economic actors will continue either to suffer or to be able to game the system as long as relatively strict territorial barriers exist among judicial systems.

Allocation of prescriptive jurisdiction

The first, and one of the most intractable, problems affects both private and

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recently proposed a federal statute that would make this a question of federal law. See ALI, Recognition and Enforcement of Foreign Judgments: Analysis and Proposed Federal Statute (Proposed Final Draft, 11 April 2005). Generally speaking, US courts enforce foreign judgments that meet fundamental due process standards; some states require reciprocity, but many do not.

[52] Arbitral awards benefit from a widely followed international convention, called the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, or the New York Convention. Title II of the Federal Arbitration Act, 9 USC §§ 201–8, implements the New York Convention in the United States.

[53] Professor Andreas Lowenfeld recounts the history of the *Laker* litigation in his casebook, International Litigation and Arbitration, at 121–45 (3rd edn, 2006). For the two leading opinions, see *British Airways Board v. Laker Airways, Ltd.*, [1984] 3 WLR 413 (HL) [1985], AC 58; and *Laker Airways Ltd. v. Sabena, Belgian World Airlines*, 731 F.2d 909 (DC Cir. 1984).

public law, but it is most important in the public or regulatory arena. It concerns the allocation of jurisdiction to prescribe rules of law among the nation-states of the world. To take a common example, it asks whether a country (say, the United States) has the right to impose antitrust liability on a German company and a French company that have conspired in Europe to fix the prices of pharmaceutical products they sell on world markets (and thus that they sell, either directly or through intermediaries, in the United States). Under existing law, the United States would answer 'yes' to that question, so long as the foreign transaction had direct, substantial, and reasonably foreseeable effects on US markets and the plaintiff's harm was traceable to those effects.[54] Those who regard this as too long a reach for US laws brand it as illegitimate 'extraterritorial' jurisdiction: just as the United States would have no business dictating the length of the public school year in Britain, they argue, it has no business telling the British how to run their insurance industry[55] or telling the Swiss how to structure their indigenous watchmaking industry.[56]

There is no doubt that the critics of extraterritorial economic regulation have a point, especially when the regulating country is seeking to prohibit conduct that is lawful in the home country.[57] On the other hand, there is a risk that the country seeking to permit the conduct is attempting to gain economic rents for itself, at the expense of consumers in the rest of the world. US domestic commerce, in the instance of the California raisin market, offers a good illustration. As then-Professor, now Judge Frank Easterbrook pointed out, California was the world's dominant raisin producer, and it exported some 90% of its raisins to the rest of the world; thus, in-state consumers bore very little of the burden of any monopoly rents that resulted from high prices, yet

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[54] See the Foreign Trade Antitrust Improvements Act, 15 USC § 6a; see also *F. Hoffman-La Roche Ltd. v. Empagran S.A.*, 542 US 155, *supra* note 46.

[55] Compare *Hartford Fire Ins. Co. v. California*, 509 US 764 (1993) (upholding assertion of US jurisdiction over London reinsurers of risks located in the United States).

[56] Compare *United States v. Watchmakers of Switzerland Information Center*, 1962 US Dist. LEXIS 5816 (SDNY Dec. 20, 1962) (prosecution of Swiss watchmakers for conduct expressly permitted, though not compelled, by Swiss government).

[57] Indeed, this has begun to happen to the United States as well. When General Electric and Honeywell, two US companies, sought to merge, the deal was approved by the US authorities, but it was blocked by the European Commission on the ground that it would have adverse economic effects in Europe. See generally Symposium (2002), 'Can We Regulate Competition Internationally? A Case Study of the Attempted GE/Honeywell Merger', *University of Pennsylvania Journal of International Economic Law*, 23, 539; see also Yeo Jin Chun (2002), 'The GE-Honeywell Merger Debacle: The Enforcement of Antitrust/Competition Laws Across the Atlantic Pond', *New York International Law Review*, 15, 61. The resulting flap between the US and the EU took quite some time to resolve itself.

as residents of the state they enjoyed the in-flow of money.[58] California, under the circumstances, had no incentive at all to prohibit the cartelization of its raisin producers. Only those outside the territory would wish to act, and they could not do so if a strict territoriality regime were in place.

If there were worldwide agreement on the substantive contours of a particular area of economic regulation, one could imagine a regime under which the regulating country of choice would not be the place where the relevant conduct occurred, but instead would be the place where the injury from that conduct was felt. That would confer the right to sue on those most affected by the negative consequences of the conduct, and it would deter nationalistic rent-seeking of the type California apparently was engaging in with its raisin producers. In order to make such a regime effective, there would have to be a concomitant duty on the part of courts in each country to assist their counterparts in the administration of cases, including especially the collection of relevant documentary evidence and the taking of testimony of witnesses. It is no accident, in fact, that coordination of litigation concerning the international sale of goods has progressed as far as it has: first, there is broad consensus that parties are entitled to choose both fora and law for such suits, and second, there is an international convention to which many countries subscribe that puts in place the necessary substantive consistency.[59]

Restrictions on forum choice

The most important restriction on a plaintiff's choice of forum continues to be the court's ability to assert personal jurisdiction over the defendant. Without valid personal jurisdiction, or jurisdiction to adjudicate, any resulting judgment would be void.[60] For the most part, adjudicatory jurisdiction rules focus on the defendant's relation to the forum state, rather than on the plaintiff's links to the state or the state's own interest in the litigation.[61] Venue rules, in contrast, take a more comprehensive look at the connections between all actors concerned – parties, witnesses, public authorities.[62] Although in the United States it is unusual for personal jurisdiction to be proper and venue not, this can and does occur, and defendants are entitled to file separate objections to

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[58] See Frank Easterbrook (1983), 'Antitrust and the Economics of Federalism', *Journal of Law and Economics*, 26, 23.

[59] See United Nations Convention on Contracts for the International Sale of Goods (1980), which, according to UNCITRAL, now has 66 parties. See http://www.uncitral.org/uncitral/en/uncitral_text/sale_goods/1980CISG_status.html.

[60] See *Pennoyer v. Neff*, 95 US (5 Otto) 714 (1878).

[61] See, for example, *Hanson v. Denckla*, 357 US 235 (1958).

[62] The general federal venue statute reflects this fact. See 28 USC § 1391.

each.[63] Finally, at the broader international level, the venue-like doctrine of *forum non conveniens* is recognized in the United States, under which the court will dismiss a lawsuit if it finds both that the litigation more appropriately should go forward elsewhere and that the other state's courts would be open to hear the case.[64]

Conflicts over the proper scope of personal jurisdiction assertions have regularly arisen in international litigation. This is not because agreement is utterly lacking. To the contrary, if one were to imagine personal jurisdiction theory graphically, there would be a central zone containing domicile (for individuals), place of incorporation and principal place of business (or *siège social*) (for corporations), and location of physical property, which would represent universally recognized valid bases for adjudicatory jurisdiction. It is when one moves beyond that zone that differences arise. Should 'general jurisdiction' – that is, jurisdiction to adjudicate claims that did not arise out of forum-based activities – exist merely because a corporation conducts continuous and systematic general business in the forum? US courts have said yes,[65] but many other countries regard this as an exorbitant basis of jurisdiction. US courts also continue to accept so-called tag jurisdiction as a valid means of acquiring power over the person of the defendant,[66] even though most other countries reject this too. On the other hand, some countries (notably France) accept the notion that a plaintiff may sue a defendant in the place of the plaintiff's nationality, even if the defendant is not a resident of the jurisdiction.[67]

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[63] See Fed. R. Civ. P. 12(b)(2) (defense of lack of personal jurisdiction); 12(b)(3) (defense of improper venue).

[64] See note 47, *supra*; see also *In re Union Carbide Corp. Gas Plant Disaster at Bhopal, India*, 809 F.2d 195 (2d Cir. 1987) (dismissing US litigation against Union Carbide, the US parent corporation, in favor of adjudication in India of the claims relating to the deadly leak of methyl isocyanate gas in Bhopal that killed thousands of people and injured hundreds of thousands).

[65] See *Helicopteros Nacionales de Colombia, SA v. Hall*, 466 US 406 (1984), *supra* note 30.

[66] See *Burnham v. Superior Court of California, County of Marin*, 495 US 604 (1990).

[67] See, for example, Art. 14 of the French Civil Code, which, in the original, states that 'L'étranger, même non résidant en France, pourra être cité devant les tribunaux français, pour l'exécution des obligations par lui contractées en France avec un Français; il pourra être traduit devant les tribunaux de France, pour les obligations par lui contractées en pays étranger envers des Français'. Text from Legifrance, le service public de l'accès au droit, http://www.legifrance.gouv.fr. The English translation of this text furnished by Legifrance reads as follows: 'An alien, even if not residing in France, may be cited before French courts for the performance of obligations contracted by him in France with a French person; he may be called before the courts for obligations contracted by him in a foreign country towards French persons'. *Id.*

One might have thought that international agreement would be possible at least on all grounds of jurisdiction that are generally accepted, with reservations as needed for those that are not, just as the Brussels Convention on Jurisdiction and Enforcement of Judgments in Civil and Commercial Matters did for the European Communities, before the 2002 Council Regulation took effect for almost all of the parties to the earlier Convention. That prediction would be inaccurate, however, as of now, perhaps because perceived differences among court systems continue to seem so great. Finally, the inability of countries to agree on standards for personal jurisdiction has also, in practical effect, made them unable to agree on an international convention for recognition and enforcement of foreign money judgments, which would be a useful counterpart to the analogous New York Convention governing foreign arbitral awards.

Collection of evidence

Another area in which the gap among systems is especially great relates to procedures for collecting evidence. The differences include who is entitled to demand such evidence – the parties, or an investigating judge – and what kind of evidence must be turned over. Policies with respect to evidence are intimately tied to public expectations about how easy access to court ought to be; who should bear the expense of litigation; how strongly should privacy rights of both litigants and third parties be protected; and what the cost is likely to be of putting a significant burden on the party who hopes to change the status quo – that is, the plaintiff. Although there is an international convention on the taking of evidence abroad, the Hague Evidence Convention,[68] it has been only a limited success from the point of view of the United States. Article 23 of the Convention permits signatories to opt out of cooperating with requests for documents in pretrial discovery, and practically all parties except the United States have done so. That, in turn, has marginalized the Convention for US litigants. Add to that the fact that the US Supreme Court held in *Société Nationale Industrielle Aerospatiale v. US District Court* that use of the Convention's mechanisms is merely optional for the US courts,[69] and it is easy to see how much ground still needs to be traveled to create an effective and generally accepted international mechanism in this area.

Transnational injunctive relief

The last longstanding, but nevertheless gaping, hole in international judicial cooperation relates to injunctive relief. Apart from some specific work in the

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[68] See note 4, *supra*.

[69] 482 US 522 (1987).

area of international bankruptcies and administration of decedents' estates, where such coordination is practically essential, very little has been attempted or accomplished here. Instead, international recognition of foreign court injunctions boils down to a simple question of power: if the issuing court can compel compliance with its order, then any foreign court concerned will have to decide whether to issue a competing injunction or to acquiesce in the first order. Without some kind of international protocol setting forth a hierarchy of courts entitled to take action, progress on this front seems unlikely. Businesses caught in the middle, however, as the Bank of Nova Scotia was in a well-known case dealing with enforcement of grand jury subpoenas,[70] have a strong incentive to push for better systems. Perhaps something like the 'lead agency' approach taken by administrative agencies in the United States that are involved with the preparation of an environmental impact statement might work; perhaps a simple first-in-time rule would suffice; perhaps one could draft a set of functional criteria that would dictate when a court should act and when it should defer to a foreign court. Pressure will build, however, to fill this gap, as more and more subjects of international litigation (think of intellectual property, for example) come to require injunctive relief.

New challenges

In addition to the familiar problem areas, there are two newer challenges to the international litigation system that deserve special mention: the internet, and the impossibility of creating an effective international system without addressing the problem of corruption that plagues so many judiciaries around the world.

Until the ascendancy of the internet over the last ten years as a global medium of communication, commerce, and crime, it was common for people to observe that the world was shrinking and that soon there would be only one global 'village'. No one could have imagined how literally and how quickly expectation would become reality. But it has happened, and among other things, it has posed enormous challenges to the litigation system. Old rules that require finding 'minimum contacts' between a defendant and a physical territory are quaint at best, when anyone with a decent laptop computer can sit anywhere on the globe and do business (or harm) to another person anywhere else. Perhaps the time has come to abandon personal jurisdiction rules altogether, and to ask only whether litigation is occurring in a convenient locale. Perhaps something like the French approach is the only one that makes sense,

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[70] See *In re Grand Jury Proceeding*, 691 F.2d 1394 (11th Cir. 1982) (Bank of Nova Scotia I); *In re Grand Jury Proceedings Bank of Nova Scotia*, 740 F.2d 817 (11th Cir. 1984) (Bank of Nova Scotia II).

under which litigation can occur wherever the victim is located, no matter where the defendant may be or may have been.

Prescriptive jurisdiction rules are under the same kind of strain. The litigation over Yahoo!'s US auction site, which could be accessed by people in France, illustrates the problem nicely.[71] In the United States, the First Amendment protects even highly offensive speech, and thus it is legal for a person to buy Nazi propaganda such as Adolf Hitler's book *Mein Kampf*; in France, the criminal code prohibits the offering of such materials for sale. Even if Yahoo! keeps these materials off its French website, however, it is the simplest of matters for a person in France to visit Yahoo!'s US website, view the offending items, and purchase them. Has Yahoo! violated any law? Assume, as was the case, that a French court duly enforces French law, and that a US court enforces US law. What is Yahoo! to do? The prospect of draconian restrictions on people's access to websites maintained outside their own country is unacceptable for a democracy, and it would have terrible consequences for the countless intellectual and commercial exchanges that occur every day over the internet. It is possible that only substantive harmonization of these rules will cure the problem, but such convergence seems unlikely at best. Perhaps there is a compromise position, under which courts could cooperate in a more individualized way, such that the display alone would be permissible if permitted by the law of the company's domicile, but the sale could be prohibited if the offensive product goes to a country with a law like France's. One way or the other, the internet is demanding an entirely new way of thinking for the courts, as it is for so many other institutions.

The other major challenge is corruption. Unfortunately, in many ways this is hardly a new problem. What is new, however, is the increasing stake that each country has in the integrity of the judicial system of all other countries of the world. Global commerce can function, of course, in the face of corruption, but overall corruption is nothing but a tax on business. The adoption by the Organisation for Economic Co-operation and Development of its Convention on Combating Bribery of Foreign Public Officials in International Business Transactions in 1997,[72] and the United Nation's passage of its Convention Against Corruption in 2003,[73] are both encouraging signs that countries are ready to take joint action against this intractable practice. As economic activ-

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[71] See *Yahoo!, Inc. v. La Ligue Contre le Racisme et l'Antisemitisme*, 169 F. Supp. 2d 1181 (N.D. Cal. 2001).

[72] Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, 17 December 1997, 37 ILM 1, available at http://www.oecd.org/document/21/0,2340,en_2649_34855_2017813_1_1_1_1,00.html.

[73] Convention Against Corruption, 31 October 2003, available at http://www.unodc.org/unodc/en/crime_convetnion_corruption.html.

ity grows, the judiciaries of the world ideally will come to depend on one another more and more. But a *sine qua non* for that kind of cooperation and interdependence is the integrity of every single judge, in every single country. Without that, policymakers and judges alike will continue to insist on the ability to act independently of others, despite the fact that independent action comes at a certain price.

Conclusion

In spite of the fact that there are many places in which significant improvements in the private dispute resolution systems available to international economic actors are needed, the sheer volume of international commerce suggests that the problems need to be kept in perspective. Using a combination of court-based litigation and ADR, international actors have been able to piece together an adequate structure. Nonetheless, dispute resolution can be very expensive, even in the best of courts or with the best of arbitrators. Action on the problems this chapter has highlighted may eliminate some of those inefficiencies, and frictions – among countries, between countries and private actors, and between private actors – can be reduced. The demands of international economic activity will, sooner rather than later, make it imperative that courts do not become the only institutions that stand apart from the globalization that has reached all other parts of society.

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